Executive Compensation Compliance and Trends in the Energy Industry
Insights from Consultants and Attorneys

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I. Compensation Programs: A State of the State
Executive Compensation Compliance and Trends in the Energy Industry

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Key Issues

• Talent Gap
• Retention
  – 5 Tools
  – The Rise of Variable Pay
• Executive Pay
• Board Pay
Talent Gap

• Energy Talent Gap
  - Due to advances in technology and new regional developments, the energy industry is in high demand for talent and dealing with a larger talent gap than most industries
  - Fewer employees in the 24-54 age range with operational experience as not many went into the field after the bust of the 1980s
  - In the 1970s, 40 U.S. colleges offered degrees in petroleum engineering; in 1984, these 40 U.S. colleges awarded approximately 1,500 undergraduate degrees in petroleum engineering; in the early 2000s, there were only 20 remaining colleges awarding approximately 800 petroleum engineering degrees
  - 48 years is the average age of an energy employee
  - Oliver Wyman study showed the number of employee 65+ jumped almost 50% in 2012 from 2002
  - The expense of losing talent is close to 300% of salary for executive positions
Retention, Retention, Retention

1. Variable Pay: Annual Incentives → Yes, they also motivate
2. Variable Pay: Long-Term Incentives → The most effective retention vehicles
3. Retention Bonuses → Temporary solutions to temporary problems
4. Hybrid Retirement Plans → The new old
5. Tailored Compensation → Choice + Value
The Rise of Variable Pay

- IRS
- SEC
- Shareholders
- Company

- AJCA
- FASB
- Shareholders
- Company

- SEC
- Internal EE
- Media
- Shareholders

- Base Salary
- Annual Incentives
- Long-Term Incentives
- Pension Benefits
- Perks
Executive Pay

• **Base Salary**: 50th – 75th percentile

• **Annual Incentives**: More formulaic; less discretion – but still some discretion (up to 25%)

• **Long-term Incentives**:  
  — Options/Appreciation Awards decreasing  
  — RSA/RSUs – “Retention hedge” increasing  
  — Performance Shares/Units – on the rise  
  — SARs – Cash-settled – a quick default  
  — MLPs – Phantom Units

• **Perks**: Have decreased substantially due to disclosure and transparency
Executive Pay

- **Employment Agreements**: shorter 1-3 years
- **Change-in-Control**:
  - Still competitive
  - Dual Trigger vs. Single
  - Excise Tax Gross Ups Out
- **Deferred Compensation Plans**: down due to 409A
- **Disclosure/Transparency**:
  - In 5 years, the size of disclosure has gone up 56% to an average of 71 pages
  - Decreasing use of perks, termination payouts, tax gross ups, and retirement benefits
  - More homogenous pay plans and values – losing some customization to culture
Board Pay

- **EQUITY**
  - Restricted Stock

- **CASH**
  - Retainers
  - Meeting fees
  - Chair fees
  - Combination of retainers and meeting fees
Board Pay (cont.)

Cross-Checks

1. Total Compensation divided by hours expended = senior investment banker rate/hour (Jay Lorsch, Harvard)
2. EQUITY > CASH
3. Number of Directors multiplied by compensation
II. Guidance from the Internal Revenue Service and Securities and Exchange Commission
A. Executive Compensation Audits

- The IRS has conducted several thousand executive compensation audits within the past few calendar years
- The information document requests (“IDRs”) involved in these audits cover hundreds of issues and it can take years to complete these audits
- These audits have involved numerous issues a sampling of which is provided below
Executive Compensation Audits (cont.)

• Loans – The IRS has put considerable effort into examining whether loans are properly structured; for instance, they examine whether loans used for option exercises are recourse or non-recourse loans; the IRS also examines whether stock is purchased with a recourse or non-recourse loan and contend that stock purchased with insufficient recourse does not close the ordinary income element.
Executive Compensation Audits (cont.)

- The IRS has examined whether substantial risk of forfeiture provisions tied to restricted property are adequate; in particular, the IRS has examined whether non-competes are substantial enough to create a substantial risk for forfeiture.
Executive Compensation Audits (cont.)

