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# *Spotlight on Change-in-Control Agreements*

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## Today's Speakers



**Peter Gleason** is a director of The Patriot Fund, managing director and CFO of NACD, and Treasurer of the NACD board of directors. He is COO of the Center for Board Leadership, a joint venture between NACD and its six Alliance Partners. Mr. Gleason is also a member of NACD's faculty, and a presenter on corporate governance issues. He is a member of the Executive Advisory Panel of the Open Compliance & Ethics Group.

**Margaret Black** is a Managing Director in the Los Angeles office of Pearl Meyer & Partners and regularly advises clients on executive compensation tax issues, including those related to corporate mergers, acquisitions, divestitures and restructurings.

**Dan Wetzel** is a Managing Director in the Los Angeles office of Pearl Meyer & Partners and advises clients in the areas of executive and board compensation, including compensation design during mergers, acquisitions and IPOs.

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# Agenda



- **Executive Pay – The Evolving Landscape**
  - Major influences affecting the design and implementation of Change-In-Control (CIC) provisions and agreements
- **2008 Proxy Revelations**
  - CIC payments and agreements among the Top 50 US-based companies
- **2009 Trends**
  - Trends in CIC design from 2009 8-K filings for 61 Fortune 500 companies
- **Looking Ahead to 2010**
  - Survey results for 2010 expected actions
- **What We're Seeing**

# Executive Pay – The Evolving Landscape



- **2008 Economic Problems**
- **The “Bailout”**
  - **TARP (Troubled Asset Relief Program) – capital injections for banks, financial institutions**
  - **AIFP – capital injections beyond the banks (i.e., automakers)**
  - **\$\$’s come with “compensation strings”**
    - New executive pay rules for TARP companies outlined in original financial bailout bill (EESA)
    - Includes a prohibition on the payout of any “golden parachute payment” triggered by termination of employment
- **409A Deferred Compensation Amendments**
  - **CIC and severance plans reviewed and amended for compliance by December 31, 2008**
- **A new Presidential Administration arrives in January of 2009**

# Executive Pay – The Evolving Landscape (Cont'd)



- **ARRA (American Recovery and Reinvestment Act) – signed February 17, 2009**
  - **Update to the TARP executive compensation restrictions including:**
    - Prohibition on golden parachute payments for top 10 employees
      - » Now includes payments for departure from a company for any reason in any amount
      - » Prohibition applies to any payment due to a CIC event under 280G or 409A
- **Draft Say on Pay Legislation (H.R. 3269) - introduced in July of 2009**
  - **Mandates Say on Pay for all public companies**
    - Includes a separate advisory vote on golden parachutes in mergers and acquisitions and disclosure of amounts to be received by NEOs as a result of a CIC
    - Bill passed the House on July 31, 2009 and will be considered by the Senate in the fall of 2009
    - Proxy effective date uncertain - 2011 proxy season?

## Executive Pay – The Evolving Landscape (Cont'd)



- **Proposed Changes to SEC Disclosure Rules (Proxies and 8-Ks) – issued in July 2009**
  - **Final rules to be effective for 2010 proxies**
  - **Comment period ended on September 15, 2009**
    - Some public comments have suggested requiring disclosure of full “walk away” numbers
- **Other Proposals**
  - **SEC Proxy Access**
  - **Pending Legislation**
  - **Federal Reserve oversight of banking compensation**



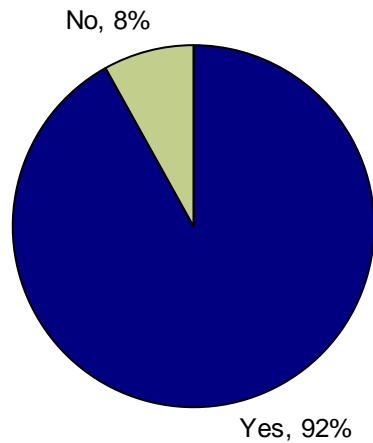
- **Continuing Shareholder Concerns and Activism**
  - **Shareholder proposals relating to severance payments/gross-ups continue**
  - **Riskmetrics Group (Formerly ISS) “Poor Pay Practices” may trigger a recommendation to:**
    - Withhold votes from compensation committee members, the CEO or, potentially, the entire board of directors, or
    - Vote against the approval of equity plans or changes to equity plans that incorporate these practices
  - **“Poor Pay Practices” now specifically include:**
    - New or materially amended severance or CIC arrangements that contain:
      - » Excise tax gross-up provisions of any kind
      - » Single trigger “walk away” rights following a CIC
    - Excessive severance and/or CIC payments, especially those with a multiple in excess of 3X cash pay such as:
      - » Broadly drafted CIC definitions in individual contracts or plans that can result in executives receiving payments without an actual CIC occurring
      - » Single triggered CIC payouts (payouts without loss of job or diminution of job duties)

