

A Director's Guide to EXECUTIVE COMPENSATION



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CEO Compensation Trends

Monitoring the historical trends in executive compensation can provide insight into future developments in executive compensation. Paying close attention to the trends in compensation that are being monitored helps companies, directors, officers and legal and compensation advisors understand what is important to the public, shareholders and shareholder advisory groups; which, in turn, helps them avoid adverse reactions to their compensation practices.

The following outlines some of the recent trends in CEO pay in Canada and the U.S.

CEO Compensation in Canada

The Globe and Mail recently released its report on Canada's Highest Paid Executives for 2010.¹ The survey ranks the compensation paid in fiscal 2010 to the CEOs of the 100 largest public companies measured by market capitalization in the S&P/TSX composite index as of December 31, 2010. Based on this report, the following trends in 2010 were noted in respect of CEOs on the job for all of 2009 and 2010:

- \$6 million = average CEO total pay, up

13% from 2009

- \$938,995 = average CEO base salary, up 4% from 2009
- \$1.6 million = average CEO bonus, up 21% from 2009
- \$7.6 million = median value of all unexercised in-the-money stock options held by CEO at year end, up 97%
- \$13 million = median value of equity – shares and vested units – owned by CEO, up 40%
- \$9 million = median estimated cost to fund CEO's traditional defined benefit pension plan, up 39%

The report notes that the 2010 double-digit gains for CEOs, commonly seen the decade before the economic crisis, came on the heels of only two years of weaknesses in 2008 and 2009, when CEO compensation fell by 5% and rose by less than 1%, respectively.

In a seemingly rare, frank comment on executive compensation, Claude Lamoureux, who sits on the boards of five public companies, commented that the process of truly linking pay and performance remains "a work in progress" for many companies and added, "A lot of times I think the relationship between performance and pay is hard to see."

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

This newsletter outlines some of the recent trends in CEO pay in Canada and the U.S. It also describes the automatic securities disposition plan recently adopted by a senior executive at RIM. In addition, I am pleased to include a commentary on the obligation to advance funds to directors and officers under a D&O indemnity agreement, by Ms. Rebecca Gosevitz, a commercial litigation lawyer at Davis LLP, a leading full service law firm with offices across Canada and in Japan. — Nadine Côté LL.B.

D&O Indemnity: The Obligation to Advance Funds

When a company's directors and officers are subject to legal proceedings in connection with the performance of their duties, it is critical that they be able to draw upon their directors and officers indemnity (D&O Indemnity) to fund their defence. Recently, it was determined that a company had an obligation to advance funds to its directors and officers even before determining the issue of whether the company had an obligation to indemnify them.

In *John Anthony Bennett v. Bennett Environmental Inc.*, 2010 ONSC 6030, the Ontario Superior Court of Justice (Commercial List) ordered Bennett Environmental Inc. (BEI) to advance funds to John Bennett, BEI's former Chief Executive Officer and Chairman of the Board, to fund legal costs reasonably incurred by Mr. Bennett in defending himself against fraud charges in the United States. The charges against Mr. Bennett stemmed from his alleged role in the misconduct relating to BEI's efforts to secure contracts in New Jersey for the thermal remediation of contaminated soil. BEI and other former employees of BEI had already pleaded guilty to similar charges. However, Mr. Bennett maintained his innocence.

Like many companies incorporated under the *Canada Business Corporations Act (CBCA)*, BEI has a company by-law requiring it to both "indemnify" directors and officers for claims made against them in carrying-out their duties, and to "advance" funds to enable them to pay for their defence. Both the *CBCA* and BEI's by-law require that the following conditions be met before indemnification or advancement can occur:

1. the director or officer must have acted honestly and in good faith with a view to the best interests of the company; and
2. in the case of a criminal or administrative proceeding that is enforced by a monetary penalty, the director or officer must have had reasonable grounds for believing that his or her conduct was lawful.

