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Executive Compensation Issues to Consider During Proxy Season

Authors: John J. Heber | Jean Kim

As companies prepare annual reports and proxy statements, the following are some key executive compensation issues to consider.

Repricing Options

If repricing underwater stock options was ever under consideration, then proxy season is the time to do it. Currently, the preferred method for repricing a stock option with an exercise price greater than the underlying stock's current fair market value is by offering a "value-for-value exchange." In a value-for-value exchange, the optionee is offered the opportunity to cancel his or her underwater options in exchange for the grant of new options or other equity, at a ratio of less than one for one, with an exercise price equal to the market price of such shares. The exchange is termed "value-for-value" because it is structured so that the value of the new option is generally equal to the value of the canceled options, which prevents any additional accounting expense. Generally, publicly traded companies must seek shareholder approval in order to effect an option repricing via a value-for-value exchange. Under the NYSE and NASDAQ rules, a company is required to obtain shareholder approval of a proposed repricing unless the equity incentive plan under which the relevant options were issued expressly permits the company to reprice its outstanding option grants. As proxy statements are being prepared, shareholder approval for an option repricing can be sought by including in the proxy statement, clear reasoning behind the exchange offer and disclosure regarding its impact.

Please see our February 9, 2009 newsletter, "The Re-Emergence of Stock Option Repricing" for a more complete discussion on the topic of stock option repricing and related issues to consider.

Newsletter Editors

Katerina Hertzog Bohannon
Partner
kbohannon@manatt.com
650.812.1364

Harold P. Reichwald
Partner
hreichwald@manatt.com
310.312.4148

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Adequate Evaluation and Disclosure of Risks

In December 2009, the Securities and Exchange Commission (the "SEC") amended the proxy disclosure rules, which significantly expanded the disclosure obligations with regard to compensation policies and practices. These new disclosure rules became effective as of February 10, 2010, and therefore, should be carefully considered in preparing annual reports and proxies. Specifically, under the new rules, there was an expansion of the compensation disclosures contained in proxy materials for reporting companies. Companies are now required to disclose whether their compensation policies and practices provide incentives or create risks that are "reasonably likely to have a material adverse effect on the company." This new rule applies to policies applicable to all employees, not just executives, and if the company determines that its policies could have such an effect, the company must disclose its policies and practices separate from its Compensation Discussion and Analysis. In evaluating whether such disclosures are required, companies may consider mitigating factors or practices that reduce the overall impact of the risk.

The following situations were cited by the SEC as ones that could potentially trigger the new disclosure requirement:

- Compensation policies and practices at a business unit of the company that carries a significant portion of the company's risk profile;
- Compensation policies and practices at a business unit with compensation structured significantly differently than other units in the company;
- Compensation policies and practices at a business unit that is significantly more profitable than others within the company;
- Compensation policies and practices at a business unit where the compensation expense is a significant percentage of the unit's revenues; and
- Compensation policies and practices that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

If it is determined that disclosure is required, examples of specific items that may be disclosed include:

- The general design philosophy of the compensation as it relates to risk-taking by employees on behalf of the company;
- Any risk assessments used in connection with structuring compensation policies or in awarding and paying compensation;
- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw-backs or imposing holding periods;
- Changes in a company's risk profile and how that impacts compensation; and

The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

New Rules for Reporting Equity Compensation

The new SEC disclosure rules also include a new requirement that equity compensation awards be reported in the Summary Compensation Table at the grant date fair value calculated in accordance with FAS 123R (now codified as FASB Accounting Standards Codification (ASC) Topic 718). The new rules apply to all stock and option awards, including performance-based awards. The grant date fair value of a performance-based award must be reported in the Summary Compensation Table based on the probable outcome of the performance condition, assessed as of the grant date of the awards. The maximum potential value for a performance-based award must be disclosed in a footnote to the Summary Compensation Table. The new rules require all companies to recalculate prior year compensation awards in the Summary Compensation Table to reflect the new rules if the information is being presented in a report or proxy statement relating to a fiscal period ending on or after December 20, 2009.

Please see our December 24, 2009 newsletter, "The SEC Adopts Enhanced Proxy Disclosure Rules" for an overview of these new rules.

For additional information on this issue, contact:

John Heber Mr. Heber is an attorney who specializes in executive compensation and benefits programs for both domestic and international companies. Prior to joining Manatt, Mr. Heber led the Compensation and Benefits consulting practice at a Big 4 accounting firm. With his tax, legal, accounting and consulting background, Mr. Heber is able to advise on the tax, regulatory and strategic issues related to executive compensation and benefits programs.

Jean Kim Ms. Kim's practice focuses on employee benefits, executive compensation and ERISA. She has advised on benefit issues in corporate mergers and acquisitions, drafted various types of executive compensation agreements, including executive level employment agreements, and has advised on the design of qualified and non-qualified compensation plans. In addition, Ms. Kim has advised collectively bargained multi-employer trusts on matters arising under ERISA. Ms. Kim also advises on federal and state income tax matters, including tax issues relating to tax-exempt organizations.

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