

U.S. Corporate Governance Today: A Reshaping of Capitalism

Follow-up Discussion of Executive Compensation

The views expressed in this memorandum are those of Peter Atkins, a senior partner of the firm, and are not presented as those of the firm. If you have any questions regarding the matters discussed in this memorandum, please call Mr. Atkins at 212.735.3700 or your regular Skadden contact.

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Introductory Comments

Last week, Skadden mailed to clients and others, and posted on its Web site, my memorandum captioned “U.S. Corporate Governance Today: A Reshaping of Capitalism.” The message of that memorandum was, in brief, as follows: “Corporate governance” has become an expansive concept today, involving many parties collectively pursuing multiple agendas. The combined purposes and effects of this movement are reshaping the U.S. private enterprise economic system. However, the nature and consequences of this reshaping are not being adequately explored — leading to the prospect that more harm than good may result from corporate governance reform as defined and pursued today. The memorandum (1) provides an understanding of what changes are afoot; (2) identifies some of the important challenges and risks they present to key underpinnings of U.S. capitalism; (3) highlights that over time, and notwithstanding significant stumbles, our free enterprise system has been the most vibrant and competitive economic system in the world; (4) offers a reminder that the very essence of capitalism is that it fosters risk-taking — and that “mistakes” will be made; and (5) in the context of pursuing corporate governance reform, urges applying the long-term view of our private enterprise system’s performance and the principle of restraint which that view dictates.

One of the key areas of governance initiatives today that raises these issues is executive compensation. As noted in my prior memorandum, executive compensation matters currently on the corporate governance agenda include:

- (1) requiring annual advisory “say on pay” shareholder votes;
- (2) requiring independent compensation consultants in certain circumstances;
- (3) requiring companies to develop and disclose “claw-back” policies;
- (4) barring severance agreements for executives terminated for poor performance;
- (5) requiring proxy disclosure of specific performance targets for incentive compensation;
- (6) requiring shareholder approval of pay above a prescribed multiple (e.g., 100x, as provided in one Senate bill) of what the average company employee is paid;
- (7) requiring expanded compensation-related proxy disclosure, including regarding compensation paid to lowest and highest paid employees, average to all employees, number of employees paid more than prescribed multiple (e.g., 100x) of average employee compensation and total compensation paid to employees paid more than prescribed multiple;
- (8) making “excessive compensation” non-deductible for federal income tax purposes (e.g., pay above 100x average compensation to company employees, as provided in one Senate bill);
- (9) requiring “excessive compensation” reports to be filed with the Treasury Department;
- (10) providing additional requirements with respect to compensation committees regarding (a) enhanced independence standards, (b) direct

responsibility for hiring, paying and overseeing compensation consultants, (c) authority to hire and pay outside counsel and advisors, and (d) independence standards to be applied to compensation consultants and outside counsel; (11) requiring *discussion and analysis of risk-related overall compensation policies and practices for employees generally*, if the risks arising from those policies and practices “may have” a material effect on the company; (12) *limiting payouts to families of executives* who die in office; and (13) requiring that *executive equity awards be held until retirement*.

The purpose of this follow-up memorandum is to examine more closely the justification, efficacy, risks and motivations associated with this broad-based effort to increase significantly the regulation of executive and other compensation arrangements of U.S. publicly traded business corporations. This effort would be effected through a combination of substantive requirements, expanded disclosure and non-binding shareholder advisory votes imposed at the federal level through legislation and regulation, and also on a company-specific basis through proposals sponsored by shareholders.

Experience-Based Reality

I approach this assessment not as an economist, academician, compensation consultant, corporate governance activist or politician. I am none of those. What I am, however, is a lawyer who, for more than 40 years, has practiced in the mainstream of the world of publicly traded U.S. companies (excluding, for purposes of this memorandum, U.S. public companies that have substantial governmental ownership resulting from recent rescue investments). Among other things, this has given me a window to observe and appreciate the central importance of these publicly traded business corporations to our economic system. I believe that the U.S. private enterprise economic system is dependent on providing these companies, in an increasingly competitive world, with an environment conducive to marshaling capital, assessing investment opportunities and risks and, ultimately, producing sustainable growth and profitability.

