INSIDE THE MINDS

Recent Changes in Employee Benefits and Executive Compensation

Leading Lawyers on Counseling Clients, Understanding New Executive Compensation and Severance Practices, and Responding to Recent Changes to COBRA and ERISA

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Negotiating C-Level Employment Agreements after the Rescue

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Just as this chapter is being submitted to the editors, Credit Suisse announces a new compensation plan in line with G-20 "best practices," essentially vesting the cash portion of the annual bonus over three years, the stock portion over four years, and in both instances, scaling the annual amounts up, down, or clawed back depending on annual returns on equity and the performance of the particular business unit. In ten days, the compensation czar releases his report and recommendations on the pay practices of Troubled Asset Relief Program (TARP) fund recipient banks, but early looks suggest he will require 60 percent of any bonus paid in "salary stock" (stock paid over three years) vesting monthly, 30 percent in restricted stock vesting ratably over three years, and in both instances not transferable for three years.

Change is hardest on those who are unprepared for change. As the compensation landscape is changing almost daily, we too must adapt our methods and goals. This chapter describes some principles and approaches that will help you effectively negotiate executive employment agreements in what I call "the post-bailout era after the hundred-year flood," or, as in the title of this chapter, "after the rescue."

Attorneys in this practice area are at least generally familiar with the TARP, claw-backs, "Say on Pay," the use of consultants by compensation committees, political grandstanding, and the evolving international consensus by which nations that cannot agree on much else are finding common ground over whether and how to limit bankers' pay. See, e.g., the G-20 Summit Resolutions Regarding Executive Pay and Reforming Compensation Practices (Apr. 2, 2009, and Sept. 25, 2009). Despite the markets having executed the largest claw-back in history and having done so more ruthlessly and efficiently than could ever have been done by governmental action—the Dow Jones Industrial Average fell an astounding 7,721 points between its October 2007 high and March 2009 low—the likelihood of additional legislative, executive, and judicial action involving executive pay, including claw-backs, is high,[1] and the continued

[1] See, e.g., Shareholder Bill of Rights Act of 2009, S.1074 111th Cong. (2009); Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269 111th Cong. (2009); Excessive Pay Shareholder Approval Act, S.1006 111th Cong. (2009) (all pending in Congress). See also court proceedings such as *SEC v. Bank of America*, No. 09-6829 (S.D.N.Y. Aug. 3, 2009).

and heightened scrutiny by the public, and by public advocates, is a certainty.[2]

At a time when executive pay is under an electron microscope, it is important to know what you really need to obtain in an executive employment letter, why that is so, and how to go about negotiating such a letter. My team has represented and advised hundreds of C-level financial services executives, many of whom work for banks that are, or were, subject to bailout legislation such as the TARP,[3] the Emergency Economic Stabilization Act,[4] and the American Recovery and Reinvestment Act,[5] or Swiss banking laws[6] or the Financial Services Authority.[7] Some of these executives testified before Congress, or the Cuomo Commission, and in various judicial proceedings concerning compensation. Most have come through unscathed, while some have not. The lessons learned reinforced certain practices and methods, exposed the flaws in others—and, in several instances, the jury, as we say, is still out.

As an overview, and in keeping with our water metaphors, it is important to keep in mind that C-level executives who have survived the market crash of 2007–2008 are like those bathers in the Warren Buffet proverb, "When the tide goes out, we can see who is wearing a swimsuit." When the tide went out with the recent economic collapse, quite a few executives were revealed to be wearing nothing but their birthday suits. However, those who were still wearing their bathing suits earned credentials that were not merely the byproduct of having a pulse on the trading floor during the long bull market, but were forged in surviving the

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[2] New York Attorney General Andrew Cuomo investigation into bonus payments

[3] Troubled Asset Relief Program, see Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

[4] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Div. A, 122 Stat. 3765 (2008).

[5] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

[6] The Swiss Financial Market Supervisory Authority regulates the Swiss banking industry. It aims to protect creditors, investors, and insured persons, and to ensure the general functioning of the financial markets in accordance with financial market legislation. See www.finma.ch/e/finma/Pages/Ziele.aspx.

