LLB&L Client Alert

June 16, 2009

Authors

Douglas P. Faucette
202-220-6961
dfaucette@lockelord.com

Laurence A. Hansen
312-443-0456
lhansen@lockelord.com

Edward A. Razim, III
713-226-1544
erazim@lockelord.com

Linda A. Wilkins
214-740-8538
lwilkins@lockelord.com

David C. Heit
202-220-6910
dheit@lockelord.com

www.lockelord.com

This *Client Alert* is provided solely for educational and informational purposes. It is not intended to constitute legal advice or to create an attorney-client relationship. Readers should obtain legal advice specific to their enterprise and circumstances in connection with each of the topics addressed.

If you would like to be removed from our mailing list, please contact us at either unsubscribe@lockelord.com or Locke Lord Bissell & Liddell LLP, 111 South Wacker Drive, Chicago, Illinois 60606, Attention: Marketing. If we are not so advised, you will continue to receive *Client Alerts*.

Attorney Advertising

© 2009 Locke Lord Bissell & Liddell LLP

Obama Administration Outlines Executive Compensation Guidelines and Legislative Initiatives

On June 10, 2009, Treasury Secretary Timothy F. Geithner and SEC Chairperson Mary L. Schapiro announced broad-based initiatives to reform executive compensation practices, applicable to all public companies, particularly those in the financial sector.

While boards of directors and compensation committees have recognized that compensation practices are now under intense scrutiny, there have been no mandated changes to public companies' existing practices, except for financial institutions receiving funds under the United States Treasury Department's Troubled Asset Relief Program ("TARP"). Now the Obama Administration is proposing legislation that would continue the regulatory course begun with the Sarbanes-Oxley Act ("SOX"), mandating changes in corporate governance for all public companies.

Executive Compensation Reforms

Treasury Secretary Timothy F. Geithner's statement indicated that the executive branch will be considering executive compensation reforms with the goal of "bringing compensation practices more tightly in line with the interests of shareholders and reinforcing the stability of firms and the financial system." He outlined the following five guiding principles:

1. Compensation plans should properly measure and reward performance. Compensation should be tied to performance in order to link the incentives with long-term value creation. Compensation practices should take into consideration a company's performance relative to the performance of its peers. Performance-based pay should be conditioned on a wide range of internal and external metrics, not just a company's stock price.

2. Compensation should be structured to account for the time horizon of risks. Compensation practices should be tightly aligned with the long-term value and soundness of the company. Compensation should also reflect the long-term risks that are taken on behalf of companies and their shareholders. The statement suggests that coupling stock awards with mandatory holding periods may be an effective way of tying compensation to long-term performance; however, Secretary Geithner mentioned that directors and experts should have the flexibility to determine how best to align incentives in different settings and industries.

   Note: *These proposals would implicate a number of different techniques for matching the risk-time horizon, such as (i) share retention programs, (ii) longer vesting periods, (iii) longer indexing, and (iv) anti-hedging rules. The likely consequence will be a codification of many of the features of executive compensation that are generally viewed as "best practices."*

3. Compensation practices should be aligned with sound risk management. Compensation committees should conduct and disclose risk assessments of pay packages to ensure they do not encourage imprudent risk-taking. At the same time, companies should explore how they can provide risk managers with the appropriate tools and authority to improve their effectiveness at managing the complex relationship between incentives and risk-taking.

   Note: *This proposal aligns with the requirement imposed on compensation committees of TARP recipients to certify that, following review with their risk manager officers, it has determined that the senior executives' pay packages do not encourage unnecessary risk detrimental to long-term shareholder value. Although this has been a relatively easy step for financial institutions, which generally have a senior risk officer who can review these issues, this concept may not be equally applicable to companies in all industries.*

4. Companies should re-examine whether "golden parachutes" and supplemental retirement packages align the interest of executives and shareholders. Golden parachutes and supplemental retirement packages should be re-examined to determine whether they truly incentivize performance or whether they reward executives even if shareholders lose value.

   Note: *Generally, under the American Recovery and Reinvestment Act of 2009 ("ARRA"), "golden parachute" payments are prohibited. In addition, the interim final rule*

issued by the Department of the Treasury for TARP participants contains an outright prohibition of tax "gross-up" payments in connection with golden parachute payments. Many commentators view the restrictions on golden parachutes to TARP recipients as a precursor of similar prohibitions that may be imposed on public companies. However, golden parachute limitations, as they apply to TARP recipients, are distinguishable from their application to public companies. TARP recipients received government funds and contemplated the repayment of such funds, at which time the restrictions would be eliminated. Therefore, the experience of the limitations contained in the TARP rules does not serve as a basis for expanding those limitations to non-TARP recipient, public companies. The strict limitation on golden parachutes may also have the unintended consequence of deterring business consolidation.

5. Transparency and accountability should govern the process of setting compensation. Compensation committees should have greater independence and disclosures to shareholders must reflect greater clarity in the committee's practices in determining executive compensation. In many cases, compensation committees have not been sufficiently independent of management and companies have not been fully transparent in explaining their compensation policies to shareholders. The release specifically cites the need to reexamine the relationships between the compensation committee and its outside advisors, particularly with respect to the potential existence of conflicts of interest.

Proposed Legislation

Secretary Geithner also described the following legislative proposals supported by the Obama Administration:

Say on Pay

The SEC should be able to require companies to give shareholders a non-binding "say on pay" vote on executive compensation packages, which would encourage boards to ensure that compensation packages are closely aligned with the interest of the shareholders. Say on pay will improve directors' accountability to the owners of the company by giving shareholders a way to express their views on executive compensation, and will allow boards and shareholders to work together to design compensation that gives executives strong incentives to maximize long-term value.

