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Executive Compensation in a Challenging Economic Environment

As 2008 draws to a close and companies continue to weather the worst economic climate in a generation, compensation committees and senior management will confront unprecedented challenges in 2009. This memorandum describes key compensation issues that have emerged as a result of the financial downturn.

Stock Options Deeply Underwater. The stock market swoon has resulted in employees of many companies holding a significant number of deeply underwater stock options. Compensation committees may determine that those options have lost meaningful incentive and retentive value. Under these circumstances, a compensation committee may wish to consider making a one-time special option grant, or accelerating the 2009 option grant, in order to take advantage of depressed share prices and restore the incentive and retentive impact of company options. Similarly, tandem or independent grants of restricted stock or restricted stock units may promote retention and ensure that equity awards have some value regardless of stock price performance. Of course, any special equity grants will deplete available shares under equity plans and increase share overhang and may generate unfair criticism that employees have effectively “doubled up” on their equity compensation opportunity. As discussed below, an option exchange program may mitigate some of these concerns.

A company may conduct an exchange offer in order to replace deeply underwater options with fewer, newly granted at-the-money options, or other equity-based awards such as restricted stock units. Option exchange programs typically raise considerations under securities laws (a company must file a Schedule TO, leave an offer open for at least 20 days and describe the exchange program in the next filed annual proxy statement), accounting rules (an exchange may result in additional compensation expense) and stock exchange requirements (other than in the case of the rare equity plan which specifically permits repricing, a company must obtain shareholder approval). In general, RiskMetrics will recommend shareholder approval of an option exchange program only if (i) there is a compelling rationale for the program, (ii) the exercise price of the surrendered options exceeds the 52-week high trading price of the stock, and (iii) executive officers and directors are excluded from the program. While a program which offers to exchange options for cash does not require shareholder approval under stock exchange rules, RiskMetrics typically will recommend withhold votes against the compensation committee members of a company that engages in a cash for options exchange program without shareholder approval.

Unexpectedly Large Equity Award Grants. Many companies determine the number of equity awards granted to employees by reference to a specified dollar value. If a company’s stock price has declined precipitously, strict application of a formulaic award level can result in equity grants with respect to an unexpectedly large number of shares and can accelerate depletion of a plan’s share reserve. Under these circumstances, the grant of “full value awards” (such as restricted stock or restricted stock units), rather than stock options, may make sense in order to maximize plan share usage.

If a company does not have adequate shares available under its plans to make new equity grants, it may make grants subject to shareholder approval; however, a contingent award may have a decreased incentive and retentive impact. A company may also grant awards outside of its existing plans in the form of cash-settled phantom equity or stock appreciation rights, although cash-settled awards will result in “mark-to-market” accounting, and awards granted outside of a shareholder approved plan will not satisfy the performance-based exception of Section 162(m) of the Internal Revenue Code.

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Annual Bonus Goals Not Attained. Many companies will find that 2008 performance will result in bonus goals not being achieved. In that case, a compensation committee must decide whether to use its business judgment to override the applicable performance goal and make discretionary bonus payments in order to promote retention or to reward outstanding individual performance. With respect to named executive officers, a compensation committee must disclose the rationale for overriding an objective bonus formula in the Compensation Discussion and Analysis of the 2009 proxy statement, and may need to report on a Form 8-K bonus payments made despite non-satisfaction of performance goals. Any such discretionary bonuses will not qualify as "performance-based compensation" for purposes of Section 162(m), and the compensation committee should carefully document the rationale for such payments in order to preserve the performance-based compensation exemption under Section 162(m) for future bonuses.

Given the possibility of significant economic volatility in 2009 and the generally uncertain business climate, compensation committees may wish to consider "smoothing" the bonus formula by adopting quarterly or semi-annual goals and/or increasing reliance upon subjective measures rather than strict, pre-established performance goals. It is possible to structure a bonus program to both preserve Section 162(m) deductibility and maintain flexible objectives by adopting an "umbrella" performance goal for the entire year that establishes a maximum award that may be reduced due to the compensation committee's exercise of "negative discretion" based on application of subjective and/or short terms goals.

Problems Retaining Employees. While job opportunities may be limited in the current environment, the most critical employees are often the most likely to have alternatives. If a company determines that employees are at risk of leaving, it may be wise to develop a special retention program of cash or full value equity awards that vest over time. Such a program will provide tangible incentives for employees to remain committed even if the company stock price declines after grant. Companies should specify whether to include any such retention awards in the formula to determine severance and retirement benefits, and how such awards may affect regularly scheduled annual equity grants.

Takeover Fears. Once the financing markets recover, depressed stock prices may lead to increased hostile takeover activity. The mere threat of a hostile takeover can disrupt a target's employees and damage the target's business even if a raider withdraws. Appropriate change of control employment agreements and other measures can help mitigate these concerns. Ideally, companies should establish suitable arrangements in advance of a hostile bid to ensure a stable and dedicated employee base.

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