Mr. Bennett requested BEI to indemnify him, but BEI refused. As such, Mr. Bennett brought an application for indemnification pursuant to section 124 of the *CBCA* and BEI's by-law. In response, BEI brought a motion to stay the application. BEI argued that it could not effectively respond until the criminal proceedings had ended and witnesses could be summonsed to testify in Canada without objection from the U.S. authorities. In support of its argument for a stay, BEI presented evidence that it claimed constituted a "prima facie case" that Mr. Bennett was involved in the alleged criminal conduct. In essence, BEI argued that, unless and until Mr. Bennett is acquitted,

he should not be indemnified.

As a result of the position taken by BEI in its motion, Mr. Bennett brought a cross-motion also pursuant to section 124 of the *CBCA* and BEI's by-law, seeking immediate advancement of funds to cover his ongoing legal costs. As required by the *CBCA* and BEI's by-law, Mr. Bennett also undertook to repay any funds advanced if it was ultimately determined by a court that he did not meet the conditions described above for being indemnified.

Case law in Canada has long recognized that a company must fulfil its director and officer indemnity obligations, unless the company can establish that the director or officer did not act honestly and in good faith with a view to the best interests of the company. The onus of proof is on the company. In *Bennett*, the Court in Ontario considered for the first time if a company had to advance funds to a director or officer pending a determination of whether the company was, in fact, obliged to indemnify that person.

The Court confirmed that the test for advancement is no different than the test for indemnification. The Court held that BEI must advance funds to Mr. Bennett, unless it could establish on a balance of probabilities that Mr. Bennett had not acted in good faith. The Court concluded that BEI had not met this onus. As a result, BEI was required to advance funds to Mr. Bennett, subject to Mr. Bennett's undertaking to repay such advances if it is ultimately decided that he was not entitled to indemnification. BEI is seeking leave to appeal this decision.

As the General Editor, I would like to comment that the Court's decision on the issue of advancement reflects the importance of protecting the interests of directors and officers in carrying-out of their duties. Had the Court decided otherwise, directors and officers could have found themselves facing significant personal financial exposure when defending claims brought against them in their capacity as directors and officers - effectively defeating the purpose of D&O Indemnity. Moreover, the decision could have had a chilling effect on the willingness of directors and officers to assume their positions and make decisions that may be disliked by some, but in the best interests of the companies they serve.

Thanks for the contribution of Rebecca Gosevitz, a lawyer at Davis LLP, specializing in commercial litigation. Ms. Gosevitz was co-counsel who successfully represented Mr. Bennett in his application and the related motions. Davis LLP is a leading full-service law firm providing comprehensive legal services to clients through offices across Canada and in Japan.



Agrium Inc. is attempting to develop a stronger link between pay and performance. Agrium Inc.'s Chairman acknowledged that rising commodity prices and improving economic factors can boost executive compensation, regardless of an individual's performance. As such, Agrium Inc.'s performance share units pay out if the firm meets growth targets compared to a selected group of other North American chemical and fertilizer companies over a three-year cycle. Adding performance hurdles to stock options and share units is consistent with the approach to compensation promoted by the Canadian Coalition for Good Governance, a group

representing Canada's largest institutional investors.

CEO Compensation in the U.S.

Total Compensation

Equilar Inc., an executive compensation research firm, has released its latest report on CEO pay trends in the S&P 500, an index of 500 large cap common stocks actively traded in the U.S. After pay declines in 2008 and 2009, Equilar Inc.'s report notes the following:

- \$9 million was the median total compensation of CEOs in 2010, a 28.2% increase from 2009
- \$2.15 million was the median CEO

bonus

- 85.1% of CEOs received an annual bonus in 2010, up from 73.6% in 2009
- Stock options were the most common type of equity award, but performance shares and restricted stock were on the rise
- Stock-based awards and bonus payouts became a larger part of the pay mix, at 38.2% and 27.2%, respectively, of total 2010 pay²

Annual Incentive

Equilar Inc. also released its more detailed survey results of U.S. CEO annual incentive payouts in the S&P 500. Pursuant to Equilar Inc.'s report:



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- Annual incentive payouts increased by 45% from 2009 to 2010
- The percentage of CEOs that received at least a target payout increased from 54% in 2009 to 79% in 2010
- Over 42% of CEOs received a payout of 1.5 times target when net income or earnings per share was included as a metric in the incentive plan³

CEO Pay vs TSR

Equilar Inc. also tracked CEO pay versus total shareholder return (TSR) in the S&P 1500, which is a composite of three indices: the S&P 500, S&P Mid-Cap 400 and S&P SmallCap 600. Equilar Inc. noted that TSR is one of the most important facts proxy-advisory firms consider in making their voting recommendations. The report's findings include:

- 23.9% of firms increased their CEO's pay, despite below-median TSR, in the past year
- 30.0% of firms increased their CEO's pay, despite below-median TSR, in the

past three years

- Almost all companies studied increased their CEO's base salary from 2006 to 2009, even if the CEO's total compensation went down.⁴

RIM's Automatic Securities Disposition Plan

In the Spring 2011 Newsletter, Michael Bowen of CIBC Wood Gundy commented on automatic securities disposition plans (ASDPs). As a follow-up note on this topic, on April 1, 2011, Research In Motion Limited (RIM) announced that its Chief Technology Officer, Software had adopted a new ASDP to facilitate the sale of 120,000 shares over two years. Dispositions pursuant to this ASDP will be reported in accordance with applicable Canadian securities laws. RIM insiders are exempt from filing insider reports under U.S. securities laws.

RIM noted that it has additional mea-

sures designed to conform with "best practices" relating to ASDPs. These include:

- ASDPs may only be adopted during a trading window
- A waiting period of three months will generally be required between the adoption of the ASDP and the first disposition under the ASDP
- An ASDP should generally have a duration of 12-24 months
- An ASDP must contain meaningful restrictions on the ability of the insider to modify or terminate the ASDP
- The ASDP should generally provide for regular sales of smaller amounts (relative to an insider's holdings) over a period of time rather than a large sale during a short period of time after the adoption of the ASDP

In addition, RIM's Insider Trading Policy requires all ASDPs to be pre-cleared by its Compensation, Nomination and Governance Committee of the Board of Directors.⁵

1. Janet McFarland, "Canadian Special Report: Canada's Highest Paid Executives" The Globe and Mail (30 May 2010) B1 and B5.

2. Equilar Inc. "CEOs Get 28% Pay Bump: S&P 500 Report" (April 2011), online: http://info.equilar.com/2011CEOPayLargeReport.html?mkt_tok=3RkMMJWWff9wsRokuKnIzKXonjHpfSx57egpXqCg38431UFwdcjKpmjr1YIDTMd0dvyCMRAVFZl5nQJJD%2BmZfZI%3D.

3. Equilar Inc. "Why Bonuses Went Up in 2010" (May 2011), online: <http://www.equilar.com/knowledge-network/research-articles/2011/201105-why-bonuses-went-up.php>

4. Equilar Inc. "TSR vs. CEO Pay: How Do You Compare?" (March 2011), online: http://info.equilar.com/2011TSRPerformanceandCEOPay.html?mkt_tok=3RkMMJWWff9wsRokuKnIzKXonjHpfSx57egpXqCg38431UFwdcjKpmjr1YIAT8F0dvyCMRAVFZl5nQJJD%2BmZfZI%3D

5. Press Release, "RIM Executive Adopts Automatic Securities Disposition Plan" (1 April 2011), online: <http://press.rim.com/release.jsp?id=4916>.

This newsletter reflects the views of the author(s) and is provided only for informational purposes. It does not constitute legal, tax, accounting, compensation consulting or other professional advice and cannot reasonably be relied upon as providing such advice. Please direct your inquiries on these matters to Nadine Côté at ncote@bell.blackberry.net.

A comprehensive review of executive compensation in Canada is available in the regularly updated loose-leaf book published by Carswell, a Thomson Reuters business, titled "*Executive Compensation: A Director's Guide*" by Nadine Côté.