I have also learned that in the private enterprise system, critical to the ability to achieve these results is the ability to design and implement compensation arrangements — particularly executive compensation. In short, the freedom of public companies to manage compensation is an essential tool for our systemic economic success. This is not a revelation, just a matter of observation and common sense. In the world generally, and in the business world in particular, monetary compensation motivates people to achieve.

Moreover, there is enormous variety in the types of compensation decisions that have to be made, and a concomitant need for real flexibility to accommodate this variety of circumstances. This is clear to anyone who has witnessed or participated in the process of dealing with, for example, corporate succession planning, competitive personnel raids, positioning a new venture, moving from a start-up to a viable ongoing business, integrating the workforce and managements of two combining companies of similar or dissimilar size, finding a highly qualified key employee to fill an essential (or just very important) position, retaining key employees in times of business distress or takeover threats, or retaining star performers with egos to match.

In our economic system the basic responsibility for managing the compensation function for public companies is a combination of the board of directors (especially the compensation committee) and senior management. It is recognized as one of the most important functions of a board and is to be performed within the framework of their fiduciary duties of loyalty (including good faith) and care.

While there may be many common elements among groups of public companies with respect to compensation decisions, each company is almost certain to have unique issues and considerations. The simplest, clearest and generally most important example is the selection or retention of the CEO. Virtually all companies have in common the need for a CEO. But each has its own specific set of requirements and concerns regarding the CEO's selection or retention. Among the many considerations a board might have to address via compensation arrangements could be: What are the CEO prospect's compensation arrangements at his or her current employer, and what will it take to lure that person away? Is there a supplemental pension benefit that will be lost if the CEO prospect moves to a new company, and must it be replicated to induce the move? How important is it to the hiring company to fill the CEO slot? How big a pool is there for world class (or merely excellent) candidates? Are there special skills, knowledge, experience and/or expertise that the hiring company needs in its CEO candidate? Is the hiring company facing a turn-around situation, which may require offering a large equity upside to the CEO candidate in lieu of scarce cash compensation? What should or must the current employer company do on the compensation front to retain its CEO in the face of a competitor's efforts to lure the CEO away? How, if at all, will the CEO compensation arrangements affect the company's overall compensation system and executive/employee morale?

The point of this illustrative list of issues is to underscore that when critical compensation decisions are required, as they surely will be in connection with hiring and retaining a CEO and other key executive officers, what is needed is decision-making by a board and compensation committee familiar with the company's situation and able to address its needs through compensation arrangements appropriately designed for that situation. Legislative or regulatory one-size-fits-all intervention in the private ordering of compensation arrangements overseen by directors of public companies should be avoided unless directly responsive to the need to mitigate material systemic risk — and, in such event, the need should be demonstrable, not just asserted, and the response should be proportionate to the risk and subject to testing as to its efficacy.

The Danger Zone

I would not deny that there are aspects of how executive compensation, and perhaps compensation more generally, have been designed and used in the recent past which may have contributed to systemic harm. In particular, certain compensation practices may have contributed to the creation of a tangled web of derivative and other financial instruments that produced substantial bonuses for some members of the financial institutions sector without an adequate assessment of the risks they carried. This clearly is an area appropriate for examination and, perhaps, if real cause and effect can be demonstrated, federally imposed constraint on the compensation front, even at the cost of some flexibility in the area of executive compensation and compensation generally.

However, the rush to judgment seems way too hasty, ill-considered and overreaching. Executive compensation (and compensation generally) can be a highly charged subject, and certainly is these days. The near collapse of our financial system and the global recession with which we are suffering have unleashed a powerful need to assign blame, with corporate compensation high on the list, as well as an environment where multiple groups with compensation-related agendas see a unique opportunity to try to advance them under the auspices of "corporate governance." The effect of these circumstances has been to generate a remarkable array of proposed compensation "reforms," most of which have no relation to systemic risk and present individually and collectively the potential to injure our private enterprise system. Before the White House, Congress, the

SEC and/or other federal agencies impose any of these proposed “reforms” they have a responsibility to all Americans to slow down, take a deep breath and do a thorough assessment of the asserted “problem,” the legitimacy of the proposed “reform,” as a response, and the risk of harm arising from the “reform,” including in conjunction with others under consideration.