# 2008 Proxy Revelations

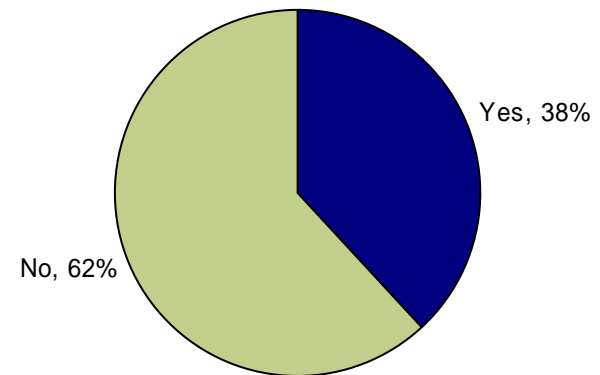


- A majority of the Top 50\* (Non-TARP) U.S. Companies provide benefits upon a CIC and nearly 40% provide excise tax gross-up provisions

Companies with any CIC Arrangement



Gross-Up Among Companies with any CIC Arrangement



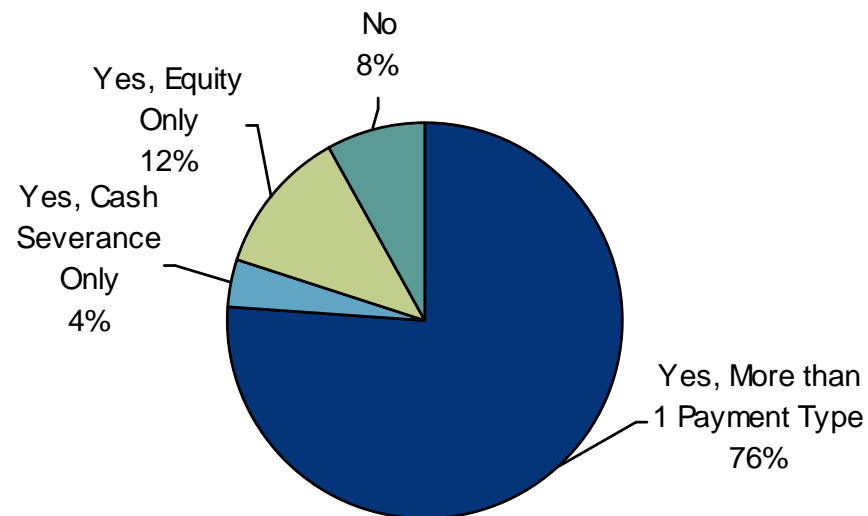
\* Represents the top 50 companies on Fortune's 2009 list excluding financial firms participating in TARP.

## 2008 Proxy Revelations (Cont'd)



- The majority of companies provide equity vesting accompanied by at least one other form of payment or benefit

