A Director's Guide to
EXECUTIVE COMPENSATION

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LEXPERT EVENTS

Retention Bonuses

Are they Necessary these Days?

In recent years, there has been much talk of pay for performance in the executive compensation field. Pay for performance is the term used to describe how an executive's pay is tied to his or her performance. An executive's performance is often measured by the organization's performance. Many organizations have recently reviewed their pay practices and adjusted them to link executive pay to performance. Yet despite these efforts, many executives appear to have been and appear to continue to be paid, regardless of performance. In fact, some executives appear to have been rewarded whether they stayed or departed amidst falling company profits, plunging stock prices and numerous other poor performance indicators. This newsletter focuses on retention bonuses and explains why they may be neccessary despite these poor performance indicators.

Why Retention Bonuses May Be Necessary

Retention bonuses are incentives to retain employees when there is a concern they may depart at times that could be detrimental to the company. This concern often arises during periods of crisis or transition, such as the reorganization or sale of a company. During such periods, certain employees may be important to completing the reorganization or obtaining the maximum value in a transaction. The departure of these employees during transitions could be detrimental because it may result in:

- A loss of valuable insider information
- A break in the continuity of the management team
- A gap that may be difficult to fill on short notice during a transitional period

Compounding the problem is that transitional periods are precisely when a company's most valuable employees often look for more secure work elsewhere, particularly if there is a high risk the transition may result in the loss of their jobs. As such, many organizations implement retention programs during periods of transition to ensure they have the necessary expertise to successfully complete the transition. When properly designed, retention bonuses usually achieve their goal of retaining employees for the intended retention period.

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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CONTENTS

From the Editor

Retention bonuses are the latest aspect of executive compensation to come under the scrutiny of investors, institutional shareholders and other interested stakeholders. This issue reviews what organizations should consider in implementing retention bonuses and comments on some recent cases in the media spotlight. I am delighted to include comments from Brad Allen, Senior Vice President of Laurel Hill Advisory Group, a North American strategic solicitation and corporate governance consulting services firm specializing in complex shareholder communication. — *Nadine Côté LL.B.*

Say-on-pay, eh!
A Canadian Commentary

Comments from Laurel Hill Advisory Group

The Rise of Say-on-Pay

We have all been reading about say-on-pay and its predecessor variants in Canada for several years. Pre-2000, shareholders made suggestions to boards of directors on how to keep executive pay at appropriate levels. These suggestions were panned by issuers and many institutional investors. Invariably, they achieved low, single digit per cent of support in shareholder votes. In the early to mid-2000s, shareholders became increasingly demonstrative as isolated stories of egregious, predominantly U.S., corporate behaviour made the newswires with increasing regularity. In 2007, say-on-pay hit home in Canada at Nortel with a shareholder proposal for "pay for superior performance". Thirty-eight percent of shareholders voted in favour of the proposal. At the time, this was a remarkable rate and reflected how shareholders were beginning to demand changes in the compensation structure and transparency in the companies they invested. Still, there was not enough impetus at the director level to drive substantial change.

Times have changed. In the most recently completed proxy season in Canada, say-on-pay shareholder advisory votes were adopted by most financial institutions in Canada. In the U.S., mandatory shareholder advisory votes have been promoted and fast-tracked by the Obama administration; initially for institutions receiving TARP assistance, but now extended to a much larger base of public companies. Recently, the U.S. House Financial Services Committee passed a supporting bill requiring, among other things, say-on-pay measures and compensation committee independence similar to audit committee independence. The Securities Exchange Commission also recently proposed amendments requiring say-on-pay for TARP recipients, as well as better compensation disclosure for most public companies.

Forecasting Next Year's Say-on-Pay Proxy Season

Sufficient data has not yet developed in Canada to assess what can be expected during next year's proxy season. However, the U.S. experience may provide some insight as the U.S. introduced say-on-pay advisory votes about a year ahead of Canada. In the U.S., voting patterns have been inconsistent. In 2008, 88 proposals were filed with an average of 42% of voter support. So far this year about 81 proposals were filed with an average of 47% of voter support.[1] Moreover, understanding specifically what is being supported remains unclear.

