



## **CHECKLIST OF POINTS TO CONSIDER IN NEGOTIATING EXECUTIVE COMPENSATION ARRANGEMENTS**

### **PHILOSOPHY OF COMPENSATION FOR KEY EXECUTIVES**

Now that the issues of corruption surrounding Enron, Tyco and World Com, just to name a few companies, are hopefully behind us, many publicly and privately held companies are again focusing on a primary business objective of maximizing shareholder value over the long term. To accomplish this objective, many companies have developed comprehensive business strategies that emphasize maximizing earnings and stock value, continuing their leadership in those markets in which the companies participate, and providing products and services of the highest value.

To facilitate the achievement of such companies' business strategies, appropriate compensation policies are essential. Among the policies available for this purpose are the following:

- Ensure that a significant amount of pay for key executives consists of long term, at-risk pay to focus senior management on the long term interests of stockholders and to balance short-term and long-term business and financial strategic goals.
- Emphasize variable, at-risk compensation that is dependent upon the level of success in meeting specific corporate performance goals.
- Provide compensation arrangements with key executives which align the executives' interests with those of stockholders.
- Enhance the company's ability to attract, retain and encourage the development of exceptionally knowledgeable and experienced executives through compensation opportunities.

- Target compensation levels at rates that are reflective of current market practices to maintain a stable, successful management team.

To aid in the achievement of the company's strategic goals, the compensation arrangement must carefully match the executive's needs and expectations with the company's needs, expectations and financial constraints, so that the executive will be challenged to perform at an optimal level. At the same time the company must be assured, to the extent possible, that its strategic goals are understood and endorsed by the executive and will be energetically and enthusiastically advanced. To accomplish this, the company must be clear what it wants from the executive, how to get it, and how much to pay for it and in what form.

The meeting of minds between the executive and the company is hopefully the beginning of what should be a long-term relationship. Like all good marriages, however, the one between executive and company will require continued effort on both sides. In many instances, the implementation of the compensation arrangement will also require the assistance of accountants, attorneys, consultants and other professionals.

To aid our clients we have included on the following pages a list of points to consider when starting the process of designing, negotiating and implementing successful employment and compensation arrangement with key executives.

## PROVISIONS/POINTS TO CONSIDER

- 1. Term of Agreement of Employment**
  - (a) Fixed nonrenewable term, e.g., 2 or 3 years
  - (b) Renewing term – "evergreen"
    - (i) daily renewing until notice given
    - (ii) renewing for successive 1 or 2 year periods if notice not given at least 1 year prior to end of initial term
    - (iii) Until attainment of specified age, e.g. 62 or 65
- 2. Position, Duties, Responsibilities, etc**
  - (a) Title, position, experience level, scope and complexity of position
  - (b) Duties and responsibilities
  - (c) Seat on board of directors?
  - (d) Reporting relationship: to board of directors or to specified individual
  - (e) Work latitude
    - (i) service on outside board
    - (ii) charitable activities
    - (iii) management of personal investments
- 3. Base Salary**
  - (a) Annual dollar amount
  - (b) Annual review for increase or decrease by board – driven primarily by individual performance
  - (c) Use of Cost of Living Adjustments (COLA); appropriate benchmark
  - (d) Performance related based on sustained levels of individual contribution
  - (e) Obtaining of independent surveys to determine base compensation levels
  - (f) Observance of IRC §162(m) limitation of \$1,000,000 of compensation that may be deducted by a company in any year with respect to the company's CEO and its four other highest paid executive officers
- 4. Bonus/Annual Incentives**
  - (a) Sign-on bonus to balance loss in leaving another company
  - (b) Fixed guaranteed amount – for how long?
  - (c) Stated percentage of salary

- (d) Discretionary with board
- (e) Performance-related – based on increase in
  - (i) earnings per share
  - (ii) after-tax profit
  - (iii) return on equity
  - (iv) return on net capital employed
  - (v) achievement of certain stock price or value
  - (vi) percentage of sales
  - (vii) other corporate, business unit and individual performance goals
- (f) Opportunity to defer
  - (i) period of deferral
  - (ii) rate of return on deferred amounts
  - (iii) security arrangements for deferred bonus – "rabbis" or secular trust, surety bond, etc.