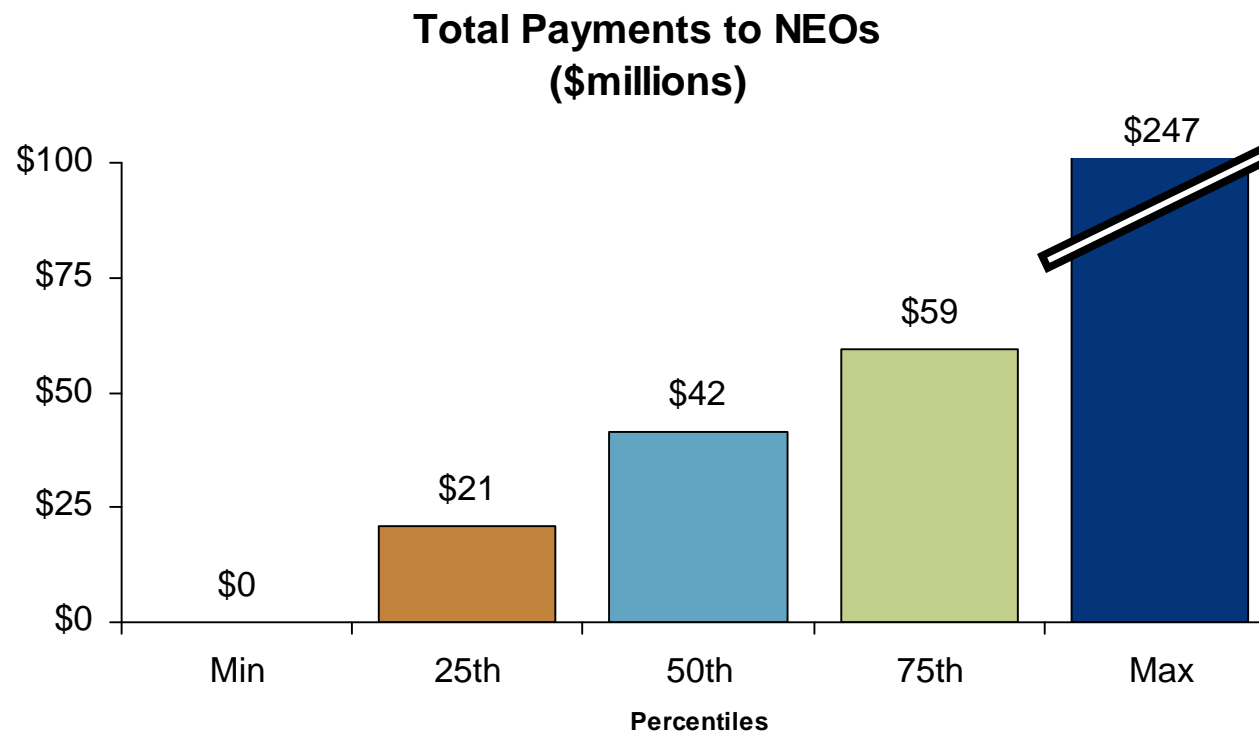
**Prevalence of CIC Provisions**



## 2008 Proxy Revelations (Cont'd)



- Total reported benefits payable upon a CIC and termination for all NEOs was significant with a median payout of \$41.6 million



- These figures do not include significant “take-away” value of other vested benefits such as unexercised stock options and deferred compensation/SERP benefits

## 2008 Proxy Revelations (Cont'd)



- Despite these substantial payment levels, reported payouts continue to reflect a relatively small proportion of companies' net income and market capitalization

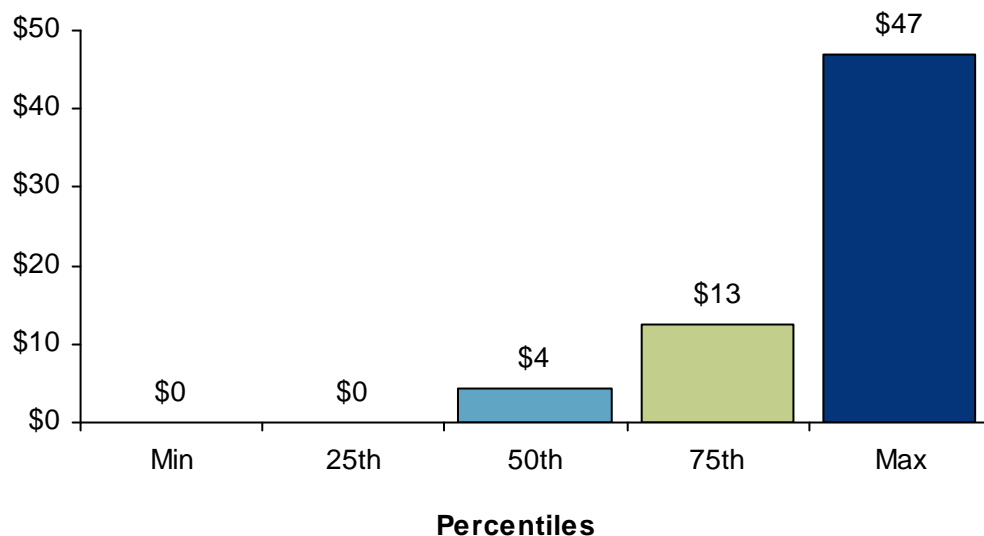
Total Payments as a % of	Percentile			
	25th	50th	Avg.	75th
Net Income	0.55%	1.29%	2.57%	2.86%
Market Cap.	0.05%	0.15%	0.26%	0.27%

## 2008 Proxy Revelations (Cont'd)

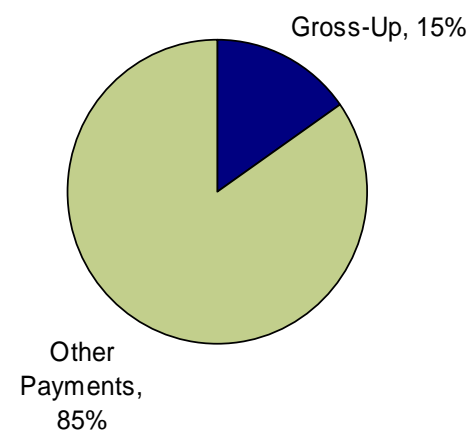


- Among companies providing NEOs with excise tax gross-up protection, the value of excise tax gross-ups varied significantly. The estimated average payment was \$9.2 million, a substantial amount of all payments
  - Two companies eliminated gross-up payments and five others stated that going forward newly elected/hired executives will not receive excise tax gross-up benefits

**Total Gross-Up Payments Where Provided  
(\$millions)**



**Average Gross-Up Payments Where Provided  
as a % of Total**



## 2008 Proxy Revelations (Cont'd)



- In 2008, excise tax gross-ups as a percentage of total CIC payments varied between 0% and 25%

