CANADIAN Lawyer

Risk and Reward

Written by Jennifer Brown
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Risk management has become the hot topic for general counsel these days and covers myriad subject matter, but managing the risk around executive compensation has attracted greater attention since the recession.

The economic crisis in 2008 changed the landscape for executive compensation. Some say executive pay schemes in the U.S. helped cause the economic meltdown due to incentives put in place to make short-term gains rather than looking at the long-term impact of those decisions on shareholders. Today, executive compensation packages in some sectors are changing to reflect more conservative times. But at what cost to shareholders and the growth of companies?

Others argue those same executives had large investments in their own company bank stocks and when those stocks dropped they lost fortunes as well. "The issues of executive compensation are constantly changing," says Nadine Côté of CSuite Law and the author of Executive Compensation: A Director's Guide. "Definitely the compensation committee's responsibilities are increasing and there is more scrutiny of the committee and compensation plans."

Following regulatory changes in the U.S., in July 2011 the Canadian Securities Administrators announced it would require public companies to disclose to investors whether their board of directors "adequately considered the implications of the risks associated with the company's compensation policies and practices.

"Issues of executive compensation have always grabbed headlines, but never have companies been held under the microscope more than now. If we look back over the years there was a huge problem with stock options and back dating, then from there with the financial crisis the initial problem was retention payments," says Côté. "Employees worldwide were protesting retention payments being made to executives when around the world people were losing their jobs and pensions were at risk. Today, experts say the goal for everyone involved is to find the right mix with a compensation package that keeps good executives engaged and rewards them but also factors in the long-term health of an organization from a financial perspective.

"There is a balance between making sure you are incenting people and making sure you are still positively reflecting where the company wants to go in the long run as opposed to just short-term cash accrual," says Shana French of Sherrard Kuzz LLP in Toronto. "I'd say a few years ago we were being a little too heavy with the pen in terms of developing 36-month severance packages with single-trigger change of control. We were a little more generous with severance packages, with how to trigger severance, with incentive compensation plans, and now we're seeing it go the other way. We can't have severance packages like that anymore — it's just not going to fly. Instead we're looking at is there a way to characterize departure payments in a different way such as a deferred payment or a departure bonus."

Much of the change in attitude has, of course, been driven by regulatory influences in the last couple of years, says Level Chan, a partner with Stewart McKelvey in Halifax. "There is greater scrutiny in general in the attention paid to the packages and compensation and it's been driven largely by legislative changes and greater shareholder scrutiny as a result of disclosure and in business reporting services online," he says.

Risk management of executive compensation is a complex matter with multiple pressures to be addressed and many different voices weighing in on how it should be handled. "Everyone wants a say in how executives are paid," says Sandra Cohen, a compensation lawyer in Osler Hoskin & Harcourt LLP's New York office. "I think the word bonus has become a four-letter word. I think we need a new word to describe achievement incentives.

"One emerging principle from the economic crisis is risk management and compensation, 'Did we analyze the risk?' Companies need to be prepared to explain themselves to shareholders as to whether appropriate measures are in place in their bonus plans. The question to consider is, 'did my compensation plan require my company to take unnecessary risks for my business?'" Cohen says. "People ask, 'what does risk management mean in compensation?' It doesn't mean taking no risk; it means finding appropriate risk and did we analyze the risk inherent in the pay package? Does it cause executives to take appropriate risks with the business and reward them for success and doesn't reward short-term inappropriate risk-taking."

Today compensation committees face difficult decisions on executive compensation."They are looking to find a balance between pay that is linked to company performance and at the same time mitigating the temptation to engage in risky behaviour," says Cohen.

Going too far away from encouraging executives to take the right risks to spur growth could end up in stunting growth, says Bassem Shakeel, vice president and secretary with Magna International Inc. "The effort to tie compensation to performance is positive, however, the closer the two get linked, the greater the inherent risk in the compensation system. This puts the pay/performance objective in conflict with the risk-management objective," says Shakeel. As a result, he says the critical thinking going forward will be how effectively companies offset the increased risk with effective mitigation strategies. "There is a fine balance that needs to be achieved. Companies that get it wrong one way will find they have loaded their compensation system with risk, while companies that get it wrong the other way may find they have inadvertently created a culture of excessive conservatism, leading to slower growth and low returns for their shareholders. Either way the stakes are high."

