Session No. 5: Executive Compensation – Jospeh Bachelder's Perspective

Joseph Bachelder, "Comments on *Pay without Performance*," (Summer 2005).

Jason Barro, Brian J. Hall, and Aaron M.G. Zimmerman, "Joe Bachelder: Executive Pay Negotiator," Harvard Business School Case Study, November 4, 2004.

Joseph Bachelder, "Carly Fiorina and Hewlett-Packard Severance Policy," *New York Law Journal* (March 2005).

Joseph Bachelder, "Negotiating Options for New Executives," *New York Law Journal* (October 2001).

NOTE: This session will take place on Monday, September 26. Students submitting memos should include three comments, one on Bachelder's paper, one on the HBS case study, and another on one of Bachelder's NYLJ columns.

Comments on *Pay without Performance*

Joseph E. Bachelder*

I. INTRODUCTION

In a thought-provoking book, *Pay without Performance*, Professors Lucian Bebchuk and Jesse Fried examine factors that can prevent executive pay from accurately reflecting true performance.[1] There is no more complete and carefully considered published work addressing the weaknesses in the current executive pay process in the United States. The authors ascribe the executive pay problem, as they see it, to a number of factors. First, there is a lack of arm's-length bargaining between boards of directors and the CEOs who sit on the other side of the table seeking to better their own pay. Second, and linked closely to the first point, CEOs possess such power that, if they wish to, they can exert inappropriate pressure on boards of directors to approve pay that is not coupled to true performance. The CEO, for example, has the power to influence the appointment and reappointment of directors who, in turn, approve (within limits, of course) pay packages the CEO wants. (The power to influence exists even if the board has a nominating committee, since the CEO ultimately has influence over the directors on the nominating committee.) Third, there are various forms of "camouflaged" compensation, the cost of which is difficult or impossible for shareholders to determine from proxy statements.

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* Bachelder & Co. This paper builds on comments delivered on October 15, 2004, at the Columbia University symposium on *Pay without Performance: The Unfulfilled Promise of Executive Compensation*.

1. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

Bebchuk and Fried suggest solutions which include greater disclosure such as mandatory expensing of stock options and assigning a monetary value to all forms of pay including pensions, post-retirement perquisites, and consulting contracts. They suggest increasing the number of specific elements of compensation required to be approved by shareholders, including certain features of stock option plans such as vesting. Tax and securities rules as well as rules of self-regulatory agencies like the New York Stock Exchange (NYSE), Nasdaq, and Amex generally require shareholders to approve such compensation plans, but with very limited requirements on specific provisions. They also suggest requiring shareholder approval of certain severance arrangements.

The authors conclude that the solution of the executive pay problem must include improvements in the corporate governance process itself. They propose, among other things, broadening shareholder rights in the process of nominating and electing directors. They note that current SEC proposals, while a step in the right direction, fall short of giving shareholders a real say about board membership. They also would broaden the rights of shareholders to include voting on governance matters such as amending the corporate charter.

Professors Bebchuk and Fried state that the implications of their work should not be limited to problems with executive pay. The problems with executive pay imply broader problems in the way our public corporations govern themselves. It would be a very valuable contribution to the subject of corporate governance if the methodology applied by Professors Bebchuk and Fried to executive pay in *Pay without Performance* were applied to other areas of corporate activity. They then might develop broader-based conclusions and recommendations on corporate governance.

II. A RESPONSE TO *PAY WITHOUT PERFORMANCE*

In their thorough analysis of the executive pay process as evidence of broader problems in the U.S. corporate governance process, Professors Bebchuk and Fried do not give us a full picture about why our society, as a whole, "tolerates"[2] the current high levels of pay. This tolerance exists despite the extraordinary criticism CEO pay receives in the media and from able commentators and academics such as Bebchuk and Fried.

I suggest the following points in this regard:

First, I doubt the critics would be so upset with executive pay if such pay was limited to current cash compensation, meaning salaries and annual bonuses at levels presently in effect. The critics' principal target is equity, primarily in the form of stock options. Part II.A takes a closer look at the stock option phenomenon in executive pay.

Second, others in our society are paid equivalent amounts without the criticism directed at CEOs. As an example, Part II.B examines asset manager pay.

Third, forces and pressures at work on executive pay go beyond the relationship between CEOs and boards of directors. Over decades, an ever growing, ever more complex, and ever faster moving economy has invested CEOs with a very high level of impact on the market values of the companies they run. Part II.C examines this phenomenon.

Finally, in this alternative view of executive pay, I note that executive pay is but a

2. "Tolerate" as in doing relatively little to combat the high levels of executive pay.

sliver of the totality of corporate activities and issues embedded in corporate governance, and corporate governance itself is inextricably tied to the challenges raised by the hyperactive, "more now" globally driven economy. The solutions to executive pay issues, including those offered by Professors Bebchuk and Fried, must be considered in this broader context.

A. Salary and Bonus Growth Versus Stock Option Growth

1. Salary and Bonus Growth

In the last 50 years, CEO salaries and bonuses have grown as follows:

Table 1

	CEO Median Salary and Bonus[3]	Annualized Percentage Increase for the Preceding Decade	Annualized Rate of Inflation for the Preceding Decade[4]
1950	$ 103,200	0.4%	5.9%
1960	153,210	4.0%	1.8%
1970	180,000	1.6%	2.9%
1980	455,000	9.7%	8.0%
1990	1,050,000	8.7%	4.5%
2000	1,628,000	4.5%	2.7%

In the 1950s and 1960s, the rate of increase in CEO cash compensation (salary and bonus) actually trailed the rate of pay increase for U.S. production workers.[5] In the 1990s, CEO cash compensation grew faster than production workers' pay.[6] However, cash compensation did not have the extraordinary growth that stock options did.

2. Stock Option Growth

From 1992 to 2002 (the earliest ten-year period available on the S&P ExecuComp Database), the value of CEO stock option grants, as measured by the Black-Scholes formula (see discussion of this formula *infra* Part II.A.3), grew 3.6 times.[7] During the same ten-year period, from 1992 through 2002, the value of stocks listed on the NYSE grew 2.4 times. During the eight-year period, 1992 through 2000, the value of CEO stock

3. This column is based on the *Business Week* Executive Compensation Survey as reported each year.

4. The rate of inflation was determined based on the Consumer Price Index (Urban) (CPI-U), published by the Bureau of Labor Statistics, U.S. Department of Labor, for the relevant period. *See* Bureau of Labor Statistics, U.S. Dep't of Labor, Consumer Price Index (containing data from 1913 to present), *available at* http://www.bls.gov/cpi/home.htm (last visited May 11, 2005).

5. For CEO compensation data, see BEBCHUK & FRIED, *supra* note 1. For production workers' pay, see SCIway, Average Hourly Earnings—SC, NC, GA, and All U.S. Manufacturing Workers—1950-2001 (2002) (using data collected from the U.S. Department of Labor, Bureau of Labor Statistics), *available at* http://www.sciway.net/data/mfg-earnings-dollars.html (last visited May 11, 2005).

6. *See supra* note 5 for sources of CEO and production workers' pay.

7. Standard and Poor's, ExecuComp Database (June 2004), *at* http://mi.compustat.com (available by subscription only, data on file with author).

options in the same database grew 6.3 times and the value of NYSE listed stocks grew 3.1 times. In a September 2002 report, the Conference Board indicated that approximately eighty percent of the increase of CEO pay between 1992 and 2000 was attributable to the increased value of stock option grants.[8]

3. Black-Scholes and Stock Options

Starting in the mid-to-late 1980s, commentators, consultants, and others became enthusiastic about stock options as a way to tie executives' objectives and motivations to increasing shareholder wealth. At about the same time, the stock market was taking off and the Black-Scholes method became an accepted measure for valuing stock options.[9] The Black-Scholes method values an option based on historical performance of the underlying stock ("volatility") as well as other factors, including the market price and the option exercise price at the time of the grant (usually these prices are the same in the case of executive stock option grants), the term of the option, the dividend yield, and the risk-free interest rate.

Notwithstanding the widespread use of Black-Scholes in valuing employee stock options, it is debatable whether the Black-Scholes value represents an accurate measure of the stock option's value to an executive. The Black-Scholes formula was designed to measure the value of short-term publicly traded options. It does not take into account the fact that an executive stock option (which typically has a term of ten years, not three to six months like most publicly traded options) is not transferable by the executive (except in very limited circumstances), and is generally forfeited if the executive fails to remain employed for a substantial period of time after the grant (vesting in annual installments over three or four years is a typical requirement).

A 2003 study by the Bachelder Firm of approximately 1200 companies found that for those CEOs (approximately 200) who were CEOs for the full ten years covered by the study, the ratio of option gains to cash compensation (salary plus bonus) for the ten-year period was approximately one-to-one. Option gains included gains realized upon exercise of options plus the spread of options at the end of the period in excess of the spread at the beginning of the period.

