

# CORPORATE AND SECURITIES LAW UPDATE

Essential legal alerts for the business community



## EXECUTIVE COMPENSATION:

### WHAT THE SEC WANTS YOU TO DISCLOSE IN YOUR PROXY STATEMENT

The SEC is looking hard at public companies' executive compensation disclosures, and in many cases it isn't happy with what it sees. That means change is in the wind—at first, probably in the form of staff comments and maybe some enforcement actions. Beyond that, changes in the formal rules appear to be a real possibility.

#### Enforcement Action Against GE

The SEC got everyone's attention last September when it brought and simultaneously settled an enforcement action against General Electric Company. In a cease-and-desist order consented to by GE, the Commission found it had violated the proxy and reporting provisions of the Securities Exchange Act of 1934 by not adequately disclosing the benefits to which its chairman would be entitled after retirement under an agreement made with him in 1996. GE's proxy statements (which were incorporated by reference into its 10-K's) all correctly disclosed that the agreement entitled the chairman to lifetime access to the company services and facilities then being made available to him, and a copy of the agreement was on file as an exhibit to a 10-K. So what was the problem? The Commission found that GE had failed to satisfy its obligation to fully and adequately describe the benefits payable under the agreement because it didn't disclose any details about the benefits (which included use of the company's airplanes and a home security system) or their cost (about \$2.5 million in the first year of the chairman's retirement).

#### Director Beller's Speech

Late last year, Allan Beller, Director of the Commission's Division of Corporate Finance, made a widely noted speech calling for changes in the way public companies disclose their executives' compensation and benefits, particularly disclosures about perks, SERPS, and severance benefits and the compensation committee's report. It appears the Division's interest in this subject is being sparked by a few notorious cases (the lavish benefits for GE's retired chairman, David Grasso's severance package from the NYSE, and of course the scandal at Tyco), as well as by the closer scrutiny compensation disclosures are receiving from shareholder advocacy groups.

#### Not Missing the Forest for the Trees

Item 402 of Regulation S-K, adopted more or less in its current form in 1992, provides detailed and highly structured requirements for disclosures about executive compensation, largely in the form of mandatory tables with specified formats. However, according to Mr. Beller, too many companies are complying with Item 402's detailed provisions but ignoring its overriding general requirement for "clear, concise and understandable disclosure of all plan and non-plan compensation" awarded to executives. The Commission still wants the tables, of course, but it also wants disclosure that readers can understand. (continued)

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## Perquisites

The SEC staff expects to see a perk disclosure in every proxy statement, whether or not the total amount exceeds the threshold for including perks in the summary compensation table. The staff seems particularly interested in executives' use of company planes, cars, and apartments and home security systems. A policy requiring top executives to fly only in company planes or to have company-provided home security systems doesn't make the benefit not a perk. Rather, the test is whether it's widely available to employees in general (such as reimbursement for business related cab fare) or reserved for the select few. Perks should be valued at their incremental cost to the company, not at the value used for tax purposes.

Does your company eschew executive perks? Then consider disclosing that fact, as Intel did in its proxy statement last year:

Intel seeks to maintain an egalitarian culture in its facilities and operations. Officers are not entitled to operate under different standards than other Intel employees. We do not provide officers with reserved parking spaces or separate dining or other facilities, nor do we have programs for providing personal-benefit perquisites to officers, such as permanent lodging or defraying the cost of personal entertainment or family travel.

## Supplemental Retirement Plan Benefits

Item 402 requires a pension and SERP table, but it's often hard to tell what executives really will receive. Some lawyers are recommending that clients disclose both a lump sum present value

and a realistic projected annual payout for each named executive.

## Severance Benefits

Companies should consider disclosing everything each named executive would receive if he or she were to retire at some point in the near future, such as the end of the current fiscal year. This would include severance pay, perks, SERP benefits, and everything else. Executives do leave, and shareholders shouldn't have to be surprised at the cost. (Recall the excitement about the \$187 million severance package received by the former NYSE chairman.) If the executives have change-in-control agreements, companies should consider disclosing the total dollar amounts executives would receive under various scenarios.