Gross up as a % of Total Payments*	Percentile			
	25th	50th	Avg.	75th
2006	13%	18%	16%	21%
2007	8%	15%	15%	21%
2008	7%	19%	15%	22%

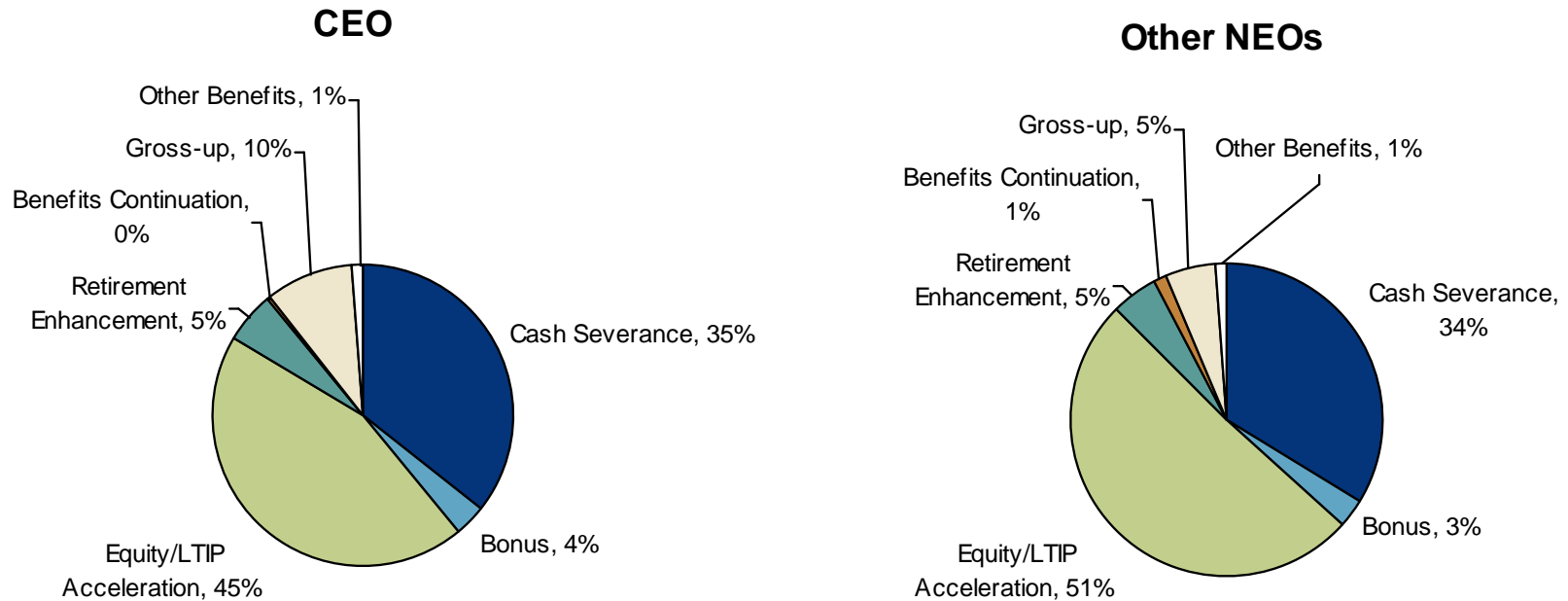
\* Among those companies paying an excise tax gross-up.

# 2008 Proxy Revelations (Cont'd)



- When paid, cash severance and the value of accelerated equity were the most significant components