In addition, while many stakeholders are in support of annual shareholder advisory votes on compensation; others are not. The United Brothers of Carpenters and Joiners of America (the "Carpenters") do not agree with the current say-on-pay proposals claiming they are too unwieldy to expect thoughtful analysis on an annual basis for hundreds of public companies. The Carpenters launched a "second generation" of shareholder proposals to 20 companies to date. Their proposals provide for triennial assessments. The Carpenters claim triennial assessments will allow for deeper and more meaningful analysis; rather than, what they describe as, a checklist process that does not promote dialogue. Their proposals require:

- Triennial advisory vote to approve the compensation of named executive officers ("NEO")
- A triennial ballot on NEO pay components, including annual incentive plans, long-term incentive plans, severance arrangements, change of control arrangements and post-employment benefits
- A triennial public forum conducted by the compensation committee for members to discuss compensation policies and provide an opportunity for shareholders to comment[2]

Another influential group in the say-on-pay debate has been proxy advisory firms, such as RiskMetrics Group, Glass, Lewis and Co., and PROXY Governance Inc. These firms provide proxy voting recommendations to their clients, composing the vast majority of institutional investors across North America. Unfortunately for board members, CEOs and investors, these organizations are not in agreement on similar proposals. Another overriding issue is whether the current U.S. legislative efforts will be passed soon, which would render moot most of the above deliberations. In the interim, there is one area that seems to offer some consistency. Results from the U.S. indicate that management sponsored proposals are overwhelmingly passing with a high rate of shareholder approval.

In sum, until the terms for shareholder advisory votes become more widely accepted, issuers would be well advised to ensure they have regular dialogue with key shareholders. At least, this would assist issuers in understanding the terms that are important to their shareholders.

Thanks for Brad Allen, Senior Vice President of Laurel Hill Advisory Group, for his contribution to this newsletter.
The Laurel Hill Advisory Group is an independent, North American strategic solicitation and corporate governance consulting services firm specializing in complex shareholder communication.

Who Should Receive Bonuses?

In assessing if retention arrangements are necessary to retain certain employees during periods of transition, consideration should be given to:

- An employee's ability to contribute to a successful transition
- An employee's ability to obtain more secure work elsewhere and his or her likelihood of departing
- An employee's other terms and conditions of work, including if there are change of control or severance arrangements already offering security in case the transition results in job losses
- The company's ability to successfully complete the transition without certain employees
- The company's succession plan and its ability to internally promote or reassign an employee on short notice to fill the role of a departed employee
- The company's ability to hire a replacement for the departed employee on short notice during the transition, particularly if the company has limited time and resources to devote to the search
- The cost to the company if it needs to "parachute in" someone new on short notice to assist during a transitional period, which costs may well exceed the cost of a retention bonus

Another important consideration is determining whether a company can afford to pay retention bonuses. Further below are examples of companies whose financial position would have suggested that they could not afford to pay executives retention bonuses. Nonetheless, for reasons some of which were clear and some of which were not, it appears the companies ultimately decided that they could not afford not to pay them.

Recently, the Shareholder Association for Research and Education (SHARE) released its 2009 Model Proxy-Voting Guidelines (Guidelines) and commented on this issue. The Guidelines acknowledged that compensation plans may be linked to objective parameters of a company's performance, such as employee retention, if other requirements were satisfied. Among the requirements, was that the compensation plans be affordable given the company's overall performance.[3]

Retention Bonus Terms

The focus of a retention bonus is retention. Typically, payment of a retention bonus is conditional on an employee's presence, not the achievement performance targets. Retention bonuses should not be provided to employees who resign or are dismissed for cause before the payment date.

Retention bonuses should be sufficient to retain most intended recipients but not so large as to guarantee 100 per cent retention. Retention bonuses are usually a fixed dollar amount or a percentage of salary, often ranging from 10 to 200 per cent of salary, depending on the retention risk and the importance of the employee in completing the transition.

Retention bonuses established in connection with a particular transaction, such as the sale of the business or a merger and acquisition, are generally paid, regardless whether the transaction closes. Bonuses that are only payable on the successful completion of a transaction are usually referred to as transaction incentives and limited to those who can directly affect the closing of the transaction. Retention bonuses are generally paid to key employees who are critical to the success of the business, regardless of whether they can directly affect the closing of the transaction. Also, they are usually paid at the earlier of: (i) the closing date of the transaction plus a transitional period; and (ii) the time estimated to complete the transaction plus a margin.

Retention Bonuses in the Economic Crisis

The current global economic crisis is forcing many companies to undergo some form of restructuring or downsizing. At first glance, restructuring and downsizing appear to be the types of transition that would support the need for retention bonuses. However, this is not an organizational or an industry-specific downturn. Rather, it is a global crisis affecting most sectors in nearly all developed countries. The crisis has resulted in significant drops in the profits and stock prices of hundreds of companies, millions of employees losing their jobs, severance pay and pensions and record high unemployment rates.

In this context, awarding retention bonuses may appear to be superfluous due to the excess labour supply, limited mobility opportunities and poor corporate performance. This is why it is important, more than ever before, that companies clearly explain their reasons for awarding retention bonuses. The explanation must go beyond stating the obvious – that retention bonuses were necessary to retain employees. Failure to fully explain the reason for awarding retention bonuses can result in strong criticism from shareholders, institutional investors and other interested stakeholders.