Shakeel also wonders whether with each new measure introduced to regulate compensation, public companies will have an increasingly tougher time keeping their top executives. "Like other employees, executives want some degree of certainty regarding how much they will be paid. The level of 'at risk' compensation that an executive is willing to accept will depend on a number of factors, including how close he or she is to retirement," he notes. "Private companies and/or companies based in geographic markets outside of North America and the U.K. may have greater flexibility to structure an executive compensation package in a way that the executive finds more appealing."

For a young executive in the early part of his or her career, the upside potential may be a fair trade-off against the downside risk. However, as an executive in the last stage of his or her career, does it have the same appeal? If not, a private company or a company located outside of North America or the U.K. may be more appealing, since companies elsewhere don't face the same pressures on their compensation systems.

"It's also important to note that compensation structures may create the incentive toward excessive risk-taking, but incentive alone does not result in risk being realized. It is the combination of incentive plus opportunity that equals risk and, typically, such opportunity arises as a result of lax controls," he says. Lehman Brothers Holdings Inc. serves as an example — there was a failure of basic investment controls such as the excessive concentration of business in sub-prime residential mortgages.

But in the Canadian environment the obsession around risky compensation packages is more muted, says Neill May, a partner with Goodmans LLP, mostly because director responsibility is reduced, the incidence of class action is reduced, and Canada generally has a more conservative culture. "This whole dynamic, unfortunately, manifests a distrust of executives which I don't have. Most executives I know are well intentioned."

May says: "Our securities regulators always orient themselves by forcing disclosure as a way of guiding behaviour. It motivates boards of directors to consider compensation frameworks and to ask, 'what does this compensation motivate our internal service providers to do? How does it work in practice? Were we right or wrong and are the motives aligned with other stakeholders in the country and are they suitably balanced between long- and short-term goals?'"

However, so far May says he isn't seeing clawbacks or some of the other tools making up more structured compensation plans. "It's easy to sit in a regulator's chair and say there should be clawbacks or ability to defer. I have seen tailoring of compensation to risk but I haven't seen people accepting compensation packages that let boards of directors take their money back or string them out. It's just not realistic, I don't think."

In Canada, market demand and policies already in place to provide transparency around executive compensation are providing controls for industries such as transportation, says Alain Doré, senior director of legal services at Bombardier Inc. "We have not changed our approach to executive compensation in the last few years. We have had a constant approach of benchmarking. You can see in our disclosure document we are benchmarking with our peers on what we're proposing to our executives and there's no big contract termination packages awarded to any of our executives," says Doré.

Bombardier recently hired Michele Arcamone from General Motors to be president of the company's commercial aircraft division. "We were looking for specialized people — it's a completely different market. We have to be competitive in what we're offering but the competition limits what we should be offering, in a way." Doré says in reality that is what keeps everyone honest — by comparing what everyone else is doing.

Organizations are considering some tools that make compensation plans less risky. Deferring bonus payment is one. "The executive would earn a bonus in one year but be paid in a future year after it's clearer what the impact of the performance from the previous year really is/will be to the company," says Cohen. "It may also mean a longer performance period, not just growth over one year but growth over multiple years."

Côté says she is also seeing interest in clawbacks on bonuses. "Most plans being developed at this stage are including clawback provisions and existing plans are being amended to include clawbacks. Definitely some of our more higher profile Canadian public companies are amending their incentive plans to put clawbacks in place."

The door has also been opened to question existing contracts particularly in a merger-and-acquisition situation where it's a distress sale. "Executive severance is getting smaller — three times is rare, two times is a more comfortable pay package, and not single trigger but double trigger — it requires change and control but also a later termination of employment," says Cohen. Retention bonuses are being paid after the deal is done and is more performance oriented rather than "pay to stay."

Côté says when looking at change of control payments there's always a balance between providing executives the necessary security to attract them during periods of transition. "The concern is if the payments are too high are you motivating the executive team to take excessive risks and trigger the change of control provisions?"

But is there a real concern that executives are looking to take advantage of those factors in an employment agreement? “I don’t think most Canadian executives engage in that conduct and I don’t think there is a prevailing concern with it, but I think when you’re looking at it from a risk assessment you need to look at the amount paid out under change of control,” says Côté, pointing to the recent example involving Viterra Inc. executives including chief executive officer Mayo Schmidt following the sale of the company to a consortium headed by Glencore International PLC.