The Bachelder study was limited to CEOs who remained employed with the same employer for ten years. CEOs who remained employed for less than ten years generally would have forfeited a significant portion of their option grants and, therefore, almost certainly would have shown a lower ratio of option gain to cash compensation than the ratio for the CEOs in the Bachelder study. A basic flaw in Black-Scholes when applied to executive stock options is that it fails to reflect the likelihood that many executives will not remain employed for the full option term and, as a result, will forfeit at least some of the options granted to them.

8. THE CONFERENCE BOARD COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, FINDINGS AND RECOMMENDATIONS—PART 1: EXECUTIVE COMPENSATION 4 n.4 (Sept. 2002), *at* http://www.conference-board.org/PDF_free/756.pdf (last visited May 10, 2005).

9. In the early 1990s, the SEC approved Black-Scholes as a method for valuing stock option grants in proxy statements.

B. Asset Manager Pay Versus CEO Pay

Asset manager pay is one yardstick against which CEO pay can be evaluated. Like CEOs, asset managers are responsible for the investments they manage, but unlike CEOs, they do not have the job of running the businesses in which they make those investments. Extensive analysis, careful attention to markets, and good judgment are among the qualities required for a successful asset manager. Yet the role of the CEO of a major public company is generally more complex than that of an asset manager. The CEO supervises thousands, sometimes tens of thousands or even hundreds of thousands, of employees. The CEO answers to dozens of other constituencies including shareholders; a board of directors; federal, state, and local governments; foreign governments; and an ever present, increasingly intrusive media. Measured by their contribution to the U.S. economy and the complexity of their jobs, CEOs and their pay certainly warrant favorable comparison to asset managers and their pay.

In the U.S. economy, we pay asset managers much more than we pay CEOs if we measure the pay of each as a percentage of the assets for which each is responsible. A typical fee for asset management is one percent of the assets under management. Table 2 shows several ranges of market capitalization of major U.S. corporations. Next to each range is the median actual pay of the CEOs of the companies in these categories as a percentage of the market capitalization of the companies they manage.

Table 2

	CEO Pay as a Percentage of Market Capitalization[10]
Over $50 Billion	0.0247%
$30 to $50 Billion	0.0373%
$10 to $30 Billion	0.0646%
$5 to $10 Billion	0.1013%
$2 to $5 Billion	0.1564%

1. Asset Managers Generally Are Businesses While CEOs Are Individuals

Asset managers are generally institutions that hire people to do the work of asset management, whereas CEOs are individuals who receive compensation and are not personally responsible for any of the expenses of the enterprise. But even if one assumes that two-thirds of every management fee dollar goes to salary, cost of space, and other expenses, the net balance to the asset manager still substantially exceeds CEO pay, as referenced by the pay to assets-under-management ratio (Table 2). It might be argued that the profit of the asset manager represents a return on capital involved. However, asset managers have relatively little capital employed beyond the intellectual capital of the asset management employees, and the fees charged to clients presumably cover the compensation of those employees.

10. Standard and Poor's, *supra* note 7. CEO pay includes salary, bonus, and stock options. The percentages shown represent the average of the ratios for each of the companies in each size range. The overall average for the 675 companies in all size ranges ($2 billion and larger) is 0.1095%.

2. Asset Managers Do Not Always Get One Percent on the Assets They Manage Because Formulas Vary

Asset managers realize less than one percentage point on very large amounts under management.[11] Asset managers of fixed income investments typically earn less than one percent of such assets under their management. On the other hand, asset managers frequently charge other fees in addition to asset-based fees. For example, in addition to the basic asset management fee, hedge funds generally charge twenty percent of profits, most often after it first achieves a hurdle return.[12]

C. A Changing Perspective on CEOs: 1953-2003

In 1953, CEOs were viewed much more as caretakers of the assets they managed. By 2003, CEOs were viewed as much more responsible for the market values of their companies and for the deployment (and redeployment) of the assets they manage. Furthermore, the market values of the companies managed by CEOs have had enormous growth accompanied by an enormous increase in trading volume and annual turnover.

Table 3 shows the averages for NYSE listed companies showing (1) market value as of December 31, 1953 and December 31, 2003; and (2) annual trading volume and annual share turnover for the years 1953 and 2003.[13]

Table 3

	1953	2003
Average market value of companies listed on NYSE	$108 million	$4.4 billion
Average annual trading volume (per company) of shares listed on the NYSE	327,000 shares	128 million shares
Average annual turnover (per company) of shares listed on the NYSE	12.4%	99.3%

In addition to the tremendous increase in the size, value, and trading volume of companies managed by CEOs, the complexity of managing the world's largest enterprises has also grown incrementally over the past fifty years. CEOs are faced with an ever quickening pace of strategic, crisis-driven, operational and financial issues. Their performance is measured against quarterly financial statements that put great pressure on them. Not only are current operational and stock price concerns involved, but the

11. For example, an asset manager may charge less than one percent for an account of $10 million or more.

12. Peter Coy, *Fear Not All Hedge Funds*, BUS. WK., Dec. 14, 1998, *available at* http://www.businessweek.com/1998/50/b3608142.htm (last visited May 11, 2005).

13. NYSE, FACT BOOK ONLINE, "Historical" chapter, *at* http://www.nysedata.com/factbook/main.asp (last visited May 11, 2005).

prospect of being merged with or otherwise acquired by a larger company regularly confronts CEOs. In the late 1950s, the average number of companies removed from the NYSE listing each year because of a merger was thirteen; in 2002 it was sixty-five.[14] This statistic does not take into account potential acquisitions of smaller enterprises that add to the portfolio of CEO responsibilities.

Neither shareholders nor boards of directors can be the "hand on the tiller" in this barrage of corporate activities swirling around major U.S. public companies. Only one person can be in charge: the CEO. The CEO is paid to take care of this barrage. If the CEO does not take care of it, then he or she should be removed. Failure to remove a failing CEO is not a pay failure: it is a corporate governance failure.

III. CONCLUSION

The CEO pay issues identified in *Pay without Performance* are part of a broader set of circumstances that include a short-term oriented economy that is moving ever faster in an ever more complex global environment. Our business enterprises, supervised by boards of directors, are willing to pay CEOs what they consider necessary to keep up in that fast-moving economic environment. The motto of that environment might be described as "more now." That motto and that environment apply to much more than executive pay.

If the results are not fair and appropriate to the shareholders who own these enterprises, it may be that significant changes in our corporate governance system are required. That means changes in the institutions and processes of corporate governance affecting not only executive pay but also other aspects of our businesses as conducted by major public corporations must be made.

What Professors Bebchuk and Fried have done—and it is a very significant accomplishment—is to conduct a close, sophisticated scrutiny of an important aspect of the governance of our major public companies. Their work shows without question that there are real problems and, I hope, real solutions to the failures in the principal-agent paradigm attributed to the modern corporation as discussed by Adolf A. Berle and Gardiner C. Means nearly seventy-five years ago.[15] Unfortunately, the board of directors as an institution "caught in the middle" in today's fast moving world of large and complex public corporations has not always lived up to its billing of seventy-five years ago. That does not mean we should not be trying to find solutions within or outside the paradigm. Finding such solutions is the direction in which *Pay without Performance* is pointing and represents a very constructive step in that direction.

14. *Id.* at "Listed Companies" chapter.

15. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (14th ed., Macmillan) (1932).

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Joe Bachelder: Executive Pay Negotiator

By the time Bachelder gets involved, the headhunters have finished their work, the directors have made up their minds, the candidate is willing, and it's up to Bachelder to close the deal.

— David Whitford, *Fortune*, June 8, 1998[1]

It was an early Saturday morning in October 2000 when Joe Bachelder stood at the window next to his desk and looked down on the rooftops of midtown Manhattan. Bachelder was an attorney who represented executives—CEOs in particular—in the negotiation of their employment agreements with the companies that hired them. In addition, when an executive left a company, he was often retained to negotiate that executive's severance agreement. The list of companies that employed his clients in their top slots read like a *Who's Who* of American corporate giants: United Airlines, RJR Nabisco, American Express, Kodak, NBC, Gillette, AT&T, IBM, Bank of America, Lucent, and Bank One, and many others. During the past two decades, Bachelder had negotiated such a high proportion of pay contracts for "superstar" CEOs that many companies had come to expect to negotiate with him when attempting to attract a high profile executive from another company.[2]

But Bachelder had just been dealt an unexpected setback with his new client, Charles Suarez, the leading candidate for CEO at Victor Sports. Suarez, executive vice president at Duncan Inc., one of Victor's competitors, oversaw Duncan's highly profitable sports equipment division. He was widely viewed as an industry star, due mostly to his work in reviving Duncan's once ailing golf division, turning it into the market leader. The board at Victor, a sporting goods and athletic apparel manufacturer, had chosen Suarez, feeling he would be able to revive the company's lagging sales and restore its former household-name status.

Wood Taylor, representative of Victor's general counsel, had just faxed Bachelder the terms of Victor's initial offer. Bachelder saw that the compensation package was significantly below the amount he and Suarez had planned to propose. He immediately faxed the terms to Suarez and called him to discuss the situation.