[7] The Financial Services Authority of the United Kingdom is an independent, non-governmental body that regulates, and is funded by, the financial services industry. See www.fsa.gov.uk/pages/about/who/index.shtml.

downturn through the fourth quarter of 2008. They were not drowned when the economic tsunami came ashore, but instead they found ways to keep themselves, their companies, and their shareholders afloat. Today, however, these same executives find that their pay is under pressure, and they live with the justifiable fear that their hard-earned compensation will be reduced, taxed away, restructured, and publicly disclosed. It is therefore necessary to recognize that a traditional employment agreement containing the usual "protections" might in fact open up the executive to a plethora of unwanted consequences, including a declaration from the compensation czar that a particular agreement is "not in the public interest." The benefits of protections afforded by a traditional agreement may be outweighed by the certain public disclosure and criticism of these employment agreements. Therefore, in negotiating an agreement in this new era, it is important to keep these ten points, which are not necessarily consistent, in mind:

1. First, the greatest protection an executive has comes from his or her own abilities.
2. Second, the most important item an executive needs to ensure compensation, longevity, and fair treatment on the way out is a "seat at the table"—membership in the highest-ranking management committee chaired by the chief executive officer, or, in the case of the chief executive officer, reporting to the board of directors and a non-executive chairperson.
3. Third, the single most overlooked element of a good employment agreement is whether it accounts for the resources the executive needs to succeed, builds in a commitment to such resources, or gives the right to exit cleanly, quickly, and unencumbered if the commitment is unfulfilled.[8]
4. Fourth, the greatest leverage for the well-performing executive comes from the ability to walk away at any time and with few if any post-employment restrictions.

[8] A resignation pursuant to a "good reason" provision will generally nullify a non-competition clause contained in a contract and hence allow the executive to continue his or her career immediately after termination. See, e.g., M.L. Mikva, *Drafting Confidentiality, Non-Compete, and Non-Solicitation Agreements: The Employee's Wish List*; ABA Regional Institute, *Labor and Employment Law: The Basics*; *Trade Secrets, Covenants Not to Compete, and Non-Solicitation Agreements: Basics* available at www.abanet.org/labor/basics/tradesecrets/ papers/mikva.pdf.

5. Fifth, nothing is forever. Like baseball managers, even the best are hired to be fired.[9]
6. Sixth, your client only wants to be rich once.[10] No one wants to lose his fortunes and then have to start all over again. The employment agreement must provide complete downside protection and indemnification,[11] including the right to advance payment of legal fees and expenses (vested on signing) or directors and officers insurance including payments from any indemnification trust. Claw-backs need to be scrutinized and negotiated with complete awareness of the risks they present. For example, an agreement requiring an executive to repay a signing bonus to the company if the executive's employment terminates within the first year will expose the executive to full repayment in the event that he or she dies or is terminated by the company without cause. Scrutinizing the wording of the claw-back and ensuring that amounts are not clawed back for the wrong reasons are vital to protecting the executive from the vagaries of life, human nature, and the marketplace.
7. Seventh, carefully read and be prepared to negotiate every word of the boilerplate. This is not being nit-picky. An iron-clad contract is, by definition, a contract wrapped in boilerplate.
8. Eighth, listen to your client and understand what is most important to the individual.
9. Ninth, a negotiation is not a competition to see who wins the most changes in the contract. Don't lose focus on the underlying business deal.
10. Tenth, close the door, take the phone off the hook, turn off your Blackberry, and think. Read the agreement and imagine that your client has been fired, or quit, or the company announced a merger. Think of all the things that could go wrong and how the contract operates under such circumstances. And think some more. Then read the contract a few more times.

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[9] Casey Stengel won ten pennants and seven world championships in twelve years with the Yankees before he was fired after losing the 1960 World Series; Joe Torre won six pennants and four world championships in twelve years prior to his ouster. High-level success breeds a demand to continue such success.

[10] See, e.g., executives whose fortunes were in shares of Lehman Brothers, Bear Stearns, or Citigroup.

[11] See, e.g., Del. Code Ann. tit. 8, § 145 (West 2009).

Noticeably absent from this list are what most would recognize as the traditional features of a well-negotiated agreement—signing bonuses, multi-year guarantees, golden parachute severances, tax gross-ups, accelerated vesting upon termination, and unique perquisites. These are for the most part no longer politically desirable, even where they may still be lawful, and in many instances may be banned outright, either by statute (as in the case of golden parachute severance payments and tax gross-ups[12]) or by compensation committees determined to demonstrate good and prudent pay and governance policies. Companies from PNC Financial Services to DreamWorks Animation eliminated such gross-ups in 2009, with many more expected to do so in the future as the public awareness of executive compensation becomes even more integral to the compensation process.

Unless your client is leaving an existing position before bonus season, a guaranteed bonus, let alone multi-year guarantees, is rarely defensible by the compensation committee that must approve them. That matters little when you consider who your client is, what he or she went through and what he or she has proved. For that client, your negotiating refrain should be "I don't need a guaranteed bonus or a fixed term of employment. Give me the human capital, infrastructure, and budget envisioned by my business plan. Give me the authority to carry out my plan. Give that to me in writing. My compensation will flow from the company's success and improved shareholder value."

Most importantly, the agreement should emphasize the executive's authority and the company's commitment to the business plan. With severance agreements and accelerated vesting disfavored and sometimes outright prohibited, "good reason" exits that result in reduced post-employment restrictions become the favored negotiated answer to the question, "What happens if the company does not give me the tools I need to be successful?"

