Finalizing 2008 and Setting 2009 Executive Compensation: A Real-Time Discussion of Critical Issues
Wrapping up 2008 Year-End Decisions

Making decisions about bonuses and LTIP periods ended in 2008 is more challenging than in any recent year:

- Performance targets set in another age
- Impact of credit freeze, recession, etc.: feels out of employee control
- Toxic political environment: one bad example drives new policy
- Media on the lookout for new “poster companies”
- RiskMetrics’ heightened scrutiny and enforcement of pay policies

How do you remain fair to shareholders but preserve employee retention and morale?
Wrapping up 2008 Year-End Decisions

Scenario 1: Paying formula bonuses where business performance was poor

- Employees played by the rules
- Yet affordability may be an issue (income/cash)
- Many laying off even as they’re anticipating paying bonuses
- Investors may not understand a payout when their stock value declined
- How do you explain this in your CD&A?

To pay or not to pay?

- Most paying according to formula
- Some eliminating bonuses altogether; making selective equity (or cash) retention awards
- Some paying bonus in stock for most senior executives (still reportable as current compensation, but perhaps more palatable)
Wrapping up 2008 Year-End Decisions

Scenario 2: Formula didn’t fund

- Most focusing on 2009 instead
- IRC Section 162(m) NEO compensation deduction limits discourage discretion for senior executives
- Some setting aside small “high performer pool” for non NEOs
- Others making selective equity (or cash) retention awards
Communication about the “why’s” of the decision critical internally and externally

- Beginning to “reset” internal expectations
- Companies who do this best capitalize on all sacrificing together to “live to fight another day” or “hunkering down to come out stronger when prosperity returns”
- Prepare for 2009 CD&A disclosure
Designing 2009 Annual Bonuses and Cash LTIPs

For the majority, a down year

- Reduced revenue & profit…or operating losses
- Rolling over debt or tripping debt covenants are real risks
- Visibility to the future unusually weak

Pay structures and targets from the past are in question

- Rear-view survey data just not meaningful
- Market LTI data is misleading
- Affordability & fairness to shareholders loom large

Retention is always an issue, but

- Unaffordable & inappropriate in broad programs
- Need to address it surgically
- For most, solve for the upturn, not 2009
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ANNUAL INCENTIVE PLANS: GOAL SETTING

Bottom line

- Annual pay drops this year in most sectors

How to make annual plans workable and viable?

- Change the structure relative to goals
  - Suspend pay targets and intro reduced targets for hitting 09 plan
  - Asymmetric payout curve: steep from threshold to target but flatten above
  - Broader, gentler leverage to acknowledge weak visibility in goal setting
  - More frequent cycles: quarterly or semi-annual targets that “bank” amounts for YE distribution
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Reduce the focus on absolute goals—provide partial funding for:

- **Relative** financial and operating benchmarks
- **Strategic progress**—how well we are positioned for an upturn
- **Discretion**—to reward selective contributions in spite of headwinds

May be unaffordable with spot awards being used more than past years

How to make annual plans workable and viable?

Broad participation
Designing 2009 Annual Bonuses and Cash LTIPs

DISCRETION: OBJECTIVE INPUTS FOR SUBJECTIVE DECISIONS

Fair criticism

- Discretion tends to forgive weak results

Response

- Put in a rigorous framework for subjective bonus decisions
  - Up front: Identify the events that might become part of the discussion and determine how they will be treated
  - Agree on “soft weights” for various factors: relative performance, strategic initiatives, etc.
  - Track the events and record them
  - Hold ongoing updates with the Board Compensation Committee
  - Show total cost in a business perspective: impact on cash flow, EBITDA, EPS
Designing 2009 Annual Bonuses and Cash LTIPs

LONGER TERM PERFORMANCE PLANS: PROCEED WITH EXTREME CAUTION

- Will screech to a halt this year
- Just too uncertain for 12 months, let alone 36 or more
- One year performance period with multi-year service period required thereafter
  - More influence on the performance outcome
  - Continued equity risk and upside with attendant retention hook
  - Potentially keeps rolling “handcuffs” out in front a few years

