

Recent Trends in Executive Pay

Few corporate governance topics get more public attention than executive pay. Rightly or wrongly, perceived abuses in executive compensation have been cited time and time again for what's wrong on Wall Street and in US business in general, being blamed for everything from the fall of Enron to the global financial crisis of 2008. Federal legislation (such as the Sarbanes-Oxley Act of 2002 and, more recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010) has sought, among other things, to improve transparency, give shareholders a greater voice in executive pay matters, and require compensation recoupment where there has been executive wrongdoing or earnings misstatements. Proxy advisory firms (such as ISS and Glass Lewis) as well as institutional investors have also been successful in shaping the way public companies pay their executives, and in eliminating what they perceive to be abusive or otherwise inappropriate pay practices. In this post we touch briefly on some of more notable trends in executive pay and the issues they raise.

Pay for Performance. Perhaps the single biggest shift in public company executive pay design is the increased emphasis on "pay for performance". Equity-based awards with meaningful performance-related vesting metrics now make up a significant portion of overall executive compensation opportunity. The most commonly-used performance metric is total shareholder return (TSR), no doubt because ISS, the largest proxy advisory firm, uses TSR as its only performance measure. Other financial metrics include profitability (e.g., EPS, net income or EBITDA), capital-efficiency (e.g., ROE, ROIC) and revenue or cash flow.

Interestingly, as the shift to performance-weighted packages has occurred coincident with a period of relative stability and growth in the US financial markets, pay-for-performance has (so far at least) not had a meaningful dampening effect on actual pay levels. It remains to be seen whether these new plan designs will serve as effective compensation and retention packages during a sustained financial downturn.

Double-Trigger Vesting of Equity-Based Awards. Historically, equity plans for public companies provided for immediate and full (i.e., "single trigger") vesting of equity awards upon a sale or merger resulting in a change in control (CIC). There are sound business reasons for single-trigger vesting, namely to assure stability of management during the sale process, and to avoid post-closing disputes as to whether an executive has been constructively terminated. But pressure from proxy advisory firms as well as pay-for-performance shareholder votes mandated by the Dodd-Frank Act have caused many public companies to adopt some form of "double trigger" vesting requirement. In its simplest sense, double-trigger means that vesting occurs only if there is a CIC and the executive's employment is actually or constructively terminated in connection with the CIC. While relatively straightforward for equity awards that vest based on service, double trigger vesting presents difficult design choices for vesting of performance-based awards. For example, how does one translate performance metrics for the target company into comparable performance metrics for the resulting, successor company?

Similarly, when the *number of shares* subject to an award is determined by relative achievement of performance metrics, how does the successor company grant substitute awards without assuming maximum achievement of such metrics in the applicable conversion ratio? These are only some of the plan design challenges that result from the increasingly common shift to double trigger vesting.

Elimination of Golden Parachute Excise Tax Gross-Ups. The Internal Revenue Code imposes a 20% excise tax (and disallows compensation deductions) for certain "excess parachute payments" paid to executives in connection with a CIC. Prior to the financial crisis of 2008, it was fairly common for public companies to provide CEOs (and other executive officers) with an extra payment to "gross them up" and hold them harmless from the excise tax. Remarkably, in a span of just a few years, pressure from proxy advisory firms and institutional shareholders (coupled with mandatory "golden parachute" shareholder votes under Dodd-Frank) have all but eliminated this practice, with the exception of a few legacy agreements. In practical terms, this means that the "excess payments" are now taxed at rates of 60-70%, depending on the executive's exposure to state and local taxes.

There are various mitigation strategies that companies can use to limit the impact of the excise tax without resorting to gross-ups. They include, among others, front loading compensation into years prior to a CIC (e.g., by having an executive exercise vested stock options), allocating compensation to post-closing noncompetition agreements, and capping "parachute payments" so as to avoid imposition of the tax. The relative utility and practicality of such strategies is often dubious and will vary from deal-to-deal. Perhaps not so ironically, the shift towards performance-based vesting conditions (as opposed to service-based conditions) generally makes the excise tax exposure more severe.

Compensation Clawbacks. In part based on their own initiatives, and in part driven by new requirements under Dodd-Frank, most US public companies have adopted (or are in the process of adopting) compensation clawback policies for executive wrongdoing and earnings misstatements. Presently these policies vary widely, though more convergence is expected in light of proposed rules issued by the SEC in 2015. While the final SEC rules will not take full effect for some time, clawbacks are already a reality and are here to stay. Some of the more interesting issues they raise are 1) how the amount of recovery is calculated, 2) how it is collected when payment has already been made, and 3) the proper tax treatment for the executive and the company.

The foregoing is only a brief summary of some of the more notable trends in executive pay. We expect that these and other similar issues will continue to receive significant attention in 2016 and beyond.

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