Some Thoughts on Specific Compensation “Reform” Proposals

Analyzing each of the compensation “reform” proposals listed under “Introductory Comments” above is beyond the scope of this memorandum. However, I offer the following thoughts regarding certain of such proposals.

Say on Pay – Clearly this is not a systemic risk issue. What’s next, “say on [fill in the blank]” proposals running the gamut of board decisions? Making discrete issues or practices the subject of separate shareholder votes, even if non-binding, seems inconsistent with the basic allocation of responsibility between boards and shareholders. Moreover, “non-binding” does not mean not intended to be influential. No doubt a failure to “appropriately respond” to a shareholder vote against a board’s pay policies and practices will lead to additional pressure on the board (which could be very binding in light of other corporate governance provisions, such as majority voting in the uncontested election of directors). It does not seem to be an appropriate role for the federal government to intrude itself into what essentially is a state corporate law relationship, especially when the impetus is unrelated to systemic risk and, in fact can, as a practical matter, diminish the willingness of boards to exercise their considered business judgment.

Provisions Applicable to “Excessive Compensation” – A set of proposed provisions relating to “excessive compensation” (*e.g.*, compensation in excess of 100x what the average employee is paid, as provided in bills introduced in the Senate) seems completely unrelated to systemic risk. These provisions would require a shareholder vote to permit such compensation, preclude deductibility for federal income tax purposes of the “excess” and require reports to the Treasury Department. They (and related disclosure provisions) seem motivated by a populist view that the federal government needs to intervene to set limits on executive (and other) compensation — a view which is completely antithetical to the free enterprise system and not supported by any evidence of systemic need.

Disclosure of Risk-Related Overall Compensation Policies and Practices – The SEC has proposed requiring disclosure in the form of discussion and analysis of risk-related overall compensation policies and practices for employees generally, if the risks arising from these policies and practices “may have” a material affect on the company. While grounded in a systemic concern relating to the financial services sector, this proposal goes much farther in its scope — it would apply to a significant number of U.S. publicly reporting companies. There seems no basis for seeking to apply the provision to a large number of companies that do not present a systemic meltdown risk through the application of general compensation policies and practices or otherwise. Public companies are required to describe the material risk factors affecting their businesses, which should be sufficient. Moreover, the “may have” standard is too broad and imprecise, especially when imposing a disclosure requirement that can be second guessed.

Requiring Executive Equity Awards to Be Held Until Retirement – This proposal (in its several variants) is one that has not made it to the federal agenda yet. Rather, it has surfaced in shareholder sponsored proposals made to certain companies. It seems to represent a reaction to the

recent financial system meltdown risk and to reflect a view that executives are not sufficiently incentivized to focus on the long-term and enterprise risk if they can monetize their equity compensation before they leave the company. Even if justified in the financial institutions sector (a conclusion that is by no means clear), there is no systemic risk issue supporting applying the proposal to non-financial U.S. public companies. Moreover, an unintended consequence could well be that some number of corporate executives who had significant value imbedded in equity awards simply would leave the company in order to monetize the awards.

Conclusion

As noted in my earlier memorandum, the U.S. free enterprise system has been the most vibrant and competitive in the world over time, notwithstanding significant stumbles. Moreover, also as noted, the very essence of capitalism is that it fosters risk-taking — and “mistakes” will be made. With these thoughts in mind, in the context of pursuing corporate governance “reform” today — which presents real challenges and risks to key underpinnings of U.S. capitalism — it is both prudent and responsible to apply the long-term view of our private enterprise system’s performance and the principle of restraint which that view dictates. In particular, this approach should be applied when assessing “reforms” — whether sponsored on the governmental front or by other proponents — relating to the areas of executive compensation and compensation more generally, which areas are central to the effective functioning of U.S. public companies and, in turn, our economy.