- Payroll issues have been a widely examined topic by the IRS
  - Employment and income taxes that equal or exceed $100,000 on any given day should be deposited by the next banking day
  - The IRS has closely examined whether the Social Security taxes associated with deferred compensation is taxed at the time the vested award is presented to the participant rather than the time when the applicable amounts are paid to the participant and subjected to Federal income tax
Executive Compensation Audits (cont.)

- Parachute payments have also been a widely examined topic
  - As will be discussed in greater detail below parachute payments are subject to excise taxes and may not be deductible in part if they exceed three times an executive’s average annual compensation
  - The IRS closely examines whether the calculation of average compensation is proper
  - Another mistake often found on audit is the lack of inclusion of all forms of change in control payments
  - The proper techniques used for shareholder approval which may exempt parachute payments from excise taxes and lack of deductibility may also be closely examined
  - Some parachute payments may be recharacterized as reasonable compensation for services and lack of services and the IRS has a tendency to examine these arrangements closely
Executive Compensation Audits (cont.)

- Section 162(m) of the Code limits deductible compensation paid to the CEO and the three highest compensated officers other than the CEO of a publicly traded corporation
  - Performance based compensation if properly structured is exempted from the prohibitions of Section 162(m) of the Code
  - In order to be properly structured the attainment of performance goals must be certified by the compensation committee; the IRS has a practice of looking into the formalities of this certification process
  - Performance goals must be established no later than 90 days after the beginning of the service period to which the performance goals relate and within the first 25% of such service period; this is another issue closely examined by the IRS
Executive Compensation Audits (cont.)

- Companies must take care to assure that performance-based compensation is not payable upon termination without cause, for good reason or retirement.
- Performance goals must be approved by the shareholders of the company and if the compensation committee has the authority to adjust targets with respect to these performance goals, the goals must be reapproved by the company every five years in order to maintain a compliant 162(m) program.
II. Executive Compensation Audits (cont.)

- The IRS has begun audits checking the accuracy of the administration of programs that should comply with Section 409A of the Code
- The provisions of 409A are described in greater detail below
- However, it should be noted that the frequency and scope of Section 409A audits is expected to increase vastly over the course of the next few years
B. Securities and Exchange Commission Pay Ratio Disclosures

• On September 18, 2013 the SEC proposed a rule implementing the provision of the Dodd-Frank Act that requires companies to disclose a ratio of their CEO compensation to the compensation of a median employee.

• Section 953(b) of the Dodd-Frank Act requires the SEC to amend its regulations to provide that the registrant must disclose:
  – The median of the annual total compensation of all employees excluding the chief executive officer
  – The annual total compensation of the chief executive officer
  – The ratio of the two amounts
Securities and Exchange Commission Pay Ratio Disclosure (cont.)

- The pay ratio disclosure is first required in a registrant’s proxy or 10-K for the first fiscal year commencing on or after the effective date of the rule
- Registrants that are required to provide a summary compensation table disclosure are required to provide a pay ratio disclosure
Securities and Exchange Commission Pay Ratio Disclosure (cont.)

- New registrants do not need to provide a pay ratio disclosure until the first fiscal year commencing on or after the date the company commences its Exchange Act filings
- Median compensation is calculated using any reasonable method including the use of statistical sampling or a consistently applied compensation measure
Securities and Exchange Commission Pay Ratio Disclosure (cont.)

- The proposed rule does not include a safe-harbor calculation
- The use of any type of sampling method, such as a random processing must be adequately disclosed when describing the methodologies
- The rule applies to all employees including foreign employees, part-time employees, seasonal employees and temporary employees
- The SEC guidance is scant in providing any intricacies of this requirement and the SEC requests comments as to alternative ways to fulfill the statutory mandate, such as whether it would be possible to exclude foreign or part-time employees
Securities and Exchange Commission Pay Ratio Disclosure (cont.)

- Total compensation may be, but is not required to be annualized for permanent full or part-time employees not employed during an entire fiscal year, however, the compensation of temporary and seasonal workers may not be annualized.
- The rules require the disclosure of the methodology, material assumptions, adjustments and estimates utilized in the determinations.
- An issuer may supplement the required disclosures with narrative descriptions and additional ratios if the additional disclosures are clearly identified, not misleading and are not presented with greater prominence than the required ratio.
Securities and Exchange Commission Pay Ratio Disclosure (cont.)