Suarez had been excited at the prospect of running Victor, a company with annual revenues of around $5 billion. Now his excitement was beginning to cool. At home in San Francisco, he stared at

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[1] David Whiford, "Becoming CEO? Call Him First," *Fortune*, June 8, 1998, pp 281-284.

[2] See Whitford, "Becoming CEO?" *Fortune*, and George Anders, "Upping the Ante: As Some Decry Lavish CEO Pay, Joe Bachelder Makes It Happen," *Wall Street Journal*, June 25, 2003, A1.

Professors Jason R. Barro and Brian J. Hall and Research Associate Aaron M. G. Zimmerman prepared this case. Some of the facts and names in this case have been disguised. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

the fax and asked Bachelder if he saw a solution. Many of Joe Bachelder's Saturday mornings started this way.

"I think they will move up on the salary and bonus," Bachelder said, "but the question is whether they will be willing to close the gap on the equity component and to provide you with an adequate supplemental pension to make up for what you're leaving behind."

"Do you think we can get that?" Suarez asked.

"I think what we are proposing is completely reasonable," Bachelder replied. "They want you to turn this company around. You're taking a considerable risk by leaving where you are now. All we're asking is that you be compensated at a level appropriate for an outstanding CEO in this industry. Now let's talk about the other aspects of their offer."

The Law Offices of Joseph E. Bachelder

After graduating from Yale University, then Harvard Law School in 1958, Joe Bachelder had worked as a tax attorney at Mudge Rose, a leading New York law firm where Richard Nixon had worked. After leaving law to work as a consultant at McKinsey for a brief period of time, he returned to another New York law firm, where he became a partner. His disagreements with the older partners at that firm led to his eventual departure. "I was a bit aggressive in expressing my views about who ought to become partner and who ought not," he recalled. "So I left."[3]

In 1980 he founded his own law firm specializing in executive compensation. In the early days, Bachelder was usually the sole representative of his client, the prospective CEO. The hiring company, however, often had a team of advisors, including lawyers from a large New York firm. Eventually, as Bachelder's practice grew, he had a bit more help[4], but the negotiation process, and his role in it, remained the same. His stated goal was to get "a fair and reasonable compensation package"[5] for his client.[6]

Bachelder's reputation as a tough negotiator was given a major boost in 1989 in a much-publicized battle with Henry Kravis of the well-known leveraged buyout (LBO) firm Kohlberg Kravis Roberts (KKR). KKR had just acquired RJR Nabisco in the largest and perhaps most infamous hostile takeover ever, and Kravis asked Lou Gerstner to take the CEO position.[7] Gerstner agreed, and retained Bachelder to negotiate his employment contract. Gerstner wanted to acquire RJR shares at a very low price, much to the chagrin of Kravis. Ultimately, due to Gerstner's insistence and Bachelder's persistence, Kravis agreed. Gerstner signed on as CEO and chairman with an initial package worth

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[3] Anders, "Upping the Ante," *WSJ*.

[4] In 2003, the Bachelder firm had four partners and six additional attorneys (employed as associates or counsel). It also employed 12 other people as financial analysts and support and administrative staff.

[5] Whitford, "Becoming CEO?" *Fortune*.

[6] Once the employment agreement was finalized, it would be signed by a top officer of the hiring company and Bachelder collected his fee, usually paid by the hiring company. In 2003, Bachelder's hourly billing rate was $975.

[7] The takeover was colorfully portrayed in the book *Barbarians at the Gate* by Bryan Burrough and John Helyar (New York: Harper and Row, 1990). The book was later turned into a movie by HBO.

$13 million, with the option to buy restricted RJR stock for pennies per share.[8] This coup helped to gain wide recognition for Bachelder as a skillful pay negotiator.

The Market for CEOs

The Good Old Days[9]

The finding and hiring of new CEOs in the US was not always so complex, nor were there always so many people involved in the process. Until the 1980s, executive search firms, compensation consultants, and third-party CEO agents like Bachelder had a very low profile in corporate America. CEOs usually came from the inside of the company in the early days of American capitalism. The person who owned the company was also the person who ran the company. If the company president was not the founder, he was often a relative or descendent of the founder. A president usually handpicked his successor then groomed him for the job. Boards simply rubber-stamped his choice.[10]

As corporations grew in the early twentieth century, the owner/founders needed help to manage their expanding empires. They began to delegate the management of their firms to the emerging class of "professional managers."[11] While the founders and their descendents had owned large portions of the company, these new managers were paid a cash salary and received little, if any, equity-based pay. As they moved up the corporate ranks, the result was that fewer and fewer CEOs were descendents of the founding family.

Simultaneously, the increased need for capital in these growing corporations required selling more portions of the company to outside shareholders. Thus ownership became more widely distributed among a diffuse group of investors. At first, these shareholders were relatively powerless. If they did not like the way a company was run, their only method of protest was to sell the stock and invest somewhere else. For the most part, CEOs had a high degree of sovereignty to run the company as they saw fit and to choose their own successors.

The Executive Search Firm

The modern executive search process began to take shape in the 1940s at the elite levels of the business world. At that time, Bill Clark (founder of William Clark Associates, an early leader in the executive search industry) and Zip Reilly (of McKinsey) conducted much of the top-executive search "process" sitting in the mezzanine lounge of the Yale Club in New York City. Eventually, McKinsey and Booz Allen developed formalized executive search practices within their firms. Soon after, independent executive search firms followed.[12] These firms were small and local in their focus: "Business was generated largely as a consequence of the [search firm's] founder's connections"—to

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[8] Anders, "Upping the Ante," *WSJ*.

[9] Much of this historical account of the market for CEOs was drawn from Rakesh Khurana's *Search for a Corporate Savior: The Irrational Quest for Charismatic CEOs*. (Princeton, NJ: Princeton University Press), 2002. pp 52-61.

[10] Khurana, 61.

[11] See Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: Belknap Press), 1977.

[12] Khurana, 121.

start a search firm, you just needed a "convincing salesman with a telephone and a carefully collected Rolodex."[13]

In post-war America, the chief service of search firms was meeting the burgeoning demand for executives after World War II. Corporate America was growing as the demand for US products increased, new industries developed, and economic power shifted away from a war-shattered Europe. Later, the 1960s witnessed the emergence of large retainer-based firms: Heidrick & Struggles International, Spencer Stuart & Associates, Russell Reynolds Associates, and Korn/Ferry International. In the beginning, these firms placed only senior executives, not CEOs.

The Rise of the Outsider CEO

In the mid-1980s, after two decades of lackluster US corporate performance, the shareholder revolution ushered in a new era of powerful institutional shareholders, LBOs, and equity-based pay for executives. Boards became more attentive to shareholder demands, and many directors began holding stock in the companies they oversaw.

It was in this environment that firms began hiring more outside CEOs. This change had its roots in the early 1990s when the boards of several *Fortune* 100 companies began to remove under-performing CEOs in response to pressure from institutional shareholders. These companies had been struggling for some time and had no clear successor from within. Consequently, they turned to search firms to help them find a new CEO. For the first time, it became acceptable for search firms to help companies find CEOs, not just executives. Business professor Rakesh Khurana explained, "Up to that point, the idea of an outsider coming into the organization as CEO without at least a few years in the firm's own senior executive ranks was close to heresy. The appointment of an outsider was seen as suspect, a failure on behalf of a company's board and top management to develop competent executives."[14]

Between 1991 and 2001, the percentage of CEOs hired from the outside jumped from 21% to 33%.[15] And by the early 2000s, there were thousands of executive search firms with worldwide industry revenues at $11.5 billion[16], and the median compensation for CEOs was worth about $7 million.[17] This was the universe where Joe Bachelder lived and thrived.

Victor Sports: An American Story

In 1925, Hiram H. Felts began producing baseball bats and gloves in Philadelphia. His quality equipment for America's pastime became increasingly popular with his slogan, "Nothing else feels like a Felts." In 1927, he scored a major success when he introduced the first baseball glove with connected fingers and webbing between the thumb and forefinger.

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[13] Ibid., 121-122.

[14] Ibid., 126.

[15] Data presented by Brian Hall and Rakesh Khurana at the Inaugural Event for the HBS European Research Center, Paris, France, March 6, 2003.

[16] 50% of revenues were generated in the United States (see Khurana, 120-121).

[17] Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspectives* 17: 3, Summer 2003, 49-70.

In the 1930s, Felts took Victor into other sports. First was tennis, which proved a very successful business move. He soon added golf, basketball, and football equipment to his business. In 1935, Felts hired his nephew, engineer E. Howard McComb, to head the R&D division. In 1947 McComb pioneered the use of nylon string in tennis rackets, offering a more durable alternative to natural gut strings. A Victor racquet suddenly became *de rigueur* for any serious tennis enthusiast and Victor Sports became the premier brand for tennis equipment. Around this time, Felts saw that McComb had an intuitive grasp of marketing and operations and began grooming McComb to replace him when he retired. In 1949, he retired and McComb succeeded him as president of Victor Sports.

