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Effectively Telling Your Executive Compensation Story As an Activist Defensive Measure

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Overview

Compensation arrangements are generally not the driver of activist campaigns, but poor (or poorly perceived) pay practices heighten a company's risk of activist activity and provide activists with additional weapons for use in their campaigns. Activists target companies that exhibit weak corporate governance structures and pay for performance misalignment. Companies should regularly evaluate their executive compensation program to assess and identify their vulnerabilities. Being prepared by having a response plan in place in the event of activist activity is a best practice.

Activists, for the most part, are focused on value creation through strategic and financial initiatives, but they use executive compensation as a point of discussion to show how their perspective differs from management's and to highlight concerns and disconnects between company performance and incentives. For example, if return on capital is not a metric used in a company's incentive plans and the company has completed several low-return acquisitions, an activist may use this to support an argument that management's strategy is weak and that the company's executive compensation structure fails to address that weakness. When executive compensation is easily tied to poor financial results as a rhetorical matter, it provides activists with another compelling reason to sway other shareholders as to why a shift in leadership or strategy is advisable.

Effectively telling your company's executive compensation story in your proxy statement can act as a key defensive measure against potential activist campaigns. Not only can it mitigate the occurrence of an activist campaign, but it can also provide a key opportunity to show other shareholders how the company is already on the right track. This positive impact can be enhanced through proactive shareholder engagement using the proxy disclosure as a tool for dialogue and influence.

Undertake a Defensive Review

Prior to engaging with shareholders (either directly or through the proxy), it is essential to review the company's executive compensation program. Such a review may also serve useful in the event the company finds itself in need of a response plan for an activist attack focused on poor executive compensation practices. A comprehensive review should include the following:

- **Market understanding and monitoring.** Track peer group companies for activist activity; monitor calls into the company from shareholders or others regarding executive compensation; follow media reports and third-party governance ratings of the company.
- **Executive compensation design.** Undertake a regular review of executive compensation programs from an activist perspective, in particular confirming continued alignment with the company's strategic vision; assess how the company's programs compare to those of its peers; consider using outside advisors to identify executive compensation program weaknesses; understand any underperformance of the company and how it is impacting executive compensation.

Focus on the "Why"

A compensation discussion and analysis (CD&A) is most effective when it moves beyond mere compliance and instead is used to tell the story in a reader-friendly manner of why the company's executive compensation design supports and enhances the business goals of the company. The now-emerged (and arguably best-practice) use of CD&A executive summaries can be helpful, as can graphic presentations—but try to do more. Shareholders, proxy advisors, and proxy commentators often say that companies are getting very good at telling us the "what," but they still do not provide the "why." Almost every company tells the reader about, for example, the 200% maximum bonus opportunity (the "what"), but few explain the reason 200% base salary was the right maximum bonus opportunity to motivate the executive team to achieve desired results (the "why"). Similarly, do not just list the performance metrics of a bonus program, but instead explain the rationale for selecting those performance metrics. Describe changes from metrics used in prior years, and connect that change to the company's changing business strategies. Or, if metrics have stayed the same, explain why they are still the right goals.

When writing the CD&A, use the tools of any good narrative:

- specificity,
- simplicity,
- active voice, and
- clarity.

Review the CD&A annually, and consider whether it remains fresh and describes the current executive compensation program. Avoid the "cut-and-paste" approach so that stale information does not get transferred from year to year without thorough review. Reduce duplication. Effective narrative can preemptively address shareholders' largest concerns, including claims of pay-for-performance disconnect, by doing the work for the reader—show the reader how the company's executive compensation program drove its specific performance objectives.

Address Hot-Button Issues

When preparing proxy compensation disclosure, be sure to discuss topics that shareholders are interested in, such as rotating committee chairs, whistleblower and ethics hotline, and structuring pay to prevent mistakes instead of paying bonuses when someone fixes a mistake. In addition, highlight mitigating factors in the company's executive compensation program, including clawbacks, holding requirements, prohibitions on hedging or pledging, and shareholder-approved limits. Finally, address performance problems or missteps head on. Meaningful, effective disclosure enables readers to assess the company's pay practices, the rigor of performance goals, comparability with peers, and alignment of pay and performance.

Current hot-button issues include the following:

- Unaddressed negative say-on-pay results
- Performance and pay misalignment
- Use of the same performance measures throughout executive compensation plans (including both long- and short-term plans)
- Use of non-objective "soft" performance criteria
- Insufficient performance-based long-term awards
- Evergreen executive contracts
- Perks and other executive-only benefit plans and policies
- Gross-ups
- Awards of special grants outside the ordinary executive compensation program structure
- Board of director compensation
- Board of director diversity concerns
- Low director election support
- Outsized compensation as compared to peers

Throughout the year, many institutional investors discuss what pay practices they expect to see at their portfolio companies. Keep in mind these as well as the above issues of interest.

Consider Culture Perceptions

When preparing disclosure, consider how it can communicate to shareholders a sense of the company's culture. For example, the active engagement of employees and directors is an indicator of a healthy culture and a signal of better organizational performance. Boards should be engaged and proactive and should regularly measure and monitor company-specific values and behaviors. This is particularly important in a year when a company might be facing brand-damaging press due to perceived or actual unethical or illegal behaviors, such as sexual harassment scandals. To the extent the board is actively engaged in monitoring the culture of the company, its activities should be described in the proxy. If board members are not already discussing culture as a key area of company-wide risk, consider raising it with them.