- Annual total compensation for the median employee is determined in the same manner as is used in an issuer’s summary compensation table.
- While the SEC provides that estimates may be appropriate in determining certain benefits such as the value of multi-employer pension plan benefits and unique benefits provided to non-U.S. employees, it does not permit the inclusion of governmental benefits under local laws, even though such benefits may be funded by the employer.
- Issuers should begin to think about the application of the rules or consider submitting comments due to the many unique features of the rules, including how the rules apply to CEO compensation that is subject to service or performance based requirements, the impact of foreign operations and the unique aspects of the rules applying to part-time, temporary and seasonal workers.
C. SEC Enforcement of Claw Back Policies

- Soon the SEC should begin the process of adopting rules to implement Section 954 of Dodd-Frank requiring companies to adopt a policy for the recovery of:
  - Any incentive based compensation (including stock options)
  - From any current or former executive officer
  - In the event of an accounting restatement resulting from the company’s material non-compliance with any financial reporting requirement under securities laws
  - In amounts equal to the excess over of what would have been paid under the accounting restatement with a three-year look back
SEC Enforcement of Claw Back Policies (cont.)

- Companies should give consideration to the adoption of a policy before the enactment of the final rules in light of shareholder watchdog groups and possible penalization by the major proxy advisory firms.
- While Dodd-Frank requires that policies cover stock options, it does not expressly cover the treatment of other types of equity awards.
- The statute is similarly unclear as to what constitutes compensation in excess of what would have been paid under the accounting restatement.
SEC Enforcement of Claw Back Policies (cont.)

- Dodd-Frank requires a listed company’s current and former executive officers to be covered the policy, however it does not address whether employees who are as culpable or more culpable should be subject to a policy.
- Note that Dodd-Frank is triggered by a restatement of financial statements but does not include a misconduct prerequisite, therefore one should consider whether the following actions should likewise result in a claw back:
  - Intentional or unethical misconduct
  - Miscalculations of incentive compensation that do not result in a financial restatement but result in an overpayment to the executive
  - Violations of restrictive covenants
SEC Enforcement of Claw Back Policies (cont.)

- Dodd-Frank requires a three-year recovery period from the day the company must prepare a financial restatement.
- Enforcement of Dodd-Frank rests with the company but it is probably safe to assume that plaintiffs lawyers will assert that shareholders have the right to obtain recovery derivatively on the company’s behalf.
- Since primary enforcement will clearly be on the company, it is wise for any entity regardless of whether they decide to adopt a claw back policy at this time to include provisions in any executive officer’s contractual arrangements that once the provisions of Dodd-Frank are effective the executive contracts are automatically amended to allow the executive’s consent to the enforcement of Dodd-Frank.
SEC Enforcement of Claw Back Policies (cont.)

- While it is clear that the primary enforcement of Dodd-Frank claw back policies wrest with the company it is unclear as to how disputes should be handled
  - Possible resolution mechanisms include arbitration or possibly decisions made in the full good faith of the company will be binding and enforceable
- It is unclear as to who should have interpretive powers with respect to Dodd-Frank claw back policies:
  - For instance, is the board to determine whether a reinstatement would have resulted in less incentive compensation for the executive
SEC Enforcement of Claw Back Policies (cont.)

• Another problem with the enforcement of the policy will be whether a company has a duty to seek recovery

• In connection with the implementation of the policy, companies should also consider how it should reverse a tax position it previously took in connection with the payment of incentive compensation, how the incoming compensation will taxed to the company and whether inability of the executive to deduct the repayment results in a cause of action for the executive, if there is not misconduct on the part of the executive

• It is also advisable to consider whether state wage laws or foreign laws will prohibit the return of compensation by the executive
  – To date there has been little indication that the SEC will provide guidance regarding how to handle such situations
III. The Impact of ISS and Glass Lewis on Exec Comp
Rise of the Proxy Advisors
• Institutional Shareholder Services ("ISS")
• Glass Lewis

ISS Pressure Points
• Pay for Performance Disconnect
• Large Increases in CEO Pay
• Weak Performance Incentive Goals
• Mega Grants
• Excise Tax Gross-Ups
• Poor Benchmarking Practices
Profile of a Say On Pay Failure

- Smaller companies are more prone to failures
Profile of a Say On Pay Failure (cont.)
• Pay Increase + Performance Decrease = SOP Failure
Profile of a Say On Pay Failure (cont.)