Building off of their brand recognition in the tennis world, in the early 1960s, McComb spearheaded Victor's drive into the athletic shoe market, producing a very popular shoe designed for tennis. They soon began producing shoes for all their other sports divisions, and added a track and field division, then headed by McComb's son, Franklin. Victor became a dominant player in the very profitable athletic shoe world. By the late 1980s, they had 19% of the market share in athletic footwear.

Franklin McComb, who became CEO in 1970, oversaw Victor's rise to prominence in the athletic apparel market. They produced shirts and shorts for tennis, track and field, along with other athletic and recreational apparel. By the 1990s, they had an 11% share of the sports apparel market.

In 1982 Franklin McComb retired, and Glen Chalmers, then president of the Victor shoe division, became CEO. For the first time in its long history, Victor Sports was run by someone outside of the founding family. The remaining descendents of the Felts-McComb clan had long ago removed themselves from day-to-day management of the company. However, family members still retained 53% of the company's stock, and four of them sat on the company's board.

The Victor Stumbles

In the mid-1990s, Victor's flagship tennis division continued to generate consistent revenues, but the company began losing momentum. Market share in footwear and apparel decreased to 10% and 5%, respectively. Earnings likewise fell. In response, Vernon Murray, who had replaced Chalmers as CEO in 1992, began some new marketing campaigns and sponsored some major tennis tournaments in the US, but the company's health had not rebounded. Board member Abe Silverman recalled, "Around that time some people on the board began to question whether Vernon was really the right guy for the job." Earnings had decreased for several quarters, and the business press began to voice louder calls for Murray's departure.

In March of 2000, under pressure from the board, Murray resigned. Chalmers, who had remained on the board, stepped in as an interim chief executive and chairman while the board began searching for a permanent replacement.

The Hunt for a CEO

The board now turned their attention to finding a CEO who could put Victor back on the map in the sports equipment and apparel industry. They met in April to discuss their options. "There were some people on the board who thought we should look within the company. Glen, the interim CEO, threw some names out. But most of the senior management were nearing retirement, and there were no clear stand-out choices from the younger ranks," one director remembered. Another recalled, "The company was not doing well, so in light of that, I didn't really want to bring in someone from the inside, from the 'losing team,' so to speak." Silverman said, "There was also a lot of pressure from

some of the larger non-family shareholders, including some pension funds, to get an outsider who could turn the company around."

"We debated for a while, but pretty quickly decided to do an outside search," summarized director Mary M. Stevenson, daughter of Franklin McComb. Stevenson, as chair of the compensation committee, was the board's choice for head of the search committee. "It's pretty standard in these cases to have the compensation chair head the search," she explained. "Plus I was retired at the time, and I suppose I had more time to devote to the process."

The Search Committee

To fill out the remaining seats on the search committee, Stevenson asked for volunteers. The resulting committee was comprised of Ed Coley, a longtime Victor director and former CEO of a packaged foods company; Abe Silverman, a law professor at the University of Pennsylvania; Michael McComb, a retired banker and great-nephew of Hiram Felts; Phil Barber, a retired professional tennis player turned entrepreneur who had long endorsed Victor products during his sports career; and Tom Felts, an advertising executive and grandson of Hiram Felts.

When the search committee met again in May, the first item on the agenda was the selection of an executive search firm. Typically, search firms engaged in a "shootout" to compete for the company's choice. Heidrick & Struggles, Lee & Neal, and Russell Reynolds each made presentations to the search committee, explaining their view of the industry, the company's needs, the kind of CEO Victor required, and why their search firm could do the job. Each firm stressed their quality research, their constantly updated database of executives, and their global reach. The committee chose Lee & Neal. Stevenson explained, "I had worked with them before, and felt confident in their abilities. Since these firms are on a retainer, there is really no difference in price. It came down to the fact that I felt more comfortable with Lee & Neal since they were more familiar to me."

Over the next two months, Charles Lee and Vivian Fraser, partners from Lee & Neal, met individually with each member of the board to discuss their requirements, ideas, and suggestions for a new CEO.

The Perfect Candidate

Charles Lee explained the search process at the beginning stage: "The first thing we do is meet with the directors to listen to their ideas for the kind of person they want to hire. Based on these conversations, we draw up a specification sheet listing the responsibilities and qualifications for the new CEO, along with a description of the company." Vivian Fraser added, "The spec sheet is a crucial part of the search process. It gets everyone on the same page, and really creates a benchmark to evaluate all the candidates. It also can be a very revealing process for the board, and it helps them to think about what they want and what their priorities are."

In their meetings with Lee and Fraser, the directors explained that they wanted a CEO who was an aggressive, decisive, and strategic leader with top-level executive experience in their industry. "We wanted someone who could really energize the firm and lead us back to the top," one director said.

After their meetings with the directors, Lee and Fraser met with the search committee in July and presented their draft of the specification sheet. The committee members gave their suggestions and clarified some parts of the document. Stevenson then instructed the search firm to produce a final draft of the spec sheet.

Making the List

With the specification sheet completed, the next step was to make a list of potential candidates. The majority of the names on the initial list came from the directors themselves, who suggested other executives they knew in the industry, as well as executives at other companies where they were on the board. The search firm added some other names from their database. From this list of about 20 people, Lee and Fraser began doing research and eliminated people who were near retirement, who would cost too much, or who their firm had placed in the last three years.

Now armed with a list of 12 candidates, the search committee met with the search firm two weeks later. "After looking at the list, even at that stage," one director recalled, "Suarez seemed to be the most desirable choice. He had really done a fantastic job at our competitor's golf division, raising revenues on the order of 20%. And the press loved him. He'd been on the cover of *Fortune* with the headline, 'Charles Suarez Hits a Hole in One.'" Charles Lee remembered that "in doing our research, Suarez had quickly risen to the top of the pack in our minds. He was a star in the industry, and had a reputation for very quick and strategic thinking." According to Michael McComb, the other candidate who stood out was Eric Tyler, who "ran a division at a smaller company relative to ours, but had done a great job."

Mary Stevenson summed up the overall mood at the end of the meeting: "When we heard about the results Suarez was producing at his current company, we were pretty enamored. He definitely seemed like the brightest light in the group by far. Although some wanted to simply offer him the job, others thought that we should keep the list broad and do more work." The search committee went through the list and narrowed it down to seven people they thought were qualified.

Narrowing the Field

The search firm then began carefully contacting the candidates, avoiding mention of the hiring firm's name. Their goal was to learn which of the executives would be willing to leave their current position for the CEO job at Victor. With this information, the search firm was able to pare down the list to four people. Following the instruction of the search committee, Lee and Fraser then met individually with each of the remaining candidates and completed background checks on them.

At that point, each person on the search committee (as well as the search firm) took responsibility for doing some quiet research on the finalists with whom they had personal or professional connections. One director sat on the board at a company that had previously employed Suarez, and he immediately called the chairman to discuss the candidate. "Making those phone calls was pretty tricky business," the director recalled. "You obviously can't call the guy's current CEO or chairman, or anyone he currently works with. But you don't want to go too far back and call his high school biology teacher either. The idea is to get people in between those extremes, people who worked with the guy a few jobs back."

When the search committee and the search firm met again in August to discuss the results of the research and interviews, the search committee found that Suarez had received accolades from everyone contacted. Eric Tyler had also been strongly recommended, but there was little discussion of the other candidates on the list, who the committee now felt were the wrong fit for Victor. "They went back and forth on Tyler and Suarez for a while," Vivian Fraser remembered. "Finally I told them, 'Look, Suarez has really done a fantastic job at Duncan. He also clearly showed us in our interview with him that he has an impressive knowledge of your business, and he knows the kinds of strategies you need to more forward. This guy can lead you back to the forefront of the sports world.'"

The Interviews with the Full Board

While its members were all but decided about Suarez, the search committee felt it would be prudent to bring in both Suarez and Tyler to meet with the full board. During the course of the search process, the committee and all parties involved had been very careful to keep the process confidential. But they grew even more cautious at this stage, since a leak to the press of the identities of the finalists could be disastrous. If the public knew who the candidates were, and if one of them eventually turned Victor down, the board felt the company's image would be tarnished and the incoming CEO would begin his job as the "runner up."

The interviews were held over dinner on Sundays a week apart in late September at the Ritz-Carlton in Dearborn, Michigan. The board had selected this location due to its central geographic location, but most importantly, it was nowhere near Philadelphia, the location of Victor's headquarters.

The committee met first with Tyler, and found him quite likable. It was clear that he was eager to make a good impression. The board asked about his family, how much he liked Philadelphia, as well as some of his ideas of how he would run Victor. He outlined his plans for some cost-cutting as well as some more targeted marketing efforts and new products. A week later, Suarez joined the board for dinner. "There was a great sense of anticipation in the room as we waited for Suarez to arrive," remembered Silverman. "Once he got there, he was a very direct no-nonsense guy. He talked about ways we could reach new demographics with better marketing and how we could grow with some strategic acquisitions." Ed Coley remembered, "He really wowed us."