An article in The Globe and Mail stated that Schmidt’s take would be an estimated $37.5 million, a combination of the value of his stock holdings and the fully vested value of his outstanding options and incentive awards such as restricted and performance share units, and includes payments that would be triggered by the change of control of the company. In accordance with his employment contract he would receive three times his $1.05-million salary and three times the average amount he has received in short-term incentive payments in the past three years for another $2.8 million. “That’s really high,” says Côté, noting the Viterra example is out of touch with trends in the U.S. and Canada where three-times multipliers are going down and two-times multipliers are going up. Three-times cash multipliers have decreased over the period of 2008 to 2010. For CEOs, three-times multipliers have decreased to 44 per cent from 66 per cent, according to Equilar Inc., a U.S.-based company that tracks and benchmarks executive compensation. At the same time, two-times cash multipliers have increased to 35 per cent from 18 per cent. “The trend in Canada is the same,” says Côté.

An Equilar August 2011 report, “Equilar Study: Change-in-control Cash Severance Analysis,” compared change-of-control strategies in Fortune 100 companies from 2008 to 2010. The report noted that the prevalence of change-of-control arrangements has not declined, but companies were decreasing payments and restricting the triggers for payments. To protect their interests companies need to stay on top of what has become an increasily scrutinized area by shareholders.

For large financial institutions and public companies the number crunching of compensation risk assessments are typically done by advisory firms skilled in stress-testing compensation plans. Paul Gryglewicz is managing partner with Global Governance Advisors, an independent executive compensation and advisory firm working for boards of directors, human resource departments, and compensation committees, primarily at financial institutions, resource companies, and even pension funds. The company helps those groups through the annual review of executive compensation, plan designs and levels, and board education. “Any time there’s a new design we want to go through a compensation risk review,” says Gryglewicz. “The objective is to assess the appropriateness of plans relative to the risk appetite for the organization, the business strategies, and the goals and objectives.”

That is done by looking at the policies like pay mix, plan vesting, frequency of payout, and the processes such as the board’s role in the oversight of the plan design. “We look at who is auditing it and double checking the work. Often finance might pass financial results to HR and they plug those numbers into the bonus formula and calculate the payout. We go through and define each of the roles and make sure the numbers are right and then look at governance practices such as board oversight and level of transparency in disclosure,” says Gryglewicz.

For each plan, Global Governance looks at the performance metrics put in place to fund the incentive pool and then they map it into a risk profile relative to the plan design and measure from a governance perspective the riskiness of the plan. “For instance, we look at whether it is a direct drive compensation plan where the sky is the limit for the size of the bonus pool — it may just be contingent on a couple of metrics the executive might need to achieve. Or, is it a more robust plan that uses deferred compensation in the mix? We simulate the business through stretching positive and negative results to understand whether the payouts accrue in those environments and do the payouts make sense given the state of the business we stretched it to?”

In terms of trends Gryglewicz says the Canadian economy seems ripe for M&A activity right now and there may be more cases like Vittera. “Depending on what side of the table they’re on, directors are starting to say, ‘let’s take another look at the employment agreement to potentially update them,'" he says. "They may request updates on the latest trends on common change and control provisions."

Global Governance just went through that process with one of its mining clients to give it an idea of where its peer group was on what could be a reasonable multiplier. "Going from two to three times can be a big differential," says Gryglewicz.

But the biggest trend he sees is boards spending more time engaging in putting some level of performance vesting conditions into the long-term incentive. "You will start to see a trend towards directors wanting to adopt up to three different long-term incentives. So performance share units, restricted share units, and stock options all being used, and when you total it the target opportunity meets the same value but what they've done is change the probability of attainment by adding performance vesting conditions into the plan design."

Of course risk to the business doesn't stop with financial results. In some sectors, executives are being measured against other factors they may find to be even harder to control from their downtown urban offices.

"The hardest one for companies in the resource space is what is the cost of a life if they have a death in a mine? Does it affect executive payout if financial results were still positive?" says Gryglewicz. "It's that process of determining which performance metrics are important and drive value for the long run that is now being implemented in pay-for-performance analysis."