What is "good reason"? Simply stated, good reason is the existence of explicit conditions that excuse the executive from performing. Good reason conditions may allow the executive to resign his or her employment without penalty—in fact, often with the compensation and vesting he or she would have received had he or she completed his or her performance and met or

[12] See TARP Interim Final Rule (effective as of June 15, 2009).

exceeded targets. Most important to the post-TARP employment agreement, an executive who resigns for good reason, like one who has been fired without cause, generally and in most jurisdictions is excused from a covenant not to compete. The most common conditions giving rise to the right to quit for good reason are: (1) material reduction in duties, responsibilities, authority, or status; (2) a reduction in the compensation the company has bound itself to pay pursuant to the contract; (3) a requirement for the executive to relocate outside of a certain radius from where he or she now works; or (4) a change in control of the company or, alternatively, a failure of the successor entity to assume the contract.

Good reason is the ultimate hedge for an executive to leave the company in the event that the company effectively blocks the executive from instituting and running his or her business plan and reaping the benefits of success. Properly drawn, a good reason provision will override any contractual restrictions such as notice periods (whereby an executive must give certain notice to the company of the executive's intention to resign), and allow the executive to leave the company immediately and begin working elsewhere—hopefully at a place that will support the vision and business plan the executive was precluded from fully implementing.

Examples of What You Are Up Against

The following is sample redacted language from an actual compensation agreement waiver from an executive of "Bailed-Out Bank" that is subject to the limits and rigors of the Emergency Economic Stabilization Act:

> As a condition of completing the exchange of Bailed-Out Bank preferred stock for Bailed-Out Bank common stock with the U.S. government, Bailed-Out Bank is seeking to obtain a waiver of claims from you. The waiver provides that you waive any claims you may have against the U.S. government or Bailed-Out Bank regarding any changes in your compensation and benefits (including outstanding awards and agreements) that are required to comply with the applicable legal limitations, as reflected in EESA, regulations or other guidance interpreting EESA, as they may be in effect from time to time, the agreements entered into

between Bailed-Out Bank and the United States Department of Treasury and Bailed-Out Bank's Compensation Policy.

Specifically, these legal limitations:

Subject to approval by a special master appointed by the government the compensation structures and payments for Bailed-Out Bank's "senior executive officers" and the next 20 most highly compensated employees. (The senior executive officers, in general, are the five named executive officers appearing in the executive compensation disclosure section of the proxy statement.) The legal limitations also limit this group's bonus, incentive, and retention payments to one-third of the employee's total annual compensation, although certain payments, such as payments pursuant to written employment agreements in effect on February 11, 2009, are exempt from special master approval and the bonus limitations;

Subject to approval by the special master the compensation structures for executive officers and employees among the 100 most highly compensated employees who are not senior executive officers or among the next 20 most highly compensated employees;

Prohibit severance and change-in-control payments to the senior executive officers and the next five most highly compensated employees;

Require "claw backs" of compensation if such compensation is based on statements of earnings, revenues, gains, or other criteria that are later shown to be materially inaccurate;

Prohibit tax gross-up payments; and

Require repayment within 15 business days of any payment received in violation of these legal limitations.

Counsel to executives should be mindful of such Emergency Economic Stabilization Act-related language in an employment agreement, and its ramifications.

In the face of these changes, the new paradigm of a well-negotiated C-level agreement is one that puts your client in the best position to be successful and relies on that success to determine appropriate compensation and protect against termination. The added benefit is that such an agreement makes the client and the company stand out as exemplary models of good governance and thoughtful compensation policy.

The following pointers may make it easier to reach such an agreement:

Know Your Client

This sounds easy and basic, but it may be the most difficult part of negotiating the agreement. Most lawyers are great talkers but poor listeners. Second, many clients are too busy to meet with their counsel, or at too great a geographic distance, or do not appreciate the advantage of having their counsel take their measure while taking the measure of their counsel as well.

Here is a real-life example: Gladstone was offered a once-in-a-lifetime opportunity as an executive board member running an important division of a major investment bank, but the division was in disarray and losing money. The company, trying to adopt "best practices," no longer guaranteed contracts for executive board members, the compensation policy prohibited severance and did not allow accelerated vesting, and equity awards could be clawed back. Why should Gladstone take the job?

Gladstone is one of the most talented leaders on Wall Street. He ran the only profitable division of a major investment bank and did so for many years under three different chief executive officers. He was being offered the job because he was, probably correctly, believed to be the only person who could succeed in turning around the business. Moreover, the board was rational. There was no way this executive would be fired, and if he did not like the job, felt underpaid, or just had enough, the contract provided that he could leave; the good reason clause, if exercised, resulted in the non-compete being cut to two months. On the other hand, if he did well, he would be richly compensated and might even be the next chief executive officer, a position that eluded him twice at his former employer. Therefore, it was as much a goal as having a guaranty, that his contract, which would be a matter of public record, be a model for good corporate governance and rational compensation policy.