The Offer

After meeting with Suarez, the board met and promptly concluded that Suarez was the one. After making their decision, Stevenson instructed the search firm to extend the offer to Suarez. Stevenson also called Ray Clayson, the committee's compensation consultant from Miller Banks & Montgomery. Clayson, at the committee's behest, had been analyzing CEO pay in Victor's industry, and had outlined the general range and composition of pay they should offer their new CEO. Stevenson now told him they had chosen a new CEO, and asked him to research Suarez's current compensation and equity holdings based on Duncan's proxy statements and SEC filings. She wanted Clayson to draft a term sheet by the end of the week to fax to Suarez, and asked Clayson to "tell us what to put into it."

Meanwhile, Charles Lee called Suarez. "Hello, Mr. Suarez. This is Charles Lee from Lee & Neal." He paused. "How would you like to be the next CEO of Victor Sports?" Suarez did not miss a beat. He immediately replied, "I'm honored and I would welcome the challenge." They agreed to work out the compensation arrangements quickly, and Suarez said he would talk to his counsel. After hanging up the phone, Suarez called Joe Bachelder.

The Call

After introducing himself, Suarez said, "I assume you know that Victor Sports is looking for a new CEO. Well, I've just been offered the job." After agreeing to represent Suarez, Bachelder stated, "The first thing we have to clear up is whether or not you have an agreement with your current employer not to go work for a competitor for a period of time after leaving." A one-year non-compete agreement was not unusual for someone in Suarez's position. "I've got good news for you," Suarez answered. "I have no such agreement."

"Great," replied Bachelder. "I'd like to meet as soon as possible." They decided to meet the next week in Seattle. Both Bachelder and Suarez were keen to avoid meeting in New York, where both had many acquaintances from the corporate world, or in San Francisco, where Duncan was headquartered. Suarez wanted to keep his candidacy under wraps in case the deal did not go through.

The Negotiation Process

Four days later, Bachelder met Suarez at his hotel suite. They exchanged pleasantries and admired the view of Seattle's skyline. Their conversation quickly turned to business.

The Compensation Package

"First," Bachelder began, "what are your top priorities in terms of compensation if you join Victor?" Suarez answered, "Well, I expect an appropriate increase in salary and bonus to put me in line with the industry." (See **Exhibit A** for Suarez's compensation package as of 2000 at Duncan.) He continued, "The hard thing is I'd be leaving behind this year's bonus since I'd be leaving mid-year, and I'm also leaving a bunch of unvested stock and options on the table. Right now, I'm holding about 300,000 options, with a third vested and two-thirds unvested, and 50,000 restricted shares[18] worth about $2 million. All of this will be forfeited when I leave except for the one-third of the vested options that I'll have to exercise before leaving. Plus, if I stay at Duncan and our EBIT numbers stay on track, I'd be up for another option grant next year. Is there a way I can be kept whole on all of that at Victor?"

Exhibit A Charles Suarez's Compensation Package at Duncan

Item	Value
Salary (2000)	$750,000
Bonus (paid in 2000 for services rendered in 1999)	$450,000
Accumulated Equity:	
Restricted Stock (50,000 shares)	$2,006,000
Options[19] (Black Scholes value of 300,000 options)	$4,447,000

Source: Casewriter

Bachelder assured him that it was standard practice for a hiring company to "make whole" a new CEO. In other words, the new company would provide a compensation package of cash and equity to restore what the executive was leaving behind from his previous employer. Typically, when Bachelder negotiated a CEO's compensation, the "make whole" amount represented a key part of the package.[20] Bachelder explained to Suarez:

[18] Duncan's stock was trading around $40 per share.

[19] The weighted average of the exercise price of these options was $30.23 and the weighted maturity was five years to expiration. Duncan shares closed at $40.12 on July 29, 2000.

[20] Bachelder employed an attorney with a doctorate in mathematics who would analyze the current value of the candidate's stock, options, and other compensation and calculate the make whole amount.

> When someone like you leaves a secure position to become CEO somewhere else, you're taking a big risk. The pay package is designed to make sure, among other things, that you're not going to be worse off because of what you forfeit. So your forfeited annual bonus should be guaranteed in the new contract. Also, new CEOs usually want a guaranteed bonus for their first full year at the new company. The thinking there is that it may take a while to turn the company around, and there may be some negative factors affecting company performance that were created before you arrived. Then there is the sign-on award. This is really where the idea of make-whole comes in. Executives leave behind unvested stock and options. And you have to consider the potential future value of all that equity if you stay put. So all that has to be restored with some combination of grants of stock, options, and/or cash. Finally, the company has to give some kind of make-whole on the pension plan, to make sure you don't lose the years of credited service at Duncan.

Bachelder explained all this to Suarez, and asked for the rough figures of Suarez's current salary and bonus. He then ran through the numbers with Suarez to get a ballpark figure for the new CEO's salary, bonus, annual equity, and sign-on equity award.

Pension

In order to make up for the loss of credited service that the candidate had accumulated under his old firm's pension plan, Bachelder would usually secure a contract that granted the new CEO a certain number of years of deemed credited service at the new company on day one of his new employment. Suarez had been with Duncan for 15 years and was fully vested in his benefit. According to Duncan's defined benefit pension plan, he would be entitled to an annual benefit of 25% of his covered compensation based on those 15 years of credited service (future service would increase the percentage above 25% based on 1.66% per year of service). Covered compensation meant average compensation (salary plus bonus) for the five highest-paid years within his last ten years of employment at Duncan at the time of his retirement. This would likely be a pension in the neighborhood of $300,000 a year based on his current compensation. But the value of this pension at Duncan, based on the 15 years of credited service that he already had accrued, would increase as his covered compensation (salary plus bonus) increased in the future.

Bachelder emphasized that, in one form or another, Victor must be asked to make Suarez whole on the pension opportunity he would forfeit on leaving Duncan. He suggested they ask for 15 years of deemed credited service beginning with Suarez's first day on the job as CEO at Victor, since the pension formulas of Victor and Duncan were the same. If Suarez worked for Victor for 10 years, Victor would credit him with 25 years of service (15 years for his service at Duncan and 10 years for his service at Victor). Victor would calculate the Victor pension based on 25 years for credited service and then would offset that pension by the $300,000 pension due from Duncan. After 10 years at Victor, Suarez would have a pension that Bachelder estimated would be approximately $1.1 million before offset for the Duncan pension. Thus, the "umbrella" pension that Bachelder proposed would mean that, if he worked for 10 years at Victor and then retired, Suarez would receive a pension of approximately $800,000 from Victor and $300,000 from Duncan, or approximately $1.1 million in the aggregate.

Benefits and Perks

From there, the conversation turned to welfare, benefits, and perquisites. This did not take much time, as Suarez was happy to accept the standards as Bachelder outlined them: health insurance (continuing for life after retirement, or for two years if Suarez were terminated without cause), one

club membership, a car with driver, and use of a company plane. Details about Suarez's use of the plane for personal or family trips, Bachelder assured, could be discussed later in the negotiation.

The Job Title

Suarez mentioned that after doing some initial research about Victor, he had a concern about running the company that had nothing to do with compensation. "The descendents of the founding family still control over 50% percent of this company. But to turn this company around, I want to be in the strongest position I can from a corporate governance standpoint. What do you suggest?"

"In addition to the CEO position," Bachelder replied, "I suggest you propose chairman of the board as well. That way you will be answering directly to the board without someone looking over your shoulder all the time." Bachelder then asked, "Who is president?" Suarez explained that there was no president but that the board wanted to hold that position open for "a future number two guy." "Ask for the position of president as well," said Bachelder. "As chairman, president and chief executive officer, it is your choice under your employment agreement exactly when and if the title of president will go to someone else. It substantially strengthens your management position." Suarez asked, "Can you make sure we get that in the agreement?"

Bachelder indicated that he thought Suarez could get all three titles.[21] He then said they had another major area to discuss: termination.

The Seven Pillars of Termination

"Going in, no one likes to talk about termination. It's like bringing up divorce before a wedding," acknowledged Bachelder. "But I've seen so many cases where it's not adequately addressed and everyone thinks everything will be fine. Believe me, many executives see me wishing they'd had a severance agreement." Severance had to do with a lot more than "golden parachutes" following a change in control. "Severance provisions also provide protection for a CEO who does well but doesn't get along with the board," Bachelder explained, "and the board wants to terminate the CEO without having specific grounds to terminate for cause."

He then outlined to Suarez a standard of his firm's practice: the "Seven Pillars of Termination." These "pillars" were the seven events that would result in the CEO's termination. They were: death, disability, termination with cause, termination without cause, termination by executive for good reason, voluntary termination, and termination after a change in control. In almost all negotiations, Bachelder told Suarez, "I review with my client the consequences that should follow from each of these terminations in terms of severance (if any), vesting, post-termination exercise of options, and vesting of pension benefits, among other things. Termination without cause gets the most attention, but it's important to cover all the others too." He also pointed out that crucial to any negotiation were defining such terms as "cause" and "good reason."

Bachelder suggested they negotiate for terms such that, in the event of termination by Victor without cause or by the executive for good reason, Suarez would receive two times both his annual salary and bonus, all unvested stock or options would immediately vest, and his medical insurance would continue for 24 months. "Sounds good to me," Suarez said.

