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*Practical guidance for those drafting and reviewing compensation disclosures*

## **Now is the Time for a True Walkaway Number: Model Disclosure for Your CD&A**

One of the most intractable problems with executive compensation disclosure—and the executive compensation decision-making process—has been the failure to adequately address the full cost of post-employment benefits payable to executives. Despite the SEC’s efforts to bring greater clarity to disclosure of post-employment arrangements in 2006, the most meaningful number of all—the full walkaway number representing the total amount of various post-employment benefits available to a departing executive—remains elusive. In fact, given the variations in disclosure practices in the wake of the SEC’s 2006 rule changes, users of the executive compensation disclosure can draw vastly different conclusions as to the amount of a departing executive’s benefits.

Moreover, this is not just a crisis of disclosure—the very directors that are making decisions with respect to an executive’s pay very well may not have access to the full walkaway numbers, and are thus left to either ignore substantial post-employment benefits or to draw significantly different conclusions as to the value of such benefits. A full walkaway number is the aggregate amount that an executive could walk away with under various termination scenarios, and should include cash compensation, unvested and previously vested equity grants, previously exercised equity grants, as well as pension benefits (including benefits from supplemental plans), deferred compensation, gross-ups and post-employment perquisites and other benefits. Compensation committees should also analyze projected walkaway numbers, which include projected future equity grants based on the assumption that they will be made on the same basis as the most recent awards, and companies should consider disclosing these projected walkaway numbers along with full walkaway amounts.

Clearly, we are now at a “tipping point” on these issues, and action is now required of companies and compensation committees to revisit post-employment compensation arrangements and the disclosure that is provided about those arrangements.

### **Table of Contents**

Now is the Time for a True Walkaway Number: Model Disclosure for Your CD&A. . . . .	1
How We Got to This Tipping Point. . . . .	2
Action Required Now. . . . .	5
Our Model CD&A Walkaway Disclosure . . . . .	6
Our Table of Walkaway Numbers for Evaluating Post-Employment Compensation—and Analysis of the Need for Safety Nets. . . . .	8

## How We Got to This Tipping Point

Concern with out-sized post-employment benefits for executives—and the lack of adequate disclosure about those benefits—is nothing new. Post-employment benefits can represent the ultimate in “pay-for-non-performance,” in that executives get benefits as a matter of entitlement rather than in recognition of extraordinary performance; yet shareholders and directors often remain in the dark as to the actual aggregate size and breadth of these benefits.

### The SEC's Rules

Over the years, the SEC has struggled with the disclosure requirements for post-employment benefits. Prior to the 2006 changes to the executive compensation disclosure requirements, the SEC had required disclosure of the “terms and conditions” of any compensatory plans or arrangements where payments would result from the resignation, retirement or any other termination of employment, as well as a change in control or a change in a named executive officer's employment following a change in control. In two high profile cases, the SEC expressed concern over the adequacy of disclosure provided under this requirement.

In the case *In the Matter of W.R. Grace & Co.*, Release No. 34-29155 (September 30, 1997), the SEC charged the company with failing to fully disclose the details of a retirement agreement, and issued a report faulting officers and directors of the company for not fulfilling their responsibilities with respect to the disclosure process, by not taking the necessary steps to ensure that all of the material details regarding the retirement agreement were disclosed. (See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.*, Release No. 34-39157 (September 30, 1997).) Several years later, in the case of *In the Matter of General Electric Co.*, Release No. 34-50406 (September 23, 2004), the SEC found that General Electric's proxy statements and other disclosures did not adequately describe or disclose the benefits that former CEO Jack Welch would receive in retirement. The disclosures at issue only generally referred to “continued lifetime access to Company facilities and services comparable to those which are currently made available to him by the Company.”