Average Payout By Component

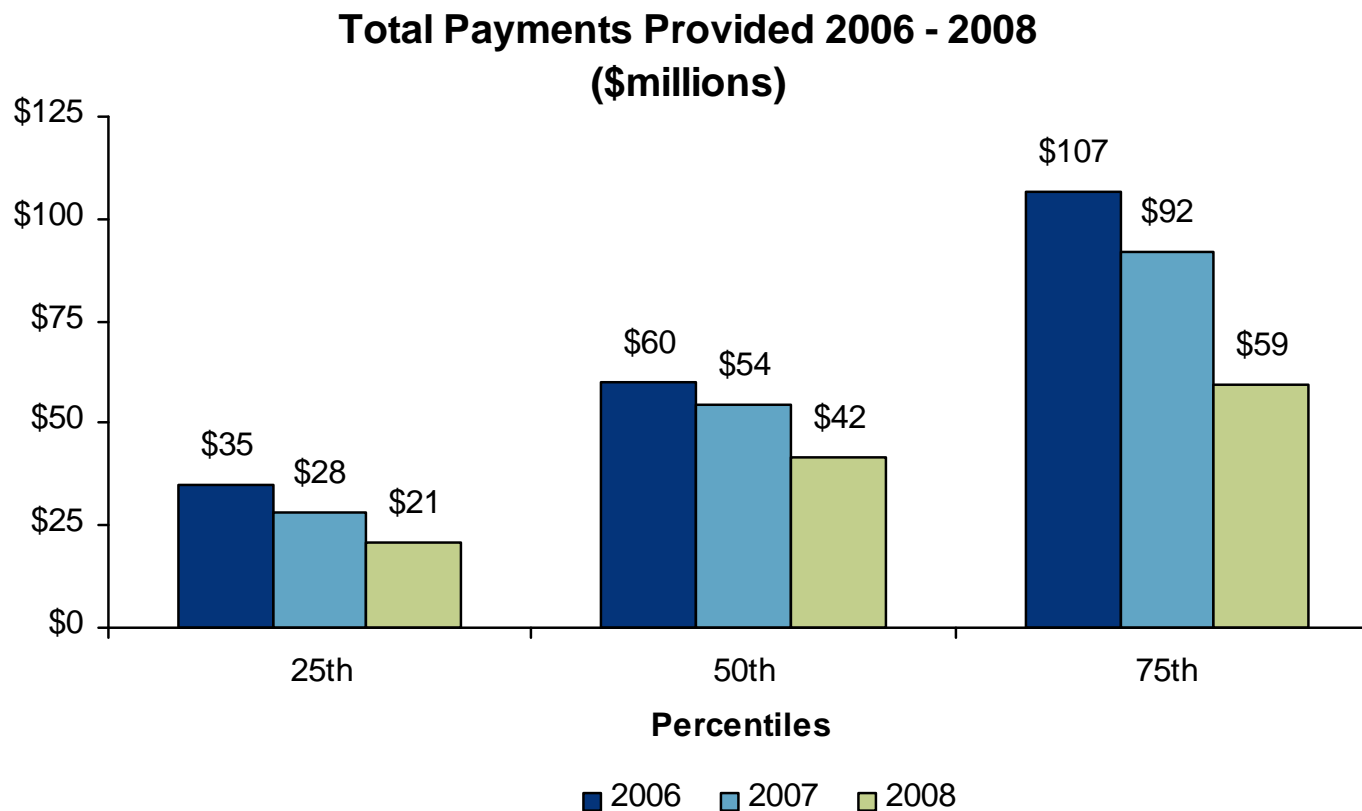


- On average, the proportion of individual types of payments between CEOs and other NEOs is very similar. However, CEOs tend to receive larger excise tax gross-ups as a percentage of total payments than other NEOs

## 2008 Proxy Revelations (Cont'd)



- **Trends in CIC payments (2006-2008)**
  - **Payments have decreased over the past three years due to decreases in stock prices and the elimination or restructuring of certain CIC provisions by some companies**

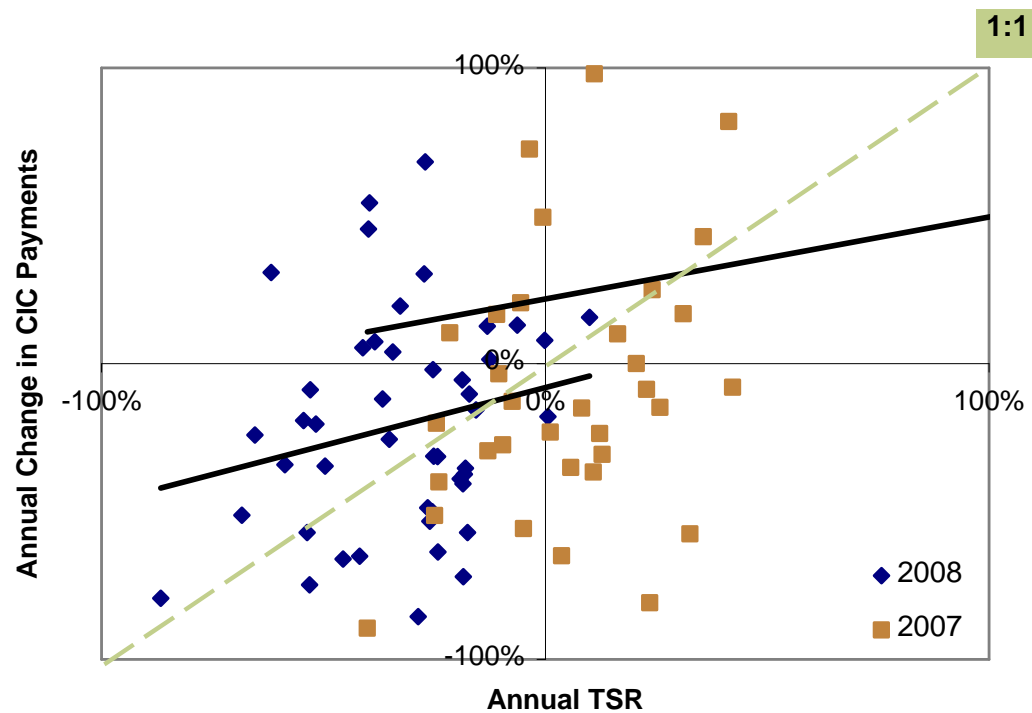


Note: Data in 2006 is based on 44 of the 50 companies which were required to file under the new disclosure regulations.