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[21] In cases in which he was negotiating for a candidate who was being hired for a senior executive position, but not the CEO slot, Bachelder might also negotiate for the candidate's promotion time-frame.

Suarez asked Bachelder what would happen if there was a change in control of Victor. Bachelder suggested that "severance should increase to three times salary and bonus." He also informed Suarez there might be a special excise tax (around 20%) on certain payments and benefits Suarez received in a change in control. Bachelder proposed that they ask Victor to "gross up" the severance amounts so that after any excise tax, the package would be worth the target amount absent the excise tax.

At the conclusion of their meeting, Bachelder asked Suarez to send him detailed information on his stock options, restricted stock, and pension entitlements, as well as five years of cash compensation history and copies of his current employment agreement and incentive compensation plans. Bachelder said, "I'll take the information you've given me today, and I'll look at what you'll send me when I get back to New York and begin putting together our proposal reflecting what we've talked about today. We should hear from Victor soon with their initial offer. Based on what they propose, we'll then be in a position to respond to Victor's general counsel who's handling all of this.[22] They'll take it to the search committee, and we'll see what they say."

Bachelder Goes Back to NY

When Bachelder returned to New York, he asked his staff to gather some data. "I want to know how other CEOs in Victor's industry are paid—particularly the CEOs at Duncan and Victor for the last five years (see **Exhibit B** for 1999 pay data). With this data, and the detailed information he had about Suarez's compensation and stock and option holdings, he determined a pay package for Suarez. He took into account what Suarez was leaving behind at Duncan, including the potential gain he would have if Duncan's stock continued to rise over the years, and his pension. Bachelder then reviewed his findings with Suarez in anticipation of receiving an offer from Victor.

Exhibit B Sports Equipment, Footwear, and Apparel: Industry-wide CEO Pay (1999)

Company	Revenues (millions)	Salary	Bonus	Restricted Stock (value at grant)	Options (Black-Scholes value at grant)
Tiger	$10,549	$1,091,478	$2,932,000	$5,010,740	-
Duncan	9,741	1,082,500	1,665,000	-	$11,862,000
Aria	7,486	890,243	2,105,000	905,500	2,037,375
Massive Sports	6,015	905,000	1,305,854	2,121,890	237,525
Victor	5,102	752,148	705,000	283,950	851,850
BOCI	2,793	783,201	952,000	-	4,330,950
AllFirst	1,058	862,899	1,025,812	845,070	745,650
Prime Group	983	499,000	1,068,950	-	175,200
Tree Line	621	652,148	677,000	260,600	2,110,860
SportLife	491	750,980	350,250	98,010	868,725
Fastlane	375	502,285	325,000	-	-
VFA	325	487,500	275,892	263,000	580,704

Source: Casewriter.

In putting together the compensation package, Bachelder explained, "I decided to ask for a 50% increase in cash compensation—salary and bonus. Charles was making about $1.2 million a year at

[22] Bachelder usually interacted primarily with the hiring company's general counsel or outside counsel. In some cases, he also worked with the search firm consultant, the chair of the search committee, and/or the company's human resources officer.

Duncan, and we decided to ask for $1.8 million. We knew this was aggressive, but it was in line with the median pay of CEOs in the industry, and reflected the value that Victor wanted Charles to bring to the company." Then Bachelder turned to the sign-on award. "Since Charles would be losing his 50,000 shares of restricted stock worth $2 million, we asked for 100,000 shares of Victor restricted stock, in order to make him whole on that."[23]

In turning to the option compensation, Bachelder took into account the fact that Suarez had 100,000 options that were vested, and 200,000 unvested. These were standard options with an average weighted exercise price of $30. Bachelder assumed Suarez would cash out his vested options, netting him about $1 million. That left the remaining 200,000 unvested options. Since Suarez would never cash in these options if he joined Victor, Bachelder asked for a cash grant of $2 million to cover the forfeited spread.

Suarez had told Bachelder that it was important to him to have the same equity stake in Victor that he'd had at Duncan, namely, that he be given an option package to replace the one he was forfeiting by leaving his current employer. Bachelder suggested they propose a grant of 600,000 Victor options. "My reasoning," Bachelder explained to Suarez, "is that you've got a lot of value in your 300,000 options at Duncan, assuming a stock price of $40. If Duncan's stock price doubled in value over the next five years, those 300,000 options would produce a growth in value of $12,000,000. Since you want Victor to give you the same opportunity at Victor, where the stock is at $20 per share, you would need 600,000 options today. So that anchors our proposal."

In addition, Suarez, knowing that he was slated to receive additional options at Duncan, proposed a guaranteed minimum option grant of 150,000 options per year for both 2001 and 2002. Thus, Suarez would be under contract to receive 900,000 aggregate option shares at Victor by the end of his second year of employment. Bachelder assured him this was "a very customary proposal."

The day after Bachelder and Suarez settled on the terms they would propose, the search firm forwarded to Bachelder the proposal prepared by three people: the head of HR at Victor, Victor's general counsel (represented by Wood Taylor), and Stevenson, the chair of the search committee. The proposal contained a bullet list giving the terms of Victor's initial offer. Bachelder immediately saw that for several items in the compensation package, there were large differences between what Victor was offering and what Suarez and Bachelder were planning to propose.

Victor's Proposal

Victor offered Suarez a salary of $800,000 a year, with the chance to earn 100% of his salary in bonus. They also offered Suarez $2 million worth of Victor restricted stock to make up for the stock he was forfeiting at Duncan. Finally, they offered him 500,000 at-the-money Victor options with a Black Scholes value of $3.5 million. They arrived at this figure by taking the Black Scholes value of Suarez's 300,000 Duncan options (around $4.5 million), and subtracting the $1 million in value that Suarez could collect from his 100,000 vested options. So they were aiming to make Suarez whole on the $3.5 million in Black Scholes value he was holding in Duncan options. With the Black Scholes value of an at-the-money Victor option at about $6.83, they offered him 500,000 options. Finally, regarding Suarez's pension, instead of 15 years credited service, they offered five extra years to be accrued over the first five years of employment (See **Exhibit C**).

[23] Victor was trading at about $20 per share.

Reviewing Victor's Term Sheet

Upon receiving the proposal from Victor, Bachelder faxed a copy to Suarez along with a copy of the term sheet he had just drafted for Suarez (See right column of **Exhibit C** for details). He then gave Suarez a call. After they reviewed the differences between the two proposals in compensation, Bachelder discussed the fact that the terms from Victor said nothing about the consequences of termination due to death and disability. It also did not protect Suarez upon the occurrence of certain events like diminution of Suarez's duties or decrease in salary (which Bachelder noted should be treated as good reason for Suarez to quit and receive severance just as in a case of a termination without cause). Bachelder pointed out that his term sheet also provided reasonable definitions of cause and good reason.

Exhibit C Competing Proposals for Suarez's Compensation Package

Item	Victor Proposal	Suarez Proposal
Salary	$800,000	$900,000
Target Annual Bonus[a] (expressed as a percentage of salary)	100%	100%
Sign-on Award		
Value of Restricted Stock	$2 million (100,000 shares)	$2 million (100,000 shares)
Stock Options	500,000	600,000[b]
Cash For Forfeited Option Spread	None	$2 million
Pension	1 extra year of credited service for each year of actual credited service up to five. [c]	15 years credited service starting day one. [c]
Severance		
Without Cause (or by the executive for Good Reason) Absent Change in Control	2 x annual salary & bonus	2 x annual salary and bonus
Without Cause (or by the executive for Good Reason) in Connection with Change in Control	2 x annual salary & bonus	3 x annual salary and bonus

Source: Casewriter.

[a] Target Annual Bonus represents the amount of bonus to be paid out if the executive meets annual performance targets. Performance below or above targets would result in a smaller or greater bonus amount based on predetermined bonus payout schedules.

[b] Suarez also asked for a guaranteed minimum option grant of 150,000 options per year for each of 2001 and 2002.

[c] Under both proposals, the Victor pension calculated, as noted, would be offset by any other Victor pension provided Suarez (e.g., under a supplemental pension program for all executives). In addition, the Suarez proposal would offset the Victor pension by the Duncan pension ($300,000) and the Victor proposal would offset a pro-rata part of the Duncan pension (up to 1/3 of it depending upon the number of years (up to 5) that it credited Suarez with under its proposal).

Other issues covered in Bachelder's term sheet were perquisites they wanted included in the contract (*e.g.*, use of company aircraft, provision of a car and driver, membership at country and luncheon clubs, and provision for financial and tax advisors), expanded life insurance coverage, reimbursement of Bachelder's legal fees, indemnification protection (including directors and officers liability insurance), and provision for the settlement of disputes (Bachelder proposed arbitration). They also discussed narrowing the restrictive covenants proposed by Victor which included protection of Victor's confidential information, Suarez's not going to work for a competitor of Victor

after the end of his employment, and non-solicitation of Victor employees and customers after ending employment with Victor.

After this discussion with Suarez,[24] and in response to Victor's proposal, Bachelder sent his term sheet to Wood Taylor (shown in **Appendix 1**). Taylor then reviewed the document with Mary Stevenson and with Charles Lee.