Be a Good Listener to Your Client

One of the most respected and admired bankers in America was offered the role of chief executive officer of an important but troubled bank. He saw this as an opportunity to give something back to the nation and the banking industry, but was concerned that regulators would make his job unduly hard and was distraught that his contract would become public record. He wanted the job but not the aggravation, and did not want his name on a public document showing an eight-figure income. I understood that he wanted the job, that he saw it as his "calling" but didn't want to be a whipping boy for regulators or a poster boy for excessive pay.

My advice to this client was twofold. First, I have learned that pre-approval may be a formality, but it is essential. If the client were going to be successful, he would need the support of the regulators. Therefore, he would need to get the regulators' approval before taking the job—and so he did. With respect to disclosure, the client needed to get the best compensation consultant he could find to prepare a traditional competitive pay study of the company's proxy reported peer group, showing exactly what that job should theoretically pay at the seventy-fifth percentile. This study was then given to the company counsel for the compensation committee. Finally, having received pre-approval and established the compensation range, the client asked for fair first-year compensation substantially below what the compensation consultant predicted the job would pay. It was still a significant amount. As a wise client observed in turning down a huge retention payment in order to accept the highly prestigious job as head of one of the world's great stock exchanges, "What kind of man am I if I can't live on $5 million a year?"

The client should then focus on the mix of cash and stock (with an emphasis on more cash—you can always buy more stock); share retention (we have seen that the market can claw back stock more efficiently and ruthlessly than any statute); good reason conditions that promote the ability to succeed (by, for example, giving the executive the right to leave and compete immediately with his or her shares vested upon exit—such conditions give the company every incentive not to diminish the executive's responsibilities or handcuff the executive from succeeding and thereby to avoid losing the executive); and because the company was such a mess and litigation was likely, vesting advance payment of legal fees as part of indemnification.

This type of employment letter, as a paradigm of good governance and compensation policy, now becomes a document that promotes confidence in leadership and gathers support for the chief executive officer's policies and performance. Freed from the shackles of public criticism, the executive can do his job and benefit from the rewards that flow. Indeed, with the confidence that comes from the knowledge of your client's superior effectiveness, and your client's confidence that you understand his or her concerns, ambitions, and strengths, you can direct the negotiation away from the traditional guarantees and instead create the document that supports your client's success.

Building a Client Base

No lawyer can succeed in this practice area without building a client base. My view is that the process of building a practice is a holistic one. As a young lawyer seeking to enter this field, you need to:

1. Be a good listener to your clients—lawyers tend to talk too much.
2. Write sparingly. Think Hemingway.
3. March the law and the facts together. Think Felix Frankfurter.
4. Sit on a jury. You will never ask a pointless question again.
5. Read the advance sheets. You must stay on top of the state of the law.
6. If you have analyzed a line of authority to the bone and are convinced that the authority is wrong, have the courage to act on your conviction.
7. Perform a self-appraisal on a daily basis.
8. Preparation, preparation, and more preparation.
9. Pick up your own phone. Never have your secretary initiate a phone call.

10. Return phone calls promptly.
11. Answer your client's questions.
12. Do not act as if you are the smartest person in the room, even if you are.
13. Evolve.
14. Treat everyone with respect.
15. Older lawyers can teach you a lot. Law is one of the few fields where experience is a plus.
16. Do not hide your light under a bushel basket.

Conclusion

Public opinion, shareholder scrutiny, regulatory changes, and legislative initiatives after the bailout require that we rethink what goes into an employment agreement that serves the interests of our clients. The new paradigm of a well-negotiated C-level agreement is one that puts your client in the best position to be successful and relies on that success to determine appropriate compensation and protect against termination. The added benefit is that such an agreement makes the client and the company stand out as exemplary models of good governance and thoughtful compensation policy.

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In each of the past three years, Mr. Eckhaus has been recognized as a "Super Lawyer" in the field of employment law, and in May 2009, he was named by Human Resource Executive *as among the "100 Most Powerful Employment Lawyers in America" and listed among the top fifteen in New York. He is on the advisory board of the University of California at Hastings Law School Center for WorkLife Law,*

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A Rhodes Scholar nominee, Mr. Eckhaus earned his B.S. from Cornell University in 1972 and his J.D. from Cornell Law School in 1976. He is admitted to practice in New York and New Jersey, the U.S. District Courts for the Southern and Eastern Districts of New York, the District of New Jersey, the U.S. Court of Appeals for the Second Circuit, and the U.S. Supreme Court.

Dedication: *To my parents, Abe and Faye Eckhaus.*

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