The Guidelines released by SHARE commented that increasing the pay of management while laying-off employees contradicted the pay for performance principle. The Guidelines noted that if the company's performance was so poor that employees had be laid off work, then performance did not warrant in increase in pay or benefits and any bonuses should be cancelled.[4] Companies considering these options should first assess their legal and contractual obligations to management to ensure their compliance.

Examples of Hit and Miss Retention Bonuses

Some companies recently came under attack for providing senior employees with retention bonuses, while at the same time shedding thousands of jobs and seeking taxpayer bailout money.

The Misses: Nortel Networks & AIG

Nortel Networks, under bankruptcy protection since January 2009, has laid-off about 5,000 employees since last November, none of whom have yet received severance pay or any other entitlements owed on termination. Nonetheless, in March 2009, approximately US$45 million in retention bonuses was awarded to about 100 senior executives, 8 of whom will share in about US$7.3 million. The company's lack of explanation for why the bonuses were necessary to retain the executives resulted in backlash.[5]

American International Group (AIG) is another company that came under fire for awarding US$165 million in retention bonuses to executives while obtaining US$180 billion in taxpayer relief to stay afloat. The bonuses were awarded to executives in the financial products section – the very section in which risky investments ultimately resulted in the company's demise. AIG reasoned that the executives were awarded the bonuses to dispose of their book of business. The financial derivatives had been reduced from US$2.7 trillion to US$1.6 trillion, but the company believed it continued to be exposed to financial risk if the remaining US$1.6 trillion was not properly disposed. AIG failed to explain why the executives needed an incentive to properly dispose of the high risk investments they had [improperly] acquired as disposing of such assets appeared to already be part of their job. The retention bonuses caused such uproar that many recipients returned some or all of the bonus payment.[6]

Nortel and AIG failed to explain how the same employees who contributed to the demise of these companies were necessary for the restructuring – if they departed for lack of a retention bonus, could new employees do any worse? In the context of the global economic crisis and with the record high unemployment levels in North America, were these employees readily able to obtain more secure work elsewhere and likely to depart if they did not receive retention bonuses? Were there really no unemployed executives available to work if the existing management departed for failing to receive retention bonuses? These companies may have been able to avoid the backlash had they been able to explain the rational for awarding the retention bonuses, including addressing why these employees were necessary, their risk of departure and the lack of alternative resources.

A Hit: Chrysler

Chrysler also found itself in the difficult position of paying millions in retention bonuses to top executives, while cutting thousands of jobs. However, Chrysler's reasoned explanation for the payments soon quelled the controversy. Chrysler's retention arrangements were put in place with about 50 executives in early 2007 when its parent company, Daimler-Chrysler, was preparing for its sale. The arrangements were necessary to assure prospective buyers that the management team would remain in place during and after the sale. In August 2007, private equity firm Cerberus Capital Management acquired about 80 per cent of Chrysler. Under the retention arrangements, 25 per cent of the retention bonus was payable in February 2008 with the balance due in August 2009, two years after the sale. In early 2007, the North American economy was doing well and had low unemployment. Attempting to sell the company for maximum value in a tight labour market required a committed management team, which necessitated the retention arrangements. The retention payments were spread over a reasonable period of time, to ensure their goal of retaining management. The fact that the payments became due when Chrysler was in financial distress and laying off thousands of workers did not change the validity of the arrangements at the time of their implementation.[7]

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1 Risk Metrics Group, 2009 Proxy Season Scorecard (15 August 2009), online: http://www.riskmetrics.com / knowledge/proxy_season_scorecard_2009.

2 Neil Stewart, "Carpenters target pay at Proctor and Gamble & 19 others" Cross Border Group Corporate Secretary (14 May 2009) online: http://www.thecrossbordergroup.com/pages/1953/Breaking +news. stm?article_id=13440.

3 Shareholder Association for Research and Education, "2009 Proxy-Voting Guidelines" (19 January 2009) online: http://www.share.ca/files/2009_Model_PV_Guidelines_WEB.pdf.

4 *Ibid.*

5 David Akin, Canwest News Service "MPs order Nortel CEO to explain bonus payments" *The National Post* (16 June 2009) FP online: http://www.financialpost.com/story.html?id=1701623.

6 David MacQuarrie, "Retention bonuses infuriate, but they're not uncommon" (20 March 2009) online: http://cbc.ca/money/story/2009/03/19/f-retention-bonus.html.

7 Tom Walsh and Tim Higgins, "Chrysler leaders get millions" *Detroit Free Press* (14 November 2008) online: http://www.usatoday.com/money/autos/2008-11-14-chrysler_N.htm.

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.