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Executive Pay and Directors' Duties

Executive pay has long been a favorite whipping boy of politicians, corporate gadflies, the media and corporate governance activists. The financial crisis has opened the floodgates for legislators to propose every compensation-related reform on the activists' wish-list including proposals to regulate the approval process, the disclosure and the very nature of executive pay. The principal proposals are:

> "Say on Pay": Shareholder advisory vote on executive compensation.
>
> "Golden Parachutes": Shareholder advisory vote on compensation payments related to a change of control.
>
> Severance for Poor Performance: No severance pay to officers terminated for poor performance.
>
> Independent Compensation Committee: Members must meet strict independence standards and have power to hire independent consultants and legal counsel. If an independent consultant is not hired, the committee would be required to explain why.
>
> "Clawbacks" of Unearned Performance Based Pay: Recovery of bonus, incentive or equity payments that are "unearned" due to subsequent restatement of earnings.
>
> Disclosure: Overall increased disclosure and special disclosure of the relationship of compensation to risk.
>
> Possible Carryover of "TARP" Rules to Non-TARP Recipients: Attempts will be made to try to require consideration of TARP-related principles by compensation committees of non-financial companies.

In addition to these proposals, a recent case has revived the threat of litigation to hold directors personally liable for "waste" if compensation is subsequently held to have been "unreasonable" under the particular circumstances that existed when it was paid. (Interestingly, a new law in Germany would hold directors personally liable if they set "inappropriate" remuneration for executives).

Notwithstanding all of the regulations, the new proposals and the threat of litigation, directors generally, and compensation committee members particularly, should not, and need not, be deterred from making pay decisions that they determine to be appropriate for their company. A series of well reasoned recent cases make it clear that the courts will protect direc-

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tors' pay decisions so long as the directors act on an informed basis, in good faith and not in their personal self-interest. In this respect, a compensation committee that follows normal procedures and has the advice of an independent consultant and legal counsel need not fear being second guessed. As the recent court decisions have said, aspirational "best practices" are not synonymous with legal requirements. Statements made by, and actions taken by, governmental officials or shareholder activist groups expressing approval or disapproval of certain forms or amounts of compensation do not set the standard for "reasonableness" under law. The key for directors in the current environment is to structure compensation that links pay with the long-term performance of the company and to avoid compensation that might encourage undue risk. Directors should establish compensation programs that pay executives in amounts and forms that they deem appropriate to attract, retain and incentivize executives. Indeed, doing so effectively is one of the most important tasks for the board of directors.

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