Additional authority granted to the SEC would include: (i) requiring all public companies to include in annual proxy statements a non-binding shareholder resolution requesting approval or disapproval of executive compensation, as disclosed in the proxy, (ii) granting shareholders the right to vote on annual compensation for the top five named executive officers, as disclosed in the company's proxy statement, (iii) allowing companies the opportunity to include additional resolutions on specific compensation decisions, and (iv) providing shareholders with the opportunity to cast a non-binding vote to approve or disapprove golden parachute payments disclosed in proxy solicitation materials for transactions involving a change in control of the company.

Independent Compensation Committees

The SEC would have the power to revise the independence standards for compensation committees to make them more comparable to the standards governing audit committees as part of SOX.

Similar to the SOX rules applicable to audit committees, the new requirements would enable compensation committees to use outside advisors in the process of setting executive pay. The compensation committees will be directly responsible for the appointment, compensation, retention and oversight of the work of any compensation consultant that it retains. In addition, the compensation committee would have the authority to engage outside legal counsel, to carry out its duties. These proposed standards would assure that compensation committees have the benefit of objective, expert advice.

Note: *The roles of outside advisors and legal counsel to the company will need to be clearly defined, so as not to raise any conflicts of interest. Advisors cannot be retained to give strategic advice to the compensation committee as well as perform various roles for the company that might influence their independence with respect to the compensation committee. Multiple roles, particularly when the engagement is by management, may cause a conflict in the advisor's independence. In addition, corporate and securities counsel may have to refrain from rendering strategic advice to the compensation committee and provide its work product to a special compensation committee counsel for review and approval, so as to eliminate any partiality. However, corporate and securities counsel should still be able to perform drafting and filing tasks on behalf of the company. This would be particularly relevant with the preparation of the CD&A in the proxy statements which securities counsel reviews, so long as this work is overseen by compensation committee counsel.*

Proposed New Proxy Disclosure Rules

Chairperson Schapiro also issued a statement in which she indicated that the SEC is actively considering new proxy disclosure rules that will provide further clarification on compensation decisions. Specifically, the proposals under consideration include disclosure regarding (i) how a company and its board manages risk, (ii) a company's overall compensation approach, (iii) potential conflicts of interest of compensation consultants, and (iv) director nominees, including their experience and qualifications to serve on the board or on particular board committees.

Note: *An issue raised by these proposals is whether compensation committee members will need to be "experts" in compensation. Unlike audit committee members, there is no objective vetting process, such as a CPA license, to determine expertise, although compensation experience in a consulting or counsel role will clearly carry some weight.*

The Effect of New TARP Restrictions

On June 10, 2009, the Treasury Department also issued interim final rules that establish standards for executive

Offices

Atlanta

Austin

Boston

Chicago

Dallas

Houston

London

Los Angeles

New Orleans

New York

Sacramento

San Francisco

Washington DC

Obama Administration Outlines Executive Compensation Guidelines and Legislative Initiatives (cont'd.)

compensation and corporate governance practices at firms receiving TARP assistance. The Treasury rules have been a precedent for evolving executive compensation limitations, however, as the foregoing proposals illustrate, these concepts are being expanded to include all public companies, regardless of participation in TARP.

Note: *The unintended consequences of the Treasury restrictions on executive compensation is that they have triggered a backlash from many companies that originally participated in TARP and are now attempting to pay back such funds. For those companies it is clear they do not view such limitations as "best practices," but as a threat to their competitiveness in recruiting and retaining personnel. With the expansion of the scope of applicability of these executive compensation restriction principles, companies will be unable to avoid these restrictions without considering deregistering and going private, so as to be subject to less regulation and government oversight. This is somewhat ironic in that the end result of applying such restrictions to public companies would be the expansion of companies doing business without the controls and investor protections otherwise applicable. Moreover, we are concerned that the Obama Administration ultimately may seek to impose these types of practices on all financial firms that are subject to regulation by the Federal Deposit Insurance Corporation, the Comptroller of the Currency and other Federal agencies, without regard to public company status.*

Conclusion

It is clear that more legislative and regulatory changes are to follow. We recommend that boards of directors of public companies begin the process of reviewing compensation practices and current arrangements with outside advisors. In particular, companies should ensure that the outside advisors engaged by the compensation committee are truly objective. The use of consultants in multiple capacities in addition to performing work for the compensation committee may affect their independence. Also, boards will have to be more selective in choosing compensation committee members to satisfy new independence and experience standards.

While executive compensation restrictions were initially limited to TARP participants, these proposals make clear that we are entering a new era of governmental oversight of corporate governance. Now more than ever, companies will need to rely on experienced professionals for advice on how to meet their obligations in this new era.

About the Authors

Douglas P. Faucette is a banking attorney in LLB&L's corporate department and co-head of the TARP Group. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions.

Laurence A. Hansen has more than 25 years of experience in the area of taxation, with emphasis on employee benefits and executive compensation. He has represented national clients in many complex corporate and employee benefits transactions, including plan mergers and terminations.

Edward A. Razim III has extensive experience in employee benefits and executive compensation, including drafting and implementing employee benefit and executive compensation programs for large and small employers; addressing compliance issues regarding Section 409A of the Internal Revenue Code and various equity compensation plan design matters.

Linda A. Wilkins works with companies and their boards of directors to design executive compensation plans to recruit and retain key executives. She also represents executives in negotiating their employment and severance agreements.

David C. Heit concentrates his practice in commercial real estate law. He represents developers, borrowers, lenders and institutional investors in a range of matters, including the acquisition, disposition, financing, and leasing of commercial real property, joint venture arrangements and mezzanine financings.

© 2009 Locke Lord Bissell & Liddell LLP