- Industry Matters: Healthcare (18%), High-tech (16%), Energy (13%), and Retail (9%) had the most failures
Profile of a Say On Pay Failure (cont.)

- CEO Tenure: CEOs < 1 year is 29% of failures; CEOs < 5 years 55% of failures
IV. Executive Compensation Litigation Update
Executive Compensation Litigation Update

- The enactment of Say on Pay legislation resulted in many plaintiffs’ firms filing class actions alleging breaches of fiduciary duties by directors of companies receiving unfavorable Say on Pay votes.
- Plaintiffs’ firms brought these actions despite the fact that Congress clearly provided that Say on Pay votes are not only non-binding but they do not create or imply any change to the fiduciary duties governing corporate directors conduct under applicable state laws.
Executive Compensation Litigation Update (cont.)

- Several of these cases initially settled but this initial wave of Say on Pay litigation has largely disappeared in light of courts findings that the business judgment of the board should be upheld in making compensation decisions even in light of a negative advisory vote.
- Nevertheless, this resulted in a change in strategy by the plaintiffs’ firms.
- The new line of attack involved class action cases designed to enjoin an annual meeting and vote unless the company made additional compensation disclosures.
- The cases alleged that directors breached their fiduciary duties by making insufficient disclosures.
Executive Compensation Litigation Update (cont.)

• After a specific company would file an annual meeting proxy statement, the plaintiffs lawyers would issue a press release to notify prospective shareholders that they wish to conduct an investigation into whether the company’s board breached its fiduciary duties in connection with the disclosures regarding the upcoming Say on Pay vote.
Executive Compensation Litigation Update (cont.)

• Additionally, plaintiffs lawyers would maintain that there are insufficient compensatory disclosures when companies attempted to adopt or amend equity compensation plans.

• Some companies have settled with the class and most notable amongst these cases is the California state court case where a judge enjoined Brocade’s annual meeting finding that the plaintiff demonstrated a potential threat of irreparable harm resulting from allegedly inadequate disclosures concerning the issuance of 35 million new shares in connection with an equity compensation plan.
Executive Compensation Litigation Update (cont.)

- Other cases were successfully fought and won by defendants.
- The common theme in the cases settled and the opinions rendered is that companies do not have an obligation to describe above what is mandated in the federal statutes and regulations.
- Where plaintiffs did have some success such as in the *Brocade* case, it is arguable that the company’s disclosures were either misleading or opened the door to further disclosures that were not given in the proxy.
Executive Compensation Litigation Update (cont.)

• The court in *Noble v. AAR* summarized the standard best in these cases when it said the “plaintiff does not dispute that the defendants have complied with the federal disclosure requirements under the Dodd-Frank Act nor does he point to any statutes, regulations, or case law that requires corporations to disclose more than the federal disclosure requirements.”
Executive Compensation Litigation Update (cont.)

- Therefore in the upcoming proxy season companies should keep several points in mind including:
  - Concise accurate disclosures are unlikely to result in a breach of fiduciary duties, however, imprecise disclosures have the potential to garner the attention of plaintiffs firms.
  - Addressing the requirements of the federal statutes and regulations is a safe course of action while opening the door to additional issues, such as providing that additional information was considered by the company in making compensation decisions without disclosing such information may have negative consequences.
Executive Compensation Litigation Update (cont.)

- While a negative Say on Pay vote is not indicative of a breach of fiduciary duty, negative Say on Pay votes are likely to garner the attention of plaintiffs’ firms and can cause them to pursue more fertile causes of action.