Trend to performance-based share or cash plans

Goal setting

Some potential solutions to the problem of long-term goal setting
Designing 2009 Annual Bonuses and Cash LTIPs

- Relative financial and operating metrics
  - Always a challenge with peer selection and normalizing comparisons
  - Many use relative TRS
    - Participants see little control over this
    - Fraught with odd outcomes due to start/stop dates

- Annual “scores” that aggregate into a multi-year average
  - Risks payouts on unacceptable downward trends

- Performance vesting with make-up/catch-up provisions
  - More complex and harder to understand and get participants to value

Some potential solutions to the problem of long-term goal setting continued
Designing 2009 Annual Bonuses and Cash LTIPs

- Too much restricted stock
  - De-lever pay for the wrong reasons
  - Hook management on getting pay delivered

- Revert to options for the wrong reasons
  - Market timing play
  - Reinforce “casino effect”
Challenges

- Large portion of past grants severely diminished in value/underwater
- Limited share pools
- Potentially high dilution
- Guarding against unintended windfalls
Equity Compensation Planning

One Early Solution: Option Repricings and Exchanges (OREs)
- Lots of discussion; limited uptake
- Stock exchange shareholder approval requirements
- Accounting and tax considerations
- Tender offer and securities law issues

Alternatives to OREs
- Extending expiration dates
- Accelerating vesting
- Gratuitous cancellations
- Other techniques
## Equity Compensation Planning

### NEW 2009 GRANTS

<table>
<thead>
<tr>
<th>Vehicles</th>
<th>Opportunity to revisit philosophy — do current vehicles and weightings make sense?</th>
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<tbody>
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<td></td>
<td>- Options vs. full value awards: pros and cons</td>
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<thead>
<tr>
<th>Performance Requirements</th>
<th>Any special terms in the current environment?</th>
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<td></td>
<td>- Shorter performance cycles</td>
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<td></td>
<td>- More relative measurement</td>
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<td></td>
<td>- Longer vesting</td>
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<tr>
<th>Size</th>
<th>Should share grants be determined using today’s price? Potential alternatives:</th>
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<tr>
<td></td>
<td>- Translate at average price</td>
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<td></td>
<td>- Determine acceptable run rate</td>
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<td></td>
<td>- Grant same number of shares as last year</td>
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The Impact of RMG/ISS Policies

Pay for Performance

RMG policies on Pay for Performance
- Consequences of being on the 2009 TSR hit list
- Consequences of CEO pay for performance disconnects

Poor Pay Practices

RMG policies on Poor Pay Practices and director withhold votes
- What are they?
- Which ones will get you in trouble?
- What are the consequences?
The Impact of RMG/ISS Policies

- Who cares about WITHHOLDs, and why
- Dealing with RMG on these issues
- Impact on 2009 plan design and proxies
- New share authorizations
  - The 3 tests:
    - Burn Rate
    - Pay for Performance
    - Shareholder Value Transfer
  - What’s changed/what has stayed the same
  - Provisions of equity plans to revisit
As enacted in the American Recovery and Reinvestment Act of 2009 Stimulus, TARP is a game changer for financial institutions.

- In rare form, the government doesn’t phase-in but phases-back
- For banks and other financials the impact is sweeping
  - Variable pay largely ruled out
  - Severance pay ruled out
  - Deductibility limited
  - Clawbacks established more broadly
  - Say on Pay votes to shareholders required
  - …and more
The Impact of TARP Compensation Limits

- Say on Pay becomes law?
- Deductibility becomes more limited?
- Severance and golden parachutes restricted?
- Limitations placed on “luxury” items?
- More certifications, including that “risk reviews” on pay programs have been conducted

For all other companies, perhaps a preview of emerging public policy

And other possible implications

- A paradigm shift in fixed/variable pay: much higher salaries
- Talent advantage to the non-banks: expect a people drain

But the new rules need to be clarified or changed

- From the major: Variable pay caps are dysfunctional
- To the technical: How do you avoid 409A exposure without date-certain vesting on bonuses paid in stock?
### The Impact of TARP Compensation Limits

#### SIDE NOTE ON CLAWBACKS: MANY THINGS UNDER ONE NAME

<table>
<thead>
<tr>
<th>Employees Directly Involved in Performance</th>
<th>Restated Results due to Material Noncompliance and Misconduct</th>
<th>Revised / Restated Results (Without Regard to Noncompliance and/or Misconduct)</th>
<th>Reversed Performance (gains)</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ As required by SOX, public companies' CEOs and CFOs</td>
<td>■ Increasingly typical</td>
<td>■ Being pushed for financial institutions</td>
<td></td>
</tr>
<tr>
<td>■ Boards want bright-line tests</td>
<td>■ Focus on senior executive group</td>
<td>■ Expect some voluntary adoption</td>
<td></td>
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<tr>
<td></td>
<td>■ TARP only requires revised results (not restatements) and extends to Top 25</td>
<td>■ Bright line tests hard to establish: Mark-to-market fair values (real or temporary?); credit losses (underwriting mistakes or an unusually harsh cycle?)</td>
<td></td>
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<tr>
<td>Employees Not Involved but Affected by Performance</td>
<td>■ Still unusual</td>
<td>■ Rare</td>
<td>■ Rare</td>
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<td>■ Growing interest from governance groups</td>
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The Impact of Say on Pay

It appears that “Say on Pay” will continue to be the hottest shareholder proposal related to executive compensation submitted for vote in 2009.

- Approximately 100 companies have filed proposals for “Say on Pay” to be voted upon this year*
- Obama co-authored bill as a Senator and has said it should be law
- Sixteen U.S. companies now offer or plan to offer shareholders a non-binding vote on executive compensation

*Source: Walden Asset Management
The Impact of Say on Pay

Companies Allowing Shareholders a “Say on Pay”*

<table>
<thead>
<tr>
<th>2008</th>
<th>2009</th>
<th>2010 or 2011</th>
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<tbody>
<tr>
<td>Aflac</td>
<td>Ingersoll-Rand</td>
<td>Hewlett-Packard</td>
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<tr>
<td>RiskMetrics</td>
<td>Intel</td>
<td>Occidental Petroleum</td>
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<tr>
<td>H&amp;R Block</td>
<td>Motorola</td>
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<td>Jackson Hewitt</td>
<td>Par Pharmaceuticals</td>
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<td>Littlefield</td>
<td>Blockbuster</td>
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<td>Zale Corporation</td>
<td>Tech Data</td>
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<td></td>
<td>MBIA</td>
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<td></td>
<td>Verizon</td>
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</tbody>
</table>

Meanwhile, the inclination to adopt “Say on Pay” legislation continues to gain momentum in this era of intense public scrutiny of executive compensation.

*Source: Walden Asset Management.
The Impact of Say on Pay

Arguments in Favor

- Will improve board accountability
- Will raise the U.S. to an international best practice of shareholder votes on pay
  - Non-binding votes are required in UK & Australia; while this practice has not reduced pay levels, it has:
    - Enhanced constructive dialogue
    - Tightened pay-for-performance links
- Will bolster shareholder influence over pay practices
- Will improve design of pay plans
- Will combat rewards for failure
- Will prevent egregious pay
The Impact of Say on Pay

**Arguments Against**

- Will be disruptive or divisive
- Special interests will highjack the agenda
- Will transgress board responsibility and proper shareholder-board relations
- Executive pay is a business decision for management and the board
- Will become a distraction and a drain on the time of directors and managers
- Companies would not know why shareholders cast high levels of no votes
- Market differences make the vote unneeded in the U.S.
- New executive compensation disclosure already addresses most of the concerns Say on Pay is targeting
- Will lead to more generic or “one size fits all” executive pay practices, limiting compensation’s role as a business tool to change behavior and drive strategy achievement
- If this is allowed, what would be next?
The Impact of Say on Pay

- Clarity on what the “no” means is not assured
- Potential power shift to proxy advisory groups like RMG?
- Risks of not taking action on a “no”
  - Director/Committee member votes withheld next time around?
  - Reputational risk
Closing

- Anything else to be watching for now?
- Any special things to do as 2009 unfolds?
- Questions?
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