# 2008 Proxy Revelations (Cont'd)



- Trends in CIC payments (2007 and 2008)
  - Movement in TSR does not translate to a similar movement in total CIC payments due to the fixed cost of certain payments (e.g. cash severance and benefit continuation)
    - Therefore, in years where share prices decline, CIC payouts may not decrease at the same rate

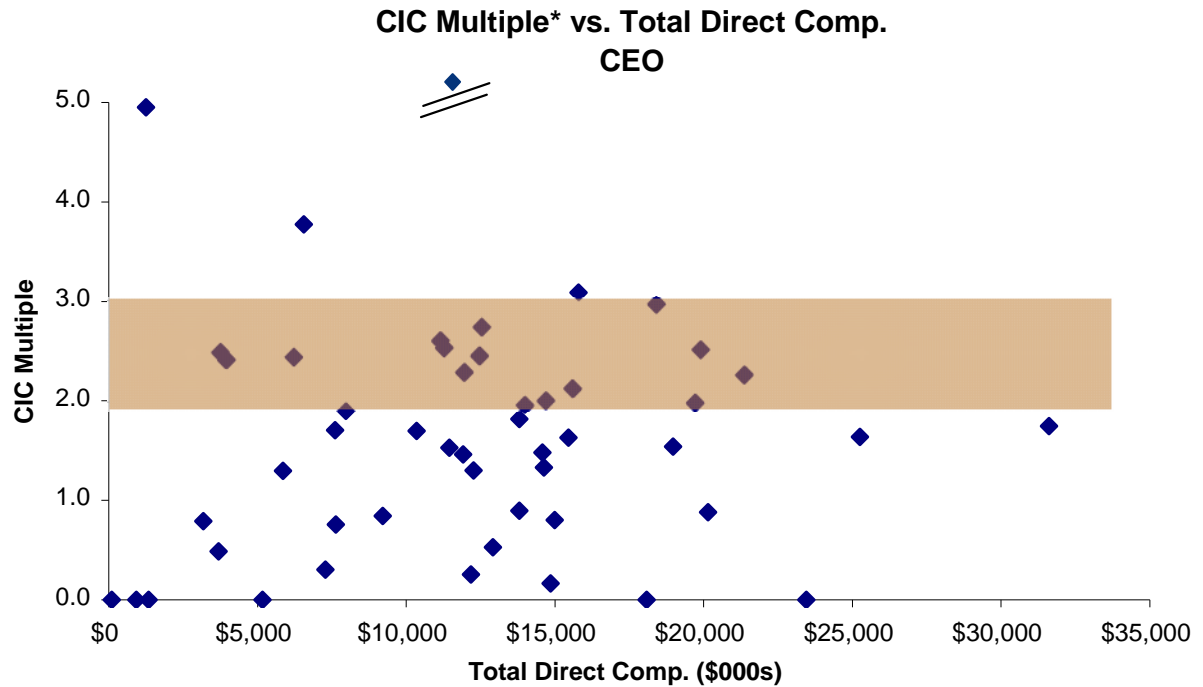


*For illustration purposes, annual change in CIC payments has been capped at 100%.*

# 2008 Proxy Revelations (Cont'd)



- **Total CIC payments as a multiple of Total Direct Compensation**
  - Total CIC payments provided by the majority of companies are less than two to three times the CEO's total direct compensation



\* Total CIC payments including excise tax gross-up as a multiple of total direct compensation.

## 2008 Proxy Revelations (Cont'd)



- **Other Trends**

- **Single Trigger to Double Trigger Equity Accelerations**

- There appears to have been some movement to require both CIC and termination for accelerated vesting of equity
      - » Ten percent of companies have moved to double trigger acceleration over the past two years

- **Self-Imposed Benefit Limitations**

- Despite recent shareholder activism, only 16% of the Top 50 reported a requirement for shareholder approval of CIC or severance benefit payouts in excess of certain limits
    - Among companies with such restrictions, most limit only CIC cash severance benefits, thus still allowing uncapped CIC benefits to be paid under their equity compensation, retirement, deferred compensation or legal assistance programs
      - » The most common restriction for those companies with such limitations is 2.99 times base salary and bonus