The Deal Sours

The Board's Reaction

The search committee convened in late October to discuss the term sheet they had received from Bachelder. Mary Stevenson recalled her reaction: "My feeling was that no matter how good he was, to pay someone that much would really damage the culture at our company. We had never paid anyone near that much." Michael McComb had similar feelings. "It was just too much money. Our compensation consultant had done an analysis comparing our firm with similar sized companies, and he said Suarez's package was totally out of whack. Taking into account his sign-on award, not only would his package make him the highest paid CEO by a large margin for companies of our size, his cash compensation alone would put him close to the top of the whole industry, all for a guy who has never been CEO." He was also uncomfortable with Suarez's request to be chairman. "We were taking a risk in bringing someone from outside the company," explained McComb, "and I thought we should have someone with more experience with our company sitting in the chairman's seat."

Ed Coley had a different view. "It's definitely a hefty package," he told the other directors, "but in terms of what we want him to do for the company, I think it's reasonable." Abe Silverman agreed. "He's done amazing work at Duncan, and I know he will add energy and life to this company. We are losing ground by the day, and we need the best there is. And if we all agree he's the best candidate, which I recall all of us saying after his interview, shouldn't we pay for it?"

Director Tom Felts added, "When we sat around a few weeks ago talking about what we wanted in a CEO, we all said we wanted a top executive from this industry. The pool of top executives is different from what we're used to—no offense. But if we want to be a first class company, we have to compete in this market for talent. These are the kinds of packages top CEOs get. If we don't pay him this, one of our competitors will. We're only talking about a few million dollars here."

"Is may seem like just a few million dollars, but it could end up costing us a lot more," McComb countered. He was concerned that paying Suarez so much would create a "vacuum cleaner effect, just pulling up the compensation of every other executive in this company." He concluded: "To agree to this package just sets a bad precedent for Victor."

Stevenson said, "I agree. I'm sorry, but this is so far above what we paid our previous CEOs. And most of them did a pretty good job. Here's what I suggest. We'll increase our offer as to salary and bonus, and we'll accept his severance proposal. But we can't just give him almost a million options.

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[24] At this point, Suarez asked Bachelder if he should make Duncan aware of the negotiation with Victor to possibly "open the door" to a separate negotiation with Duncan to improve his package there. While this was not uncommon, Bachelder discouraged this because Suarez had not yet received a final signed offer from Victor. If that were to be received, he and Suarez would discuss negotiating a period of time (up to a week) in which to decide whether to accept Victor's offer, allowing Suarez to meet with Duncan's chairman and see what, if any, response Duncan was prepared to make.

He'll have chance to build up equity in Victor over time. If money alone determines whether he accepts this offer, then perhaps we don't want him."

The committee debated for four hours. Finally, they decided to give Suarez the salary and bonus he asked for, but to stick with original offer regarding the make-whole on equity (*i.e.*, 500,000 options rather than the 600,000 asked for by Suarez). They would not offer a $2 million cash payment. Nor would they guarantee the option grants for 2001 and 2002. As to the pension proposal, they declined to increase the deemed credited service from five years as originally offered. On other points raised by the Bachelder term sheet, they were willing to accept the counter-proposals. (See **Exhibit D**). Stevenson contacted Wood Taylor and told him to communicate the offer to Bachelder. Taylor called Bachelder the next day and told him he was faxing the new term sheet.

Exhibit D Victor's Counter-offer to Suarez

Item	Victor Counter Proposal
Salary	900,000
Target Annual Bonus[a] (expressed as a percentage of salary)	100%
Sign-on Award	
Value of Restricted Stock	$2 million (100,000 shares)
Stock Options	500,000
Cash For Forfeited Option Spread	None
Pension	1 extra year of credited service for each year of actual credited service up to five.[b]
Severance	
Without Cause (or by the executive for Good Reason) Absent Change in Control	2 x annual salary and bonus
Without Cause (or by the executive for Good Reason) in Connection with Change in Control	3 x annual salary and bonus

Source: Casewriter

[a] Target Annual Bonus represents the amount of bonus to be paid out if the executive meets annual performance targets. Performance below or above targets would result in a smaller or greater bonus amount based on predetermined bonus payout schedules.

[b] Under the Victor Counter Proposal the Victor pension, as noted, would be offset by any other Victor pension provided Suarez (e.g., under a supplemental pension program for all executives). In addition, the Victor proposal would offset a pro-rata part of the Duncan pension (up to 1/3 of it depending upon the number of years (up to 5) that it credited Suarez with under its proposal).

Back at Bachelder's Office

Suarez flew into New York the next week and met with Bachelder to review the new term sheet from Victor. Suarez sat on the couch in Bachelder's office, and took the term sheet Bachelder handed him. After talking about Victor's proposed terms, Suarez said, "I still can't believe it. They want an outstanding performer but are unwilling to pay for it," he said. "I would still love to run a company, and after looking at Victor's numbers, I really know I could do this well. I know if I stay at Duncan, it's likely that I'll become CEO, but there's no guarantee."

Suarez concluded he was unprepared to accept Victor's new offer, but would continue to negotiate. "I am willing to back off my proposal for a sign-on option grant of 600,000 shares. I'll take the 500,000 shares offered instead. But beyond that, I am unwilling to move. The two guaranteed

option grants in the future and the 15 years of credited service I want to keep." He then asked Bachelder, "What do you think?"

Bachelder indicated that competitive data and practices supported Suarez. "I also feel that by reducing the sign-on proposal," Bachelder said, "you are signaling continuing interest and good faith in the negotiation." Based on his discussions with Wood Taylor, however, Bachelder was "not sure that Victor would accept the counter offer." But he did not think that Victor would "walk away from the table" simply because Suarez countered, rather than accepted, Victor's offer. "OK," Suarez agreed, "but I'm getting a bad feeling about this."

At Suarez's instruction, Bachelder called Wood Taylor to let him know that they were sticking with the original Suarez proposal except to the extent of reducing their sign-on option amount to 500,000 shares.

Victor's Volley

After receiving notice of Suarez's response to Victor's counter offer, the committee met to discuss their response. They decided to call a full board meeting to discuss the offer to Suarez. "Frankly, we were surprised when Charles turned our offer down," recalled Stevenson. "Considering the fact that what we offered was much more generous than what we've paid in the past. And we were giving him the chance to run one of the great American companies. But we all have our priorities, I suppose." Michael McComb felt that "It would have been nice to have Charles Suarez as CEO, but we felt like our products were strong enough, we had a great brand, and we could get someone else who could run the company well who wouldn't cost us so much." McComb suggested that they call Eric Tyler. Silverman pointed out that Wall Street might question the wisdom of hiring someone from a smaller firm and recommended acceding to Suarez's proposal. But eventually the other board members won out and they voted not to adjust their offer. Wood Taylor was instructed to advise Bachelder that Victor was not prepared to change its offer.

Upon hearing of the board's response, Suarez walked away from the deal. "I felt I had a better future at my current employer," he said. "And judging from my interaction with the board at Victor, I'm not sure I would have enjoyed working with them."

The board met a few days after the deal with Suarez had fallen through. Interim CEO and chairman Glen Chalmers asked the directors, "Of the remaining candidates, who do we feel is the one to lead Victor?" Mary Stevenson proposed Eric Tyler. McComb seconded it. All were in favor. "Very well," Chalmers said. "I'd like to conclude this quickly. Mary, put a call into Eric Tyler and see if we can wrap this up by the end of the year."

Shortly after receiving the call from Stevenson, Tyler called Joe Bachelder.[25]

[25] Upon receipt of the call from Tyler, Bachelder spoke with Suarez who, having concluded he had no further interest in the Victor job, gave his permission to Bachelder to represent Tyler.

Appendix 1: Term Sheet as Proposed by Bachelder and Suarez

CONFIDENTIAL

Key Terms for Proposed Employment Agreement

1. **Term**: The term of the employment agreement shall be 5 years (the "Term") commencing on January 1, 2001 (the "Effective Date").

2. **Position/Title**: Chairman of the Board of Directors, (the "Board"), Chief Executive Officer ("CEO") and President of Victor Sports Company (the "Company").

3. **Duties**: Duties and responsibilities customary for such positions. Will have responsibility and authority to manage the day-to-day business affairs and operations of the Company (subject to the direction and authority of the Board and the customary policies and practices of the Company and its affiliates). Will devote substantially all of his full working time and efforts to the performance of his employment with the Company.

4. **Other Activities**: May continue to serve as a member of the board of directors of the companies of which he is currently a director, and after the first anniversary of employment may, in addition, serve as a member of the board of directors of one additional company. At any time, will be entitled to serve on civic and charitable boards. Except for current memberships, all service on outside boards is subject to the approval of the Board and is authorized to the extent such service does not interfere with the performance of his duties as an employee and Board member of the Company.

5. **Principal Place of Employment**: The Company's World Headquarters in Philadelphia, PA.