Culture red flags to keep in mind include the following:

- Focus on performance with little regard to how results are achieved
- High performers allowed to operate outside established policies, and rewards for conduct inconsistent with stated values or code of conduct
- Excessive focus on consensus or collegiality and a discouragement of sharing of "bad" news
- Promotions or recognition tied to relationships rather than skills and performance

Know Your Shareholders

Crafting the right disclosure is only the start of effectively telling your executive compensation story. Shareholders can voice their support for, or concerns with, a company's executive compensation program through a non-binding advisory vote on executive compensation, commonly referred to as "say-on-pay." But a significant shortcoming of say-on-pay is that it does not allow shareholders to provide specific input on executive compensation program design and pay practices. It also does not provide a forum for the company to get to know its key shareholders and build rapport. Having an open dialogue with key shareholders regarding executive compensation in place prior to the onset of an activist campaign can be essential in containing an activist message that a company's executive compensation program does not support value creation.

Companies need to proactively engage shareholders to get their specific feedback and reactions to the company's executive compensation program and to confirm shareholders understand the program's design. This is true whether the shareholders vote "for" or "against" say-on-pay, but is heightened when there has been negative shareholder response to say-on-pay. When engaging with shareholders, explain the company's executive compensation decisions and philosophy and address performance problems head on. Make directors available (but ensure they are properly prepared first). Ask for feedback, and give any feedback received thoughtful consideration. Be sure to engage with shareholders outside the proxy season. This provides time for an ongoing dialogue with shareholders and for the company to implement changes based on feedback.

When undertaking shareholder engagement, make sure other shareholders know about it. According to a 2017 survey by Shearman & Sterling,[1] 74% of the top 100 companies[2] made shareholder engagement disclosures in their 2017 proxy statements.[3] Of these companies, 93% disclosed that they engaged on executive compensation matters.[4] This was the most prevalent shareholder engagement issue specifically discussed in disclosure. Also increasing in prevalence is disclosure regarding the actions companies have taken in response to prior shareholder engagement. In the context of executive compensation programs, after engaging with shareholders, make sure that the following year's disclosure makes the impact of feedback clear.

In planning for shareholder engagement, keep in mind the evolving role of historically passive institutional investors. Expect to see increased "activism" from passive institutions. These institutions are not looking for board seats or express control over management, but they are being vocal about their investment priorities. In his 2017 letter to directors, President and CEO of State Street Global Advisors Ronald O'Hanley made clear a willingness to use proxy voting power to effect change.[5] Similar messages have been made by Vanguard in its 2017 annual report[6] and by Blackrock,[7] among others. These institutions want to see companies with a long-term strategic plan and sensitivity to specified environmental, social, and governance issues. Use the CD&A to address the linkage between these areas of shareholder focus and the company's executive compensation program so that this information is available for shareholders and can be used in shareholder engagement.

When engaging with shareholders, be aware of potential violations of Regulation Fair Disclosure (Regulation FD).[8] Meetings with individual shareholders could lead to sharing information that has not been disclosed to others in the market. This concern can be mitigated by using the CD&A as a script in shareholder discussions, which is more effective when the CD&A is written with shareholder engagement in mind.

Educate Your Directors

Shareholders are increasingly asking to talk to directors about executive compensation, and companies are being responsive. Corporate governance leaders are also promoting the significance of director engagement with shareholders. According to the Shearman Compensation Survey, 35% of the top 100 companies that made shareholder engagement disclosures in their 2017 proxy statements reported that board members engaged with shareholders.[9]

To facilitate and prepare for shareholder engagement, companies should focus on director education. Role-play with directors—make sure they can answer the tough questions about the company's executive compensation program. Update directors regularly on changes to plans or developments that could impact how they react to shareholder questions. Conduct director self-evaluations to identify board member training needs. Consider and promote among directors outside director training programs and the engagement of third-party facilitators for evaluation exercises.

It is also essential to educate directors on the disclosure implications of executive compensation decisions, ideally before they are made. Boards must work with management to ensure pay practices are designed to promote strategic goals and are defensible and supportable in light of company performance and good governance standards. Without that foundation, it is difficult to craft an effective CD&A or shareholder engagement talking points.

Control Your Own Story

To help prevent an activist attack and to be well positioned in the event of an attack, companies need to be proactive and bring together thoughtful executive compensation design and disclosure. Be keenly focused on shareholder perception, and make sure shareholders know what, *why*, and how your executive compensation program supports the strategic objectives of the company by clearly and engagingly telling them about it in your disclosure.

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NOTES

1. Shearman & Sterling LLP, Corporate Governance & Executive Compensation 2017: 15th Annual Survey of the 100 Largest U.S. Public Companies (Oct. 24, 2017), http://digital.shearman.com/i/889672-2017-corporate-governance-survey/0? [hereinafter Shearman Compensation Survey]; *see also Shearman & Sterling Releases 15th Annual Corporate Governance & Executive Compensation Survey*, Shearman & Sterling (Oct. 24, 2017), www.shearman.com/en/Perspectives/2017/10/Releases-15th-Annual-Corporate-Governance (last visited June 1, 2018).
2. The top 100 companies are selected based on a combination of their latest annual revenues and market capitalizations.
3. Shearman Compensation Survey, *supra* note 1, at 4.
4. *Id*. at 7.
5. Letter from Ronald P. O'Hanley, Pres. and CEO, State Street Global Advisors, to Board Members (Jan. 26, 2017), www.ssga.com/investment-topics/environmental-social-governance/2017/Letter-and-ESG-Guidelines.pdf.
6. Vanguard Group, Inc., Investment Stewardship 2017 Annual Report 11, 28 (Aug. 31, 2017), https://about.vanguard.com/investment-stewardship/annual-report.pdf.
7. BlackRock, 2017 Annual Report 20 (2018), http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287.
8. 17 C.F.R. §§ 243.100–243.103.
9. Shearman Compensation Survey, *supra* note 1, at 9.