In 2006, the SEC sought to address the shortcomings of its prior disclosure requirement, as had been highlighted by the *Grace* and *General Electric* cases. In proposing a new approach, the SEC stated that “[c]urrent disclosure may make it difficult for the reader to understand which amounts relate to any particular named executive officer, and may thus obscure the value of a significant component of compensation.” The SEC then adopted a requirement for narrative disclosure of specific aspects of written or unwritten arrangements that provide for payments at, following, or in connection with the resignation, severance, retirement or other termination (including constructive termination) of a named executive officer, a change in his or her responsibilities, or a change in control of the company. Citing the difficulty of establishing a “one size fits all” tabular approach, the SEC left it up to companies to decide how best to present the required information. Further, the SEC required amounts to be computed assuming a termination, retirement, etc. at fiscal year-end, and only required quantitative information with respect to specific elements of compensation, given the availability of tabular disclosure with respect to other elements, e.g., pension and non-qualified deferred compensation.

While the 2006 amendments to the disclosure rules went a long way toward eliciting significantly more disclosure about the potential amounts payable under retirement, termination and change-in-control arrangements, they did not go far enough because they do not require any bottom line, walkaway number. Rather, what shareholders often find are several pages of data that is dense,

unfocused and confusing. The SEC Staff has sought to address these issues to some extent in the course of its review of proxy statements, issuing comments in numerous cases asking for a “total” column to be added to the tabular presentations so that aggregate amounts are reported, but this approach has never been widely suggested in the form of a rule change or interpretation.

Further, the analysis presented in the required post-employment disclosure is only static—it does not take into account the impact of, *e.g.*, future grants, the accumulation of pension benefits, and amounts accumulated through exercised options or previously vested restricted stock grants. This leaves only a partial picture of the full walkaway amounts and limits the usefulness of the disclosure for shareholders.

The Compensation Discussion and Analysis (CD&A) requirement also presents impediments in terms of requiring complete information about post-employment arrangements. Currently, the disclosure requirement only addresses the basis for selecting particular events as triggering events in post-employment arrangements, without specifying a requirement to fully address the underlying rationale for the arrangements. Further, the CD&A does not specifically address the need for the overall consideration of a named executive officer’s wealth accumulation when severance, retirement or change-in-control benefits are established or maintained. As a result, the CD&A disclosure about severance, retirement and change-in-control arrangements often does not provide the critical analysis and justification for why these arrangements are necessary, particularly in situations where a named executive officer may have already accumulated sufficient wealth so that there is no longer a need for the safety net provided by these provisions.

Unfortunately, the SEC’s proposed revisions to the executive compensation disclosure rules have not sought to remedy the problems with the post-employment disclosure and analysis requirements. As a result, now is the time for companies to take the lead in providing more complete, useful disclosures to investors (and directors) regarding the full walkaway numbers—and the attendant analysis and rationale.

### Revisiting Employment Arrangements

A notable trend this year has been the extent to which companies have been taking at least initial steps toward fixing post-employment compensation arrangements. This trend has been partly driven by the need to revisit employment agreements in light of Section 409A, which opened the door to renegotiating other elements of these agreements (including post-termination and change-in-control benefits), as well as due to increasing attention by shareholders and proxy advisors to the issues associated with extraordinary post-employment benefits. Changes that companies have implemented include:

- The elimination of single-trigger change-in-control provisions in favor of double-trigger provisions, whereby benefits accrue only upon both a change-in-control and a qualified termination of employment;
- The elimination of pension enhancements;
- The elimination or reduction of tax gross-ups;
- The reduction or elimination of severance benefits;
- The elimination of “evergreen” contracts which allow executives to retire *and* get severance benefits;

- The elimination or reduction of the “good reason”/“open window” period of voluntary departure for any reason after a change-in-control where the executive gets full severance (which effectively converts most double triggers into single triggers);
- Adopting sunset provisions on post-termination and change-in-control benefits.

Adopting these sorts of proactive changes provides an opportunity for companies to more fully explain their rationale behind post-employment compensation arrangements in their CD&A, as well as provide an opportunity to justify the walkaway amounts that need to be presented whenever discussing such rationale.

### Greater Regulatory Focus

Post-employment compensation is one of the key areas of “pay-for-non-performance” highlighted by the recent financial crisis. As a result of renewed attention on these arrangements, pressure is mounting to rationalize the approach and to take shareholders’ interest into account when negotiating, implementing and maintaining post-employment compensation arrangements.