Remember too that even if your company doesn't have severance agreements with top executives, if it has a "policy" (that is, a history) of always giving them two years' pay, for example, the staff would consider the policy a "plan" that should be disclosed.

## Compensation Committee Report

Many companies have settled into a comfortable pattern in their compensation committee reports, changing them little from year to year. However, shareholder advocacy groups are concerned about the "Lake Woebegone" effect, where companies hire consultants to report on average compensation among their peers and then conclude that *their* executives are above average, which of course raises the average for next year, and so on. As a result, some of these groups are calling

- prepare a “tally sheet,” on which they tally up *all* executive compensation;
- make a determination as to whether or not total compensation is excessive and adjust it if need be; and
- finally, report on these activities in its report in the proxy statement.

Some commentators have even suggested standard paragraphs covering these matters that they recommend including in all compensation committee reports.

The SEC staff seems generally to be in agreement with many of these ideas, though standardized paragraphs would fly in the face of the instruction for the report in Item 402 that states: “Boilerplate language should be avoided . . .” Nevertheless, the staff thinks committees should take a fresh look at their reports and review the staff’s most recent (1993) guidance on the subject, which it believes is still good today.

### Possible Changes in Disclosure Rules

In his speech, CorpFin Director Beller said the staff is in the early stages of considering what rule changes they might recommend to the Commission. Some of the things they’re looking at are:

- *Perks.* What benefits should be classified as perks, and is incremental cost the best way to value them?
- *SERP* disclosure.
- *A requirement to disclose “total compensation.”* Many investors would be interested in such a disclosure,

but it may be too hard to formulate how to compute it.

- *Named executive officers.* Should the CFO and general counsel always be included, even if they aren’t among the top five in compensation?
- *Director compensation.* Should the required disclosure be expanded?
- *Compensation committee report.* Should it continue to be excluded from being considered “filed” or incorporated by reference into registration statements on Forms S-3 or S-8 (and thus continue to be excluded from the potential liability relating to filed documents and information in registration statements)?
- *Related party disclosures.* The rules in S-K Item 404 are very old and may need revamping.

It appears the Commission will be receptive to suggestions along these lines. In an interview published in *The Wall Street Journal* on February 10, SEC Chairman William Donaldson said the current Item 402 structure “obfuscates the total package” and that he “will push for better disclosure so investors know exactly how much chief executives and other corporate officials are getting.”

### Conclusion

As of this writing, it appears some companies will make serious efforts to improve their compensation disclosures this year, while others (perhaps not wishing to risk being on the cutting edge) will take a wait-and-see attitude before making changes. Exactly how the developments discussed above will play out is still anyone’s guess, but change is definitely on the way.

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## MICHIGAN BUSINESS CORPORATION ACT AMENDMENTS PROPOSED

The Corporate Laws Committee of the Michigan State Bar Business Law Section has recommended amendments to the Act that would:

- make documents filed with the Administrator effective as of the date received rather than on the date the Administrator completes its review (already being done informally);
- permit public companies to send notices of shareholder meetings by third-class mail, potentially saving some of them thousands of dollars in postage costs and conforming our law with that of Delaware and most other states;
- permit “householding” (mailing a single meeting notice and annual report to a household with multiple shareholders if the shareholders have consented);
- clarify that corporations have the authority to guarantee debts of wholly-owned limited liability company subsidiaries;
- provide that “willful and oppressive conduct,” for purposes of a minority shareholder action, may include unfair termination of a shareholder’s employment or disproportionate reductions in his or her distributions;
- permit board committees to create subcommittees;
- require board action for articles amendments, conforming our law with that of Delaware and most other states; and
- repeal Chapter 7B, the “Control Share Act.”

A draft of the proposed amendments is under review by the Legislative Services Bureau.

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