## 2009 Trends



- **PM&P identified 61 Fortune 500 companies which made material modifications to CIC benefits from November of 2008 to August of 2009**
  - 32 employment and 29 CIC agreements were reviewed
- **Agreement Terms and Renewal Feature**
  - Terms: Remain two to three years
  - Renewals: Slight decrease in the number of agreements with an evergreen renewal feature
- **Restrictive Covenants**
  - Over half of the agreements continue to include non-compete and/or non-solicitation provisions for an average of two years following termination
- **Good Reason Definitions**
  - There was little change in the way the agreements define a “good reason” termination which entitle an executive to CIC severance benefits



- **CIC Severance Formulas**

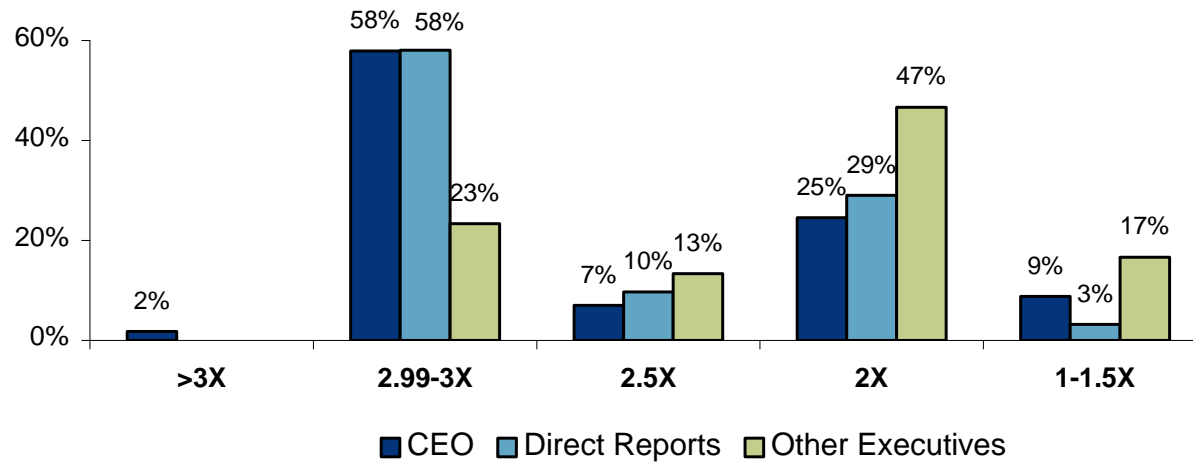
- **Basis:**

- The majority of companies use base salary and annual incentive
    - Only 3% of the companies also use long-term incentives in the severance basis
    - 17% use base salary only

- **Multiples:**

- The most common severance multiple for a CEO and their Direct Reports is 2.99X to 3X and for Other Executives is 2X

**Prevalence of CIC Severance Multiples**



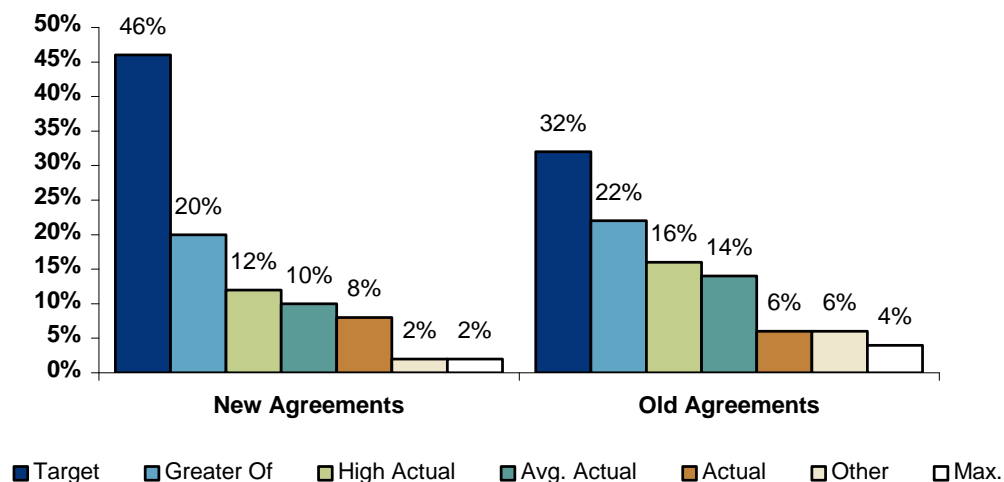


- **CIC Severance Formulas (Cont'd)**

- **Annual Incentive Component of Severance:**

- Typically based on the target bonus opportunity in the year of termination
    - Some use definitions such as prior year actual, maximum, average or highest bonus paid over a period of 3 years
    - There was a significant shift to the use of target annual incentive in lieu of other definitions and a movement away from more executive friendly definitions such as the maximum opportunity or highest paid bonus