Earlier this year, the Obama Administration—through the Treasury Department—sought to advance compensation reforms brought about by the financial crisis with the release of a set of broad-based compensation principles, along with specific legislative proposals for say-on-pay and compensation committee independence that have been passed in the House and are awaiting consideration in the Senate. (See the Summer 2009 issue of *Compensation Standards* for a complete description of the Treasury Principles.) These Treasury Principles are not limited in their applicability to bailout recipients or financial institutions.

Treasury’s Stance. One of the four key Treasury Principles focuses on the extent to which golden parachutes and supplemental executive retirement packages are properly aligned with shareholder interests, stating:

Golden parachutes were originally designed to align executives’ interests with those of shareholders when a company is the potential target of an acquisition. Often, they have been expanded beyond that purpose to provide severance packages that do not enhance the long-term value of the firm. Likewise, supplemental executive retirement benefits can make it more difficult for shareholders to readily ascertain the full amount of pay due a top executive upon leaving the firm.

We should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholders’ interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value.

In addressing this issue, Treasury Secretary Geithner singled out the importance of providing full walkaway numbers in proxy disclosures, stating: “disclosures typically failed to make clear in a single place the total amount of ‘walk-away’ pay due a top executive, including severance, pensions, and deferred compensation.”

The Federal Reserve’s Recent Guidance—A Risk Assessment Angle That Will Need to be Addressed in the CD&A. We should also not overlook the very recent Fed Guidance (issued on October 22) addressing the importance of eliminating “safety nets” that enable decision makers to make decisions without concern for risk—since the executive will have a generous safety net payout, no matter what the outcome.

This excerpt from the new Fed Guidance (at pg 29)—which has application to all companies, not just banks—underscores that the impact of post employment safety nets needs to be addressed from a risk perspective by compensation committees and disclosed in the CD&A:

Banking organizations should carefully consider the potential for ‘golden parachutes’ and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations. Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes, can provide the employee significant incentives to engage in undue risk-taking. Banking organizations should carefully review any such existing or proposed arrangements (sometimes called ‘golden parachutes’) and the potential impact of such arrangements on the organization’s safety and soundness. A banking organization should ensure that golden parachute arrangements do not encourage excessive risk-taking in light of the other features of the employee’s incentive compensation arrangements.

The SEC and Principles-Based Disclosure. The lack of an explicit SEC requirement should not lull companies into avoiding walkaway disclosure, given that the full walkaway numbers are material to an understanding of the discussion of post-employment arrangements in the CD&A and elsewhere.

A Head’s Up: Shelley Parratt, the Deputy Director of the Division of Corporation Finance, who is responsible for managing the Staff that reviews proxy statements, underscored this point in her address at the just held “4th Annual Proxy Disclosure Conference,” stating: “As a principles-based disclosure requirement, the CD&A provides companies with wide discretion on how to address those principles. As such, companies should think broadly and not limit their disclosure to the non-exclusive examples the Commission provided in Item 402(b) of Regulation S-K. **Where additional disclosure would be material to an understanding of a company’s compensation policies or decisions, a company should provide that disclosure [our emphasis].**”

Shelley Parratt also announced a new Division of Corporation Finance policy for reviewing proxy disclosures. In those situations where disclosures do not meet the Staff’s expectations, the Staff will request an amendment to correct the disclosure, rather than issue a “future” comment requesting corrected disclosure only in future filings. As a result of this major change in policy, mutual and companies risk having to endure the embarrassing and costly process of filing an amendment. Further, the need to file an amendment will flag for investors and other critics where the company had omitted required disclosure or provided inadequate disclosure (in the Staff’s view). This information could ultimately influence votes for the company’s compensation committee members or on say-on-pay. The line has now been drawn in the sand, and it is clear that the Staff won’t be reading lightly when compensation disclosure is inadequate.

### **Action Required Now**

In light of the Treasury Principles, the Fed Guidance, the SEC’s expected scrutiny discussed above and the developing “best practices” in post-employment compensation, compensation committees of all public companies have an obligation (perhaps even a fiduciary obligation for the board, *a la Disney*) to analyze and reassess a company’s termination and change-in-control arrangements, as well as pension and supplemental retirement benefits, to determine whether the terms of these arrangements are necessary and appropriate under the company’s current circumstances and the circumstances of the individual executive.

## Renew Now for Complete Version of this Critical Issue

This analysis can only be done with the benefit of a full walkaway number that includes not only unvested and vested equity grants, but also previously exercised grants and pension benefits (including benefits from supplemental plans). [See the walkaway table provided at pg 8, below.] The analysis should be augmented with projected future grants of equity awards based on the assumption that awards will be made in the future on the same basis as the most recent awards, as well as an assumed rate of return. [Companies may want to consider providing various scenarios of potential returns and grant assumptions—see the [model walkaway chart](#) prepared by Watson Wyatt and Deloitte Consulting that is posted on [CompensationStandards.com](#) in the “Walkaway” Practice Area.]

The walkaway numbers also must be shared with shareholders in the form of clear and complete tabular disclosure in the proxy statement, accompanied with CD&A disclosure providing the “why” behind these numbers. Once walkaway numbers are disclosed, the chance for unfortunate “surprises” (and potential liability) upon the termination or retirement of an executive are greatly reduced. The time is upon us for companies to take the “high road” with their disclosures regarding post-employment compensation.

### **Our Model CD&A Walkaway Disclosure**

We are providing the following model walkaway disclosure as an example of how companies might approach this issue, recognizing that the diversity in arrangements makes it difficult to capture in any model disclosure all of the possibilities that companies must address. Companies will have to determine where the walkaway disclosure best fits in their compensation disclosure, in terms of whether it should be a separate section of the CD&A or as part of the post-employment disclosures required by Item 402(j) of Regulation S-K. We believe that the walkaway numbers will have the most relevance in the context of the CD&A discussion of why post-employment arrangements are necessary, and could potentially be confusing when presented alongside the incomplete analysis required by the SEC’s rules. As a result, we have presented the model walkaway disclosure as a separate section of the CD&A. (Note, however, that the walkaway table itself could be presented with the Item 402(j) post-employment disclosures, with a reference to the discussion in the CD&A.)

#### **Our Analysis of Walkaway Numbers in Evaluating Post-Employment Compensation—and Our Analysis of the Need for Safety Nets**

In evaluating any new agreements, arrangements or provisions that provide for post-employment compensation, the Compensation Committee considers the aggregate amounts that an executive would be entitled to receive under all applicable agreements, arrangements or provisions under various termination scenarios. Further, in connection with its annual review of existing agreements, arrangements or provisions that provide for post-employment compensation, the Compensation Committee evaluates the aggregate amounts that executives are entitled to receive under those arrangements under various termination scenarios, and considers those amounts when making any current compensation decisions—particularly with respect to equity grants and other long-term incentive compensation for the executives.

We refer to the amounts derived from the analysis of post-employment compensation under termination scenarios as “walkaway” numbers, because the amounts represent the best estimate of the value of compensation that an executive can walk away with following the termination of his or her employment. These walkaway numbers are critical to

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understanding whether severance, retirement and change-in-control provisions are justified and properly aligned with the interests of our shareholders. An important question that the Compensation Committee addresses is whether the executive in question has, or will have, accumulated a sufficient amount of wealth so that those “safety net” post-employment provisions may no longer be appropriate.

The tables on page \_\_\_ present the walkaway numbers for our CEO and named executive officers, and should be read in conjunction with the disclosure regarding post-employment compensation arrangements included in the section of this proxy statement entitled “Termination and Change-in-Control Agreements” on page \_\_\_.

As a result of its analysis of these walkaway numbers in 2009, the Compensation Committee has determined to eliminate certain benefits contemplated by the current post-employment arrangements, agreements and provisions. In particular, the Compensation Committee has decided to:

- Eliminate the pension enhancements contemplated under our pension plan and Supplemental Executive Retirement Plan (SERP);
- Eliminate the payment of excise tax gross-ups in the event of a change-in-control;
- Reduce the multiple used for determining the size of severance benefits from three-times salary and bonus to one-time salary and bonus; and
- Eliminate the continuation of post-employment executive pension plans and gross-ups.