## **5. Long-term Incentive Compensation**

- (a) Usually comprises largest portion of executive's total compensation package
- (b) Designed to motivate management to achieve a high level of long term performance
- (c) Long term incentives should link executive compensation to long term shareholder value
- (d) General types of long term incentives
  - (i) stock options – fair market value, below market or premium price (monitor proposed accounting rule requiring options to be treated as an expense which might require expensing at date of grant)
  - (ii) restricted stock
  - (iii) phantom stock, performance stock, bonus stock
  - (iv) stock appreciation rights
  - (v) cash awards

## **6. Employee Benefits**

- (a) Regular company-sponsored plans
  - (i) pension
  - (ii) medical

- (iii) long-term disability
- (iv) travel accident and accidental death
- (v) term life
- (b) Supplemental plan
  - (i) retirement – funded or unfunded, purchase of annuities, etc.
  - (ii) long-term disability – insured or uninsured
  - (iii) special executive medical
  - (iv) life insurance, amount, type of policy, etc.
  - (v) use of "portable" (i.e., individually owned) benefits

**7. Perquisites**

- (a) Estate planning, tax preparation and financial counseling
- (b) Car and driver
- (c) Aircraft
- (d) Club memberships
- (e) Annual physical

**8. Termination of Employment/Consequences**

- (a) Death
  - (i) Continuation of salary – for what period?
  - (ii) Payment of partial bonus
  - (iii) Acceleration of stock options
  - (iv) Acceleration of long-term incentive
  - (v) Continuation of special medical benefits for surviving spouse and children; if yes, for how long?
- (b) Disability
  - (i) Definition of "disability"
  - (ii) special definition
    - (1) definition in regular long term disability (LTD) plan
    - (2) Continuation of salary – for what period?
  - (iii) Payment of partial bonus
  - (iv) Acceleration of stock options
  - (v) Acceleration of long-term incentive
  - (vi) Level of LTD benefits
    - (1) 60% - 65% of salary or salary and bonus

- (2) insure or self insure
  - (vii) Continuation of life insurance
  - (viii) Continuation of special medical benefits for spouse and children
- (c) Termination for Cause
  - (i) Definition of "cause"
    - (1) indictment or conviction of a felony
    - (2) negligent conduct causing material harm to the company
  - (ii) "Due process" right to appear before the board with counsel before termination
  - (iii) Opportunity to correct
- (d) Termination Without Cause
  - (i) Include termination by executive for "good reason"
    - (1) decrease in salary
    - (2) decrease in bonus opportunity
    - (3) decrease in benefits
    - (4) change in title, responsibilities or duties
  - (ii) Opportunity for company to correct
  - (iii) Entitlement
    - (1) salary and bonus to end of term but not less than a minimum number nor more than a maximum number of months
    - (2) continuation of medical and disability benefits; if yes, for how long or economic equivalent?
    - (3) continuation of life insurance
    - (4) acceleration of options and long-term incentive
  - (iv) Obligation to set off against subsequent earning or partial set-off?
  - (v) Obligation to seek new employment?
- (e) Following a Change in Control
  - (i) Definition of "change in control"
  - (ii) Entitlement: lump-sum payment equal to compensation that executive would receive following a termination without cause

- (1) exception for medical and disability benefits – to be continued for term of employment
- (2) continuation of life insurance
- (iii) If payment not in lump sum, provide security for post-termination payments
- (iv) "Golden parachute" problems:
  - (1) tax gross-up – whole or partial
  - (2) IRC §280G cap
  - (3) no cap
- (f) Voluntary
  - (i) Liquidated damages for early termination

## **9. Restrictions on Competition**

- (a) Definition of "competition" or competing entity
- (b) Duration of restrictions
  - (i) specified time
  - (ii) applicable only while receiving post-termination compensation?
- (c) Geographic limits of restriction
- (d) Limitation of passive investment
- (e) Restrictions vanish if executive elects to forgo post-termination compensation and benefits?
- (f) Remedies
  - (i) limited to cessation of post-termination compensation and benefits?
  - (ii) injunctive relief?

## **10. "No Raid" Provisions**

- (a) Duration
- (b) Present employees of the company only?
- (c) Customers of the company?
  - (i) Applicable to subsidiary or affiliated business?

## **11. Nondisclosure of Confidential Information**

- (a) Definition of "confidential information", e.g., financial and marketing plans, etc.
- (b) Return of documents

**12. Resolution of Disputes**

- (a) Internal settlement mechanism
- (b) Arbitration, including who pays cost?
- (c) Litigation

**13. Indemnification/Officer and Directors**

- (a) Provide in separate agreement
- (b) Review the company's charter, by-laws and existing arrangements
- (c) Require purchase of directors' and officers' liability insurance

With so much to consider in the designing and negotiating successful employment and compensation arrangements, please give us a call if you have any questions or if we can be of any assistance to you in the executive compensation area.

*“Taking Stock” is presented for general informational purposes only, is not intended as legal advice, and cannot substitute for advice of counsel. If you would like to speak with an attorney at Gould & Ratner regarding the topic presented in this article, please contact Tom Korman at 312/899-1608 or [tkorman@gouldratner.com](mailto:tkorman@gouldratner.com).*