- Companies are well advised to continue to take all steps necessary in order to garner the highest possible Say on Pay vote by reaching out to institutional shareholders and taking other appropriate steps since we are living in an environment where low shareholder support for compensatory packages will not immediately result in litigation, however, it is likely to draw unwanted scrutiny and result in the plaintiffs lawyers dissecting a company’s proxy statement.
V. Cross Border Executive Compensation Issues
Executive Compensation Compliance and Trends in the Energy Industry

Insights from Consultants and Attorneys

U. S.
≠
U. K.
≠
Australia
≠
Switzerland
≠
?
• Procedures for the determination of executive compensation, where they are not fixed by shareholder meetings, differ among countries employing a one-tier or two-tier corporate governance system
  – One-tier: The board is responsible for fixing the compensation of executive officers; oftentimes, companies are asked to create a special remuneration committee of independents (U.S.; U.K.; Hong Kong)
  – Two-tier: A management board and a supervisory board are in the place with the latter determining pay (Germany, the Netherlands, Austria)
    ❖ Sometimes you will see a system of co-determination where the employee representatives may also participate
Switzerland

Minder – Executive Summary

**Background**
- Constitutional Amendment: March 3, 2013
- Draft Ordinance: June 14, 2013
- Final Ordinance: Nov. 22, 2013 (expected)
- Overall Effective Date: January 1, 2014

**Highlights**
- Applies to Swiss companies listed on *any* stock exchange
- Far reaching Governance and Executive Compensation implications
  - Requires mandatory votes on Chairman, Compensation Committee elections, and requires that compensation paid to directors and executive management be approved by shareholders
  - Highly restricts certain payments to board of directors and “executive management”
  - Requires certain other amendments to Articles of Association
  - Requires certain additional proxy disclosures
  - Criminal prosecution exposure
  - Difficult to reconcile Swiss governance topics with US style OFS company, energy industry competitive landscape, and peer group
**Minder – Executive Compensation**

**Who is impacted?**

- “Executive management”
  - Not defined under *Minder*
  - Generally, the members of the group to whom the BOD has delegated management of that company

**Which executives?**

- CEO
- CEO customary direct reports: Chief Operating Officer, Chief Administrative Officer, Chief Financial Officer
- Possibly other executives

**What is prohibited?**

- All “severance” payments to executive management (as construed under *Minder*)
- Pre-payment of salary (but sign-on bonuses are possible)
- Bonus payments ("commissions") to executive management for sale or acquisition of a business or parts thereof (prohibits change of control payments)
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Minder – Shareholder Voting

Current Practice

- Shareholders Vote to Elect
  - Each Director

- Shareholders Vote to Approve
  - Compensation of Named Executive Officers (advisory and non-binding)

2014 Requirements

- Shareholders Vote to Elect
  - Each Director
  - Chairman of the Board
  - Each Compensation Committee Member
  - Independent Proxy Holder
  - Deputy Chairman and Deputy Proxy Holder (recommended by not required)

- Shareholders Vote to Approve (required 2015/recommended 2014)
  - Compensation of Directors (individually by director) (binding)
  - Executive Management (individually by officer and total for all officers) (binding)
Executive Compensation Compliance and Trends in the Energy Industry

Minder – Other Requirements & Uncertainties

- Annual Compensation Report Requirements
- Independent Prox(ies) Required (corporate or custody proxy are impermissible)
- Electronic Voting Requirements (required by 2015)

Other Requirements

- Definition of “Executive Management”?
- What constitutes “severance”?  
  - Is 2014 really a transition year?
- How to reconcile 2014 vs. 2015 requirements?
- Risk of criminal prosecution for violating vague law
  - Company, BOD, and individual liability
  - Up to 3 years sentence and 6x compensation
  - Non-circumvention and aiding/abetting prohibited
- Fundamental Question: cost/benefit of being “Swiss”

Grey Areas
VI.
Preparing for Mergers and Acquisitions
Preparing for Mergers and Acquisitions

- Treatment of equity awards
  - In stock transactions outstanding equity awards may be assumed, substituted, cashed out or cancelled
  - Often plans will only provide limited possibilities for the treatment of equity awards rather than the full array of acceptable treatment
  - There may be legal limitations on how equity awards are handled, such as consent requirements
Preparing for Mergers and Acquisitions (cont.)

- Care must be taken to assure that the treatment of equity awards does not enlarge the size of parachute payments to the extent it results in excise taxes or lack of compensation deductibility.
- Thought should be given to whether or not different types of equity awards should be treated differently; whether or not certain groups of employees should be treated differently; whether or not vested and unvested awards should be given different treatment and whether or not in the money options should be treated in the same manners as out of the money options.
- However care should be taken whether disparate treatment results in securities violations or prohibited discrimination.
Preparing for Mergers and Acquisitions (cont.)

- Section 409A of the Code governs certain types of equity based compensation
  - Section 409A of the Code generally governs the timing of elections applicable to deferred compensation and the time at which deferred compensation can be paid out
  - Violations of 409A will result in a 20% penalty tax
  - Restricted stock units are a prototypical equity award that is governed by Section 409A
  - Earnouts and escrows in a transaction also need to be structured to comply with Section 409A, this is possible if the earnout or escrow is paid on the same schedule and according to the terms and conditions as payments made to shareholders generally and the amount is paid out in full within five years from the time of the change in control
Preparing for Mergers and Acquisitions (cont.)

- While stock options and stock appreciation rights are generally exempt from Section 409A, the awards must have an exercise price or a threshold price at least equal to the fair market value of the underlying shares as of the date of grant.
- Options and stock appreciation rights can be exchanged and adjusted in connection with a transaction, however, such exchange or adjustment must comply with Section 409A.
- Section 409A requires the ratio of the exercise price to the fair market value of a share subject to the option or SAR immediately after the assumption or substitution to not be greater than the ratio of the exercise price to the fair market value of the share subject to the option immediately before the assumption or substitution.
Preparing for Mergers and Acquisitions (cont.)

– This rule imposed by 409A raises an interesting issue when dealing with escrows or earnouts; it essentially allows the presumed stock value upon the conversion of an option or stock appreciation right to either include the earnout or escrow or not include the earnout or escrow – this is contrary to previous Internal Revenue Code rules governing stock options and has left significant confusion in the executive compensation community – many practitioners just recommend an appraisal of the security
Preparing for Mergers and Acquisitions (cont.)

- Deductions for equity compensation are usually taken by a target, however, in a spinoff context usually the parties can agree in the purchase agreement whether a target or acquiror will claim the deduction.
- Parachute Payments – Section 280G of the Code imposes excise taxes and non-deductibility on payments to officers and highly compensated employees that are paid on account a change in control and exceed three-times the individual’s average compensation for the five years preceding the transaction.
Preparing for Mergers and Acquisitions (cont.)

– Many items constitute parachute payments that may not immediately be thought of as parachute payments, including continued health benefits, accelerated bonuses or equity compensation and the acceleration of non-qualified deferred compensation benefits

– Amounts that are deemed to be reasonable compensation, including compensation paid due to non-compete provisions or consulting obligations arising after a transaction may be excluded from parachute payments

– Private companies may avail themselves of the shareholder approval exemption to the parachute payment rules, however, this requires that the parachute payments be put at risk and be approved by 75% of the shares entitled to vote, however, 100% of the shareholders must be informed of all pertinent aspects of the parachute payment.
Preparing for Mergers and Acquisitions (cont.)

- Care must be taken in handling of employment, change in control and severance agreements in connection with transactions
- Often companies wait until the eve of closing to renegotiate employment and other key agreements
- It is important to remember that Section 409A applies to many payments under employment, change in control and severance agreements and if these payments are improperly restructured in a manner that changes the date the executive would have been paid under prior agreements an impermissible substitution may arise which would result in a 20% penalty tax on the payments
Preparing for Mergers and Acquisitions (cont.)

• Stock Exchange Requirements
  – It is important to remember that NASDAQ and NYSE rules may require the re-approval of equity based compensation plans following a transaction – by way of example if plans are inherited and one intends to use shares or units under the plan for purposes of the acquiror’s employees new shareholder or unitholder approval must normally be obtained

• Securities Filings – The assumption of equity based compensation plans will often require the new filing of a form S-8 registration statement
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