These changes will be accomplished through renegotiation of applicable agreements and arrangements with the named executive officers, which are more fully described in the section of this proxy statement entitled “Employment Agreements” on page \_\_\_. Moreover, the Compensation Committee determined that the benefits outlined above will not be included in any future employment agreements, and that severance provisions of future employment agreements will be limited to new hires and will sunset after three years. We are also pleased to report that our CEO has volunteered to sunset/eliminate any severance and change-in-control benefits applicable to him.

As a result of these changes to the employment agreements, John Smith’s current walkaway number for an involuntary termination will be reduced from \$\_\_\_ million to \$\_\_\_ million, and his current walkaway number for a change-in-control will be reduced from \$\_\_\_ million to \$\_\_\_ million.

—DL, MB

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## Walkaway Numbers for John Smith, CEO

(Presented in Dollars)

	Voluntary Resignation	Involuntary For Cause	Involuntary Without Cause	Retirement	Disability <sup>1</sup>	Death <sup>2</sup>	Change-in- control
<i>Cash Compensation</i>							
<b>Base Salary</b>	-	-	1,000,000	-	-	-	1,000,000
<b>Bonus</b>	-	-	3,000,000	-	-	-	3,000,000
<b>Pro-rata Target Bonus</b>	-	-	-	-	-	-	2,000,000
<b>Sub-Total</b>	-	-	4,000,000	-	-	-	6,000,000
<i>Equity Awards</i>							
Accelerated Options	-	-	-	-	10,000,000	10,000,000	10,000,000
Option Gains Realized <sup>3</sup>	20,000,000	20,000,000	20,000,000	20,000,000	20,000,000	20,000,000	20,000,000
Accelerated Restricted Stock	-	-	-	-	5,000,000	5,000,000	5,000,000
Unvested Restricted Stock <sup>4</sup>	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
<b>Sub-Total</b>	30,000,000	30,000,000	30,000,000	30,000,000	45,000,000	45,000,000	45,000,000
<i>Pension and Deferred Compensation</i>							
Unvested Pensions <sup>5</sup>	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000
Pension Enhancements <sup>6</sup>	-	(5,000,000) <sup>6</sup>	4,000,000	-	-	-	4,000,000
Unvested Deferred Compensation	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
Deferred Compensation Enhancements	-	-	-	-	-	-	-
<b>Sub-Total</b>	17,000,000	12,000,000	21,000,000	17,000,000	17,000,000	17,000,000	21,000,000
<i>All Other Compensation</i>							
Health and Welfare Benefit Contributions	-	-	50,000	-	-	-	50,000
Retirement Contributions	-	-	100,000	-	-	-	100,000
Retirement 2009 Catch-Up	-	-	-	-	-	-	5,400,000
All Other Tax Contributions	-	-	100,000	-	-	-	100,000
<b>Sub-Total</b>	-	-	250,000	-	-	-	5,650,000
<b>Current Walkaway Amount</b>	47,000,000	42,000,000	55,250,000	47,000,000	62,000,000	62,000,000	77,650,000

Projected Equity Awards <sup>7</sup>	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000
<b>Projected Walkaway Amount</b>	97,000,000	92,000,000	105,250,000	97,000,000	112,000,000	112,000,000	127,650,000

<sup>1</sup> Excludes the present value of disability payments in the amount of \$8 million payable through a disability insurance policy.

<sup>2</sup> Excludes death benefits of \$5 million payable pursuant to life insurance at base.

<sup>3</sup> Includes the gains realized upon the exercise of call options during the period 1999 through 2005.

<sup>4</sup> Includes the value of restricted stock vested during the period 1999 through 2009.

<sup>5</sup> Includes amounts payable under the defined benefit pension plan and the supplemental executive retirement plan.

<sup>6</sup> Represents a reduction in pension benefits in the event of a involuntary termination.

<sup>7</sup> Assumes equity awards (including options and restricted stock) equal to December 2009 grant values are also granted in 2010 through 2015 and a projected total shareholder return of 10%. [Note that the compensation committee should be provided with projections at various rates of return for the expected full tenure of the CEO.]

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