6. **Compensation**:

   (a.) Sign-on Awards

      (i) Cash payment of $2,000,000. $1,000,000 payable six months after the Effective Date and $1,000,000 on first anniversary of the Effective Date.

      (ii) Restricted shares - 100,000 shares, 50,000 vesting on first anniversary of the Effective Date and 50,000 vesting on second anniversary of the Effective Date.

   (b.) Base Salary - $900,000 per year, with annual review for increase, and increase to be in the sole discretion of the Board. Any increased salary shall become the new base salary.

   (c.) Annual Bonus - Will be eligible to receive Annual Bonuses pursuant to the Company's Management Incentive Plan (the "Bonus Plan"). Bonuses are paid for each fiscal year of the Company ("Fiscal Year") subject to meeting performance goals. Annual performance goals will be determined by the Compensation Committee in accordance with the terms of the Bonus Plan. The Executive will have an annual bonus target of no less than 100% of base salary. For Fiscal Year 2001, he will have a minimum guarantee of the target amount, pro-rated for the period of active employment during such Fiscal Year. Bonus opportunity for Fiscal Year 2002 will be guaranteed at $900,000 with upside potential subject to the terms of the Bonus Plan.

(d.) Initial Equity Awards - On the Effective Date, a grant of stock options under the Company's 1994 Long-Term Incentive Plan (the "Plan") providing for 600,000 shares of the Company's common stock, which will have a ten-year term and one-third of which will vest on each anniversary of the date of grant.

(e.) Future Equity Grants

(i) Stock Options - Will be eligible to receive annual awards of stock options under the Plan. Grant in each of calendar years 2001 and 2002, to be awarded in June or July of options for no less than 150,000 shares (to be adjusted for any recapitalization, stock split, etc., prior to grant date). Options will have a ten-year term and vest at a rate of 30% of the option shares on the first and second anniversaries of the date of grant and the remaining 40% will vest on the third anniversary of the date of grant.

(ii) Restricted Shares - Will be eligible to receive grants of restricted shares under the Company's regular long-term incentive program.

(iii) With respect to any other equity awards, including future grants of stock options or restricted shares, the Executive will receive such equity awards in such amounts and on such terms and conditions as may be established by the Board and the Compensation Committee in accordance with the terms of the Plan on a basis at least as favorable as awards to other senior executives of the Company..

(f.) Deferred Compensation - Will be eligible to defer compensation pursuant to the terms of the Company's Deferred Compensation Plan.

7. **Pension:** The executive will be provided a supplemental pension determined by the number of years of credited service with the Company, plus the number of years (15) of credited service with his prior employer, multiplied by 1.66%, which percentage will then be multiplied by his covered compensation. For this purpose, covered compensation means the average total cash compensation (salary and bonus) for the Executive's five highest-paid years (or, if shorter, the number of years he is employed) within his last ten years at the Company. The pension as so determined shall be offset by any other pension provided by the Company and by the pension provided the executive by his prior employer.

8. **Welfare Benefits**: No less favorable than those provided to other senior executives of the Company; in all events, life insurance policy with face amount of no less than four times Base Salary and long-term disability coverage equal to 50% of his Base Salary to age 65. Eligible for 4 weeks vacation each year starting in 2001 in accordance with the Company's vacation policy.

9. **Perquisites**: No less favorable than those provided to other senior executives of the Company; in all events, use of Company aircraft (on same basis as provided the prior chief executive officer), car and driver, membership at one country club and one luncheon club and $25,000 annual financial and tax planning allowance.

10. **Expenses**:

(a.) Temporary Living Expenses - From January 2001 through the earlier of June 2002 or his relocation to permanent housing, Executive will be reimbursed for reasonable temporary living expenses in the Philadelphia area, including apartment and furniture rental, and will be provided a car and driver on as-needed basis.

(b.) Relocation Expenses - Executive will be entitled to reasonable relocation expenses in accordance with the Company's Relocation Policy.

(c.) Other Expenses - Reimbursement for all appropriate business expenses, including legal fees for these employment arrangements.

11. **Definitions of Cause, Good Reason, and Change in Control**: See definitions set forth in **Attachment #1** hereto.

12. **Termination**:

(a.) Without Cause by the Company or due to Good Reason by the Executive (other than in connection with a Change in Control). The Executive shall receive the following: (i) All amounts earned or accrued through the termination date but not paid as of the termination date, including Base Salary, reimbursement of reasonable expenses and vacation pay (collectively referred to as "Accrued Compensation") and a pro rata portion of bonus for the year of termination based on the portion of the Company's Fiscal Year that has elapsed prior to the date of termination, provided that the Executive has been employed by the Company for at least three months of the Fiscal Year, and with the payout determined following the close of Fiscal Year and certification of performance (accelerated payment of guaranteed bonus amount for 2001 if termination occurs during that year); (ii) accelerated payment and/or vesting of any sign-on award under Section 6(a) not yet paid or vested, as the case may be; (iii) a lump-sum payment equal to two times Base Salary and Target Bonus; (iv) 24-months continuation of employee welfare benefits, including medical and life insurance benefits (capped at age 65); and (v) 24 additional months of deemed employment for purposes of vesting and accrual of benefits under the Company's pension plans (capped at age 65). Accelerated vesting of unvested options and all options will remain exercisable in accordance with the terms of the Plan at the time of the grant (currently, the earlier of (i) three years from the date of the termination or (ii) the expiration date of the option).

(b.) Without Cause by the Company or by the Executive for Good Reason in Connection with a Change in Control. The Executive shall receive the following: (i) Accrued Compensation and a bonus for the year of termination equal to a pro rata portion of the Bonus Amount (as defined below); (ii) accelerated payment and/or vesting of any sign-on award under Section 6(a) not yet paid or vested, as the case may be; (iii) a lump-sum payment equal to 3 times Base Salary and Bonus Amount (which is defined as the greater of (a) the Executive's Target Bonus under the Bonus Plan for the Fiscal Year in which the termination of employment occurs, or (b) the average of the annual bonuses paid or payable during the two full Fiscal Years ended prior to the date of the termination of employment); (iv) 36-month continuation of employee welfare benefits, including medical and life insurance benefits (capped at age 65); (v) vesting of accrued pension and savings plan benefits through the date of termination plus the actuarial equivalent of 36 months additional benefits (capped at age 65) in lump sum payments, pursuant to the Company's pension and 401(k) plans; and (vi) accelerated vesting of all unvested options and all vested options shall remain exercisable for the remainder of their term. For excise tax gross up see Section 13 below.

(c.) Death or Disability. The Executive or his Estate will be entitled to: (i) Accrued Compensation and a pro-rata bonus (determined as set forth under Termination Without Cause, supra); (ii) accelerated payment and/or vesting of any sign-on award

under Section 6(a) not yet paid or vested, as the case may be; and (iii) 12-months continuation of employee welfare benefits, including medical and life insurance. Vested options will remain exercisable in accordance with the terms of the Plan at the time of grant.

(d.) For Cause by the Company. The Executive will be entitled to (i) any Accrued Compensation and (ii) accelerated payment of any cash under Section 6(a)(i) not yet paid.

(e.) Voluntary Termination by the Executive. The Executive will be entitled to any Accrued Compensation and may exercise options vested on the date of termination in accordance with the terms of the Plan at the time of grant [currently, the earlier of 90 days from the date of termination or the expiration date of the option]. A Voluntary Termination shall not be a breach of the employment agreement.

(f.) Miscellaneous. In the case of any of the foregoing terminations, the Executive or his estate will also be entitled to other benefits, if any, in accordance with applicable plans and programs of the Company. If the Executive is entitled to continuation of employee welfare benefits under Section 12(a), 12(b) or 12(c) but the applicable plan does not permit eligibility following termination of employment the Executive shall receive the after-tax economic equivalent to the benefit that he would receive except for such ineligibility.

13. **Excise Tax Gross Up in the Event of a Change in Control**: If the Executive incurs Federal excise tax (20%) upon certain payments and benefits in connection with a Change in Control ("Change in Control Payments"), the Company will provide him with a tax gross-up payment so that he will not be out of pocket on account of the excise tax. (This means payment of an amount, which after all taxes including excise tax on that amount, is equal to any excise tax on the Change in Control Payments.)

14. **Confidentiality**: The Executive shall be subject to a confidentiality covenant during the Term and following his termination of employment.

15. **Non-Competition/Non-Solicitation**: The Executive shall be subject to non-competition and non-solicitation covenants during the Term and for 12 months following his termination of employment.

16. **Indemnification**: Appropriate indemnification provisions, including, but not limited to, indemnification pursuant to the Company's by-laws and applicable law. Insurance pursuant to the terms of the Company's D&O liability insurance.

17. **Applicable Law**: Pennsylvania.

18. **No Mitigation/No Offset**: In the event of any termination of employment, Executive will be under no obligation to seek other employment and there will be no offset against amounts due to him under the employment agreement on account of any remuneration attributable to any subsequent employment that he may obtain or any claims the Company may have against him.

19. **Resolution of Disputes**: Arbitration in accordance with commercial arbitration rules of the American Arbitration Association.

20. **Status of Term Sheet/Entering Into Employment Agