

Proxy Statements — Compensation Committees' Toolkit for Building Shareholder Support

By Thomas P. Flannery & Edward J. Speidel

STORMY WEATHER AT PAXON TECHNOLOGIES

April had brought more than its usual share of showers to Paxon Technologies in the form of an uninspired first quarter earnings report. Unfortunately, May had not brought any expected flowers. Instead, it brought Paxon's annual shareholders' meeting and more downpours. In fact, when Henry Meeker, Paxon's chairman and CEO, opened up the annual meeting to questions and comments from the shareholders, he got drenched in shareholders' skepticism and criticism. A sample exchange with a shareholder follows:

"I read in the proxy statement that management wants shareholders to approve yet another stock option program for executives? Paxon's stock has still not really rebounded from the low it hit in 2001. In fact, the only dollar values at Paxon that had significantly increased in the last five years were those associated with executives' compensation packages. In contrast, both revenues and earnings per share (EPS) growth have been lackluster. Is this the time for executives to be asking for more options? What ever happened to 'pay for performance'?"

Meeker felt he was obliged to set the record straight. "Paxon, like the entire high-tech industry, has had a difficult few years financially. Before 2000, analysts — and shareholders — had become quite accustomed to annual earnings per share growth of 10 to 15 percent. That kind of growth is simply not sustainable for any company in any industry. So at this time, we...."

"My point exactly, Mr. Meeker. Growth of executives' pay packages should reflect growth in earnings per share. At Paxon, it doesn't seem to work that way. Why not?"

"I'll let Ms. Vera Wright, Paxon's Compensation Committee Chairwoman, answer your questions about our compensation program. She is an outside director who was heavily involved in shaping our current executive compensation program."

"Executives must make decisions that will affect not only what the earnings per share will be next quarter, but for the next dozen quarters. That's what they are compensated for — improving the long-term prospects of their company. Shareholders who are in it for the long haul understand and appreciate that philosophy. There's an idea out there that earnings per share should increase each quarter and, if it doesn't in one company, it's because of bad luck or, more likely, bad executive decision-making. It's a false and misleading idea, destructive to the financial interests of shareholders."

What could the board and senior management have done beforehand to make this meeting turn out differently and to better demonstrate how management and shareholders' interests are aligned? Read on.

INTRODUCTION

The dictionary defines "proxy" as a substitute, a stand-in, a surrogate, an understudy. A proxy statement, known formerly as the Notice of Annual General Meeting and Proxy Statement, is supposed to be all those things for a company's board of directors. How effectively any board — like the fictional Paxon Technologies' board — uses the proxy statement to articulate its rationale for taking the positions it does can greatly influence shareholders' understanding of the company's business strategy and the role of executive compensation in driving performance against that strategy.

This paper will demonstrate how a board of directors can reshape a proxy statement from the perfunctory and somewhat defensive document it often is into a compelling message to investors and their advisors. Specifically, we will focus on how a board of directors' Compensation Committee should use the proxy statement to convey a convincing rationale for its executive compensation policies and practices. We will also suggest how board members can improve communications with shareholders.

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THE PURPOSE AND PROTOCOL OF PROXY POWER

A publicly traded company is required to send a proxy statement to its registered shareholders prior to its annual meeting. Generally, the proxy statement arrives between 10 and 60 days prior to the meeting. In that period, investors — and the media — have an opportunity to read about the Committee's rationale for taking the positions it does on a variety of issues including executive compensation. Much of this compensation information is found in the Compensation Committee Report on Executive Compensation, a required section of every proxy statement.

Board members in general, and perhaps Compensation Committee members in particular, must be able to communicate with shareholders and their advisors in an organized, shareholder-sensitive manner. The proxy becomes the storyboard for this communication. (See Five Recommendations for Improving Board-Shareholder Communications on page 5.)

A company's Director of Investor Relations may have more ongoing contact with institutional investors than any other member of the management team. This exposure is likely to give him or her a good sense of what investors want to know regarding executive compensation. For that reason, the Compensation Committee should work with the company's Director of Investor Relations (along with the General Counsel's office and Human Resources Department) to craft and deliver their proxy statement message to shareholders and other stakeholders. It is critically important for the Compensation Committee to understand this report and claim ownership of its contents. In this time of increased board scrutiny, it should be a vehicle for effectively communicating to shareholders. The Compensation Committee's Report on Executive Compensation is its opportunity to be proactive in thoroughly explaining its positions on executive compensation.

This report should use understandable and positive language to explain:

- This deliberative process and due diligence the Compensation Committee used in achieving its conclusion;
- How executive compensation practices support the company's philosophy and competitive positioning;
- How the short- and long-term incentive measures for plan performance link to short- and long- term business strategy;
- How executives' annual bonus payouts link to the company's

annual performance and reasons for short-term disconnects (if any);

- The reason(s) for any changes, particularly in the design of the Long-Term Incentive Plan;
- The elements and costs of change-in-control and severance arrangements, as well as SERPs and other deferred compensation arrangements; and
- As transparently as possible the total cost and corporate obligations related to executive pay.

Examples of how various Compensation Committees explained each of these seven items are discussed next.

COMPENSATION COMMITTEES — WHAT THEY SAY ABOUT BASIC AND STOCK-BASED EXECUTIVE COMPENSATION AND HOW THEY SAY IT

The Compensation Committee Report on Executive Compensation should discuss the compensation policies applicable to the company's executive officers, including the specifics about how corporate performance relates to executive compensation. The report also should disclose the basis for the compensation paid for the last completed fiscal year to the company's CEO, including the factors and criteria upon which the CEO's compensation was based. This should include a specific discussion of the relationship of the company's performance to the CEO's compensation for the last completed fiscal year, describing each measure of the company's performance, whether qualitative or quantitative, on which the CEO's compensation was based.

For instance, one company worked hard to strengthen its corporate governance processes in the last two years. It used the proxy statement's fiscal year 2003 Compensation Committee Report to inform shareholders that senior executives' basic compensation is still comprised of three elements: base salary, annual incentive bonus opportunity and long-term equity-based incentive compensation. However:

- The annual incentive bonus for all officers is tied solely to company and/or segment performance after fiscal year 2003.
- The Committee reaffirmed its belief that the company's long-term equity-based compensation aligns shareholders' and executives' interests through its multi-year vesting schedule and its practice of paying a significant portion of executives' compensation in company equity. In fact, to reinforce those

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aligned interests, the Compensation Committee recommended new stock retention and ownership guidelines for all executive officers, which the board approved. Generally, these executives must retain at least 75 percent of "earned equity awards" until they've attained their required ownership levels, and 25 percent of subsequently earned equity shares for at least three years after such shares are earned.

As noted above, some Compensation Committees use Proxy Statements to explain how their stock retention and ownership guidelines align shareholders and executives' interests. Others explain how share award programs established for the CEO and executive officers are linked directly to performance. For instance, in 2001 another company's Compensation Committee established a contingent share awards plan for the 2003 to 2007 performance period. Actual payments are determined by measuring total shareholder return and diluted earnings per share over the applicable performance period relative to the performance of the peer group.

The Committee's Report explains how the plan works. It weighs the two criteria equally. If performance (as measured by both criteria) is below the threshold level of the peer group, eligible executives earn no performance-contingent shares. To the extent that the company's performance under either or both criteria exceeds the threshold performance of the peer group, shares of common stock up to the maximum will be earned.

The Committee also discusses the stock ownership requirements it made applicable to the CEO and other executives. These executives must own company stock at least equal in value to their annual salaries and up to five-times (in the CEO's case) their annual salary. The Committee monitors compliance with these ownership requirements and reports that all ownership targets were met.

The Compensation Committee Report of a third company outlined its continuing efforts to use stock-based awards to executives to align shareholders and executives' interests. As part of that ongoing effort, the Committee reported that senior executives will receive a majority of their annual equity award in 2004 in the form of premium-priced options. Such options will ensure that shareholders experience an increase in value before executives receive their rewards for business performance. The Report also states that executives are required to purchase company stock from their annual cash incentive payouts in order to receive an option grant that remains vested only as long as they hold the stock.

Committees may want to consider changing both the timing and proxy disclosure of stock option grants. One proposal is to make option grants early in the year basing the grant size on the prior year's financial/strategic performance and then to report the grant size in the next proxy statement indicating that it reflects the prior year's performance. This proposal is designed to facilitate CEO pay/performance comparisons. (See New ISS Policy on Pay for Performance and Compensation Committees on bottom of page 3.)

CLEARING SKIES AT PAXON TECHNOLOGIES

It's early February of the following year. The board's Compensation Committee has been meeting regularly for weeks with the company's Director of Investor Relations, its Legal Counsel and V.P. of Human Resources. Their task is to shape a Compensation Committee Report for inclusion in this year's proxy statement to be sent to shareholders a month before the annual meeting in April. The Committee's goal in doing so is to explain their actions regarding executive compensation in enough detail so as to avoid the criticism and anger so obvious among shareholders at last year's meeting.

Coming up with that detail took year-long planning and participation. In the spring and summer after last April's meeting, Paxon conducted a comprehensive self-assessment to determine which issues are the most likely targets for shareholder proposals. Stock option and other executive compensation programs that topped the target list will all be discussed in this year's Compensation Committee Report. By Labor Day, the company had identified key shareholders who were likely to either sponsor or support such proposals. Throughout the fall, Paxon held a series of "town meetings" with these shareholders to discuss and, where appropriate, resolve several of the issues surfaced by the self-assessment before they rose to the level of shareholder proposals.

NEW ISS POLICY ON PAY-FOR-PERFORMANCE AND COMPENSATION COMMITTEES

Institutional Shareholders Services (ISS) generally recommends withhold votes for the Compensation Committee of any company that does not meet the ISS pay-for-performance criteria unless the Committee provides new, previously undisclosed evidence of improvements in its performance.

According to the ISS U.S. Corporate Governance Policy — 2005 Updates, evidence of improved Compensation Committee

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Performance includes all of the following:

- Committee review of all components of the CEO's compensation with dollar amounts affixed to various payout scenarios. Specifically, the costs of the components must be disclosed if:
 - Termination occurs within 12 months
 - “Not for cause” termination occurs within 12 months
 - “Change of control” termination occurs within 12 months
- The Committee's commitment to provide additional information on named executives' annual cash bonus program and/or long-term incentive cash plan for the current fiscal year. Providing this information will tell shareholders the minimum level of performance required for any cash bonus to be paid and the maximum cash bonus payable for superior performance.
- The Committee's commitment to grant at least 50 percent of shares awarded to named executives as performance-based awards that are earned and payable when the company achieves its performance targets. Providing details on these performance targets will tell shareholders the minimum level of performance required before executives receive any performance-based equity grants.
- The Committee's sole authority to hire and fire outside compensation consultants to assist in analyzing executive pay packages and contracts and understand the company's financial measures.

EXECUTIVE PERKS AND SEVERANCE BENEFITS — BEST PRACTICES

According to the Corporate Library, a research firm dealing with corporate governance issues, there have been some interesting developments in the last year regarding how much various proxy statements disclose about these benefits and about changes in the policies governing them. Consider the following:

- In its latest Proxy Statement, one company itemized all 16 benefits its named officers received, regardless of their value.
- Over the last few years, many companies eliminated several perks, including subsidies for club memberships, automobiles

and split-dollar insurance programs, corporate matches for the 401(k) contributions of senior management and other highly compensated employees, and they also eliminated special executive severance policies.

- One large high-technology company's most recent Proxy Statement reports that it refrains from offering perks exclusively to any employee or group of employees including senior executives. This means no country club memberships, private use of corporate assets, such as aircraft, apartment or luxury boxes, supplemental retirements funds or tax-sheltered accounts. In essence, senior executives at this company have the same components of total compensation (base salary, annual cash bonuses and stock options) as do all employees.
- Another large financial institution has terminated special retirement benefits for executives, and its CEO has terminated his own employment contract thereby removing his guaranteed eligibility for severance benefits.
- An increasing number of companies have reduced, or are considering reducing, executive severance benefit eligibility and level. In fact, nearly two-fifths of CEOs in the S&P 500 have no formal severance arrangement at all. Although this does not necessarily mean they will receive no severance, it does mean that a separation agreement will have to be drawn up at termination.

CHANGE-IN-CONTROL EXECUTIVE BENEFIT PROGRAMS — REVIEWERS BEWARE

A change-in-control often leads to an executive's departure from his or her employer, with the payment of substantial benefits. A Compensation Committee reviews the program providing such benefits before events trigger payment of any of them. When it does, the Committee can confidently report to shareholders that the program, if needed, will work as intended to protect their interests by assuring the retention of executives' services during any post-acquisition transition period.

It's the Compensation Committee's responsibility to fully review not only the components of these programs, but also their costs and the triggering events. Among other things, the Compensation Committee's review should include:

- An inventory of all benefits to be provided and the value of each. Compiling such an inventory allows the committee to

identify and eliminate redundant benefits such as continuation of salary and bonus and additional service or compensation credits for SERP purposes.

- A detailed analysis of the cost of post-employment benefit coverage. Keep in mind that this coverage must be negotiated with insurance carriers typically at higher rates charged for active employees. Also, if the benefits are self-funded, an actuary should determine their value as part of assessing the reasonableness of the overall package.
- Consideration of a requirement that all benefit-eligible executives serve at least six to 12 months after the acquisition to assure a smooth transition and to give the acquiring company an opportunity to negotiate a new employment contract with those executives it wants to retain.
- Conditions executives must agree to before these benefits commence. These might include a general release of all claims against the company, a promise to continue abiding by their proprietary information agreement while receiving these benefits, a one-to-two-year non-compete period and an agreement not to solicit any company employees to work for their new company.

FIVE RECOMMENDATIONS FOR IMPROVING BOARD-SHAREHOLDER COMMUNICATIONS

In March 2004, The National Association of Corporate Directors (NACD) and the Council of Institutional Investors published recommendations on Improving Board-Shareholder Communications. The 15-member task force assembled by the two organizations in early 2003 was comprised of corporate executives, board members and institutional investors. Among other things, they examined how inadequate communications between boards and shareholders could have contributed to some recently reported scandals. Based on that examination, they recommended that:

1. Board-shareowner communications be part of an ongoing communications program that includes periodic, comprehensive and publicly available disclosures about important topics, including performance and governance issues.
2. Boards should provide detailed contact information for the corporate secretary and/or other management representative, and for at least one independent director. Board members

should receive copies of all correspondence addressed to them by shareholders and be made aware of all other communications intended for them, no matter what the topic

3. To facilitate the communications process, boards should detail which issues are appropriate for them to address and which are appropriate for management
4. Boards should develop and disclose policies covering all forms of communications, including in-person meetings, telephone calls, e-mail, and other written communications

The Task Force agrees that it is appropriate for shareowners to communicate with directors, through in-person meetings.

Specifically, Directors should:

- Commit to shareowners that they will receive a response to their direct communications
- Attend annual shareowner meetings
- Disclose ground rules for other meetings with shareowners
- Make a good-faith effort to accommodate all legitimate and important requests for meetings
- Respond in writing to all requests for meetings involving topics appropriate for board-shareowner communications

5. Boards should take an active role in developing and adhering to communications policies, and ensure that communication efforts and policies are current, accurate and effective

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