**Prevalence of Severance Bonus Basis**





- **Annual Bonus - Termination Year**
  - **The majority of agreements (70%) provide for a pro-rated bonus in the year of termination following a CIC**
  - **Of the agreements with a pro-rated bonus:**
    - The bonus is typically based on the target opportunity in the year of termination (53% of the agreements)
    - 26% used a bonus based on actual results for the year of termination
    - 16% use more executive friendly definitions such as use of the maximum award, highest paid bonus over a period of years, or the greater of target or other definition
    - The remaining provide that the award is discretionary
  - **There was no major shift in the prevalence of the annual bonus paid in the termination year or the basis upon which it is calculated among new and old agreements**
- **Benefit Continuation**
  - **The most common period for continuing benefits in terminations after a CIC followed the severance period or multiple in the agreement**
  - **However, some agreements decreased the period to the 18 month COBRA continuation coverage period**



- **Treatment of Excise Taxes**

- **Over 10% of the agreements reviewed eliminated excise tax gross-up provisions**

- Where excise tax gross-ups were eliminated, the majority are now silent on the handling of excise taxes. Others now contain:
      - » Best after-tax provisions (i.e., an executive will be scaled back to the golden parachute safe harbor if better off on an after-tax basis), or
      - » Require a reduction of payments to the golden parachute safe harbor

- **More than 50% continue to provide a gross-up**

- Among those companies providing a gross-up, 42% use an efficient gross-up

Excise Taxes	New	Old
Gross-up	36%	49%
Efficient Gross-up (Avg. 110%)	26%	25%
Pays Excise Tax	0%	2%
Best After Tax	18%	10%
Scaleback	5%	3%
None	15%	11%

- **One company added an excise tax gross-up provision**

# Looking Ahead to 2010



- PM&P launched an online survey “Looking Ahead to Executive Pay Practices in 2010” to assess critical executive pay topics, including anticipated changes to severance and CIC plans and benefits. Initial findings include:**

- **Changes in Cash Severance\***

	Increase	Decrease	Introduce
Will Likely	1%	1%	10%
Have Not Considered	96%	91%	87%

- **Equity Acceleration Provisions\***

	Move Double to Single	Introduce Double Trigger	Move Single to Double
Will Likely	3%	3%	3%
Have Not Considered	96%	92%	91%

- **Excise Tax Modifications\***

	Increase	Decrease
Will Likely	3%	9%
Have Not Considered	92%	79%

\*Prevalence excludes those companies implementing changes in 2009 and those not likely to implement changes in 2010.



## ▪ **Severance**

- **As is evidenced by the Fortune 50 study, review of 8-K filings in 2009 and our experience, multiples of 2X-3X compensation and benefits following a CIC for large company NEOs remain the most common**
- **Some of the more generous severance provisions are becoming less commonplace. This includes the following practices:**
  - Voluntary “walk-away” provisions following a CIC
  - Multiples in excess of 3x base salary and bonus
  - Use of long-term components when computing severance
  - Use of maximum or highest bonus over a period of years as the bonus component
  - Enhanced retirement benefits
- **Some companies are providing a fixed dollar amount (as opposed to a formulaic benefit)**
- **Boards are beginning to review the appropriateness of paying severance on a case by case basis**
  - For example, if executives have significant pension or equity benefits, the payment of severance may not be perceived to be necessary



- **Excise Tax Gross-Ups Provisions**
  - **RiskMetrics characterization of gross-ups as a “Poor Pay Practice” has significantly increased the attention by compensation committee members on these provisions**
  - **Some companies have managed to successfully renegotiate contracts with all executives to remove these provisions**
    - In our experience, a CEO’s support for the removal of the gross-ups was influential
    - Some quid pro quo was often provided:
      - » For example, the severance multiple increased slightly, a new LTI plan was put in place, the benefits coverage period increased, etc.
    - Company policies that reduced taxable pay were often discontinued
      - » For example, encouragement to defer pay or to discourage option exercises ended
  - **Many companies are grandfathering existing contracts and barring future agreements from including gross-up provisions for the time being**
    - This may be a “band aid” fix. If a contract is materially amended, the compensation committee members may face negative consequences from RiskMetrics or other institutional shareholders if the gross-up provision is maintained



- **Excise Tax Gross-Ups Provisions (Cont'd)**
  - **A few companies have successfully implemented new excise tax gross-ups**
    - In one case, the approval was as a result of an impending hostile takeover bid. The gross-up contained sunset provisions and would not be effective if the bid was not successful
    - In a few other instances, the potential dollar value of excise tax gross-ups was capped
    - In all of these instances, the companies are not dependent on proxy advisor support and expect to communicate separately with their major shareholders to mitigate any negative repercussions
- **Equity Acceleration**
  - **There appears to be a movement to require both CIC and termination**
  - **Some companies have implemented partial single trigger equity acceleration, with full acceleration upon termination without cause**
    - These companies also expect to communicate separately with their major shareholders

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Please feel free to direct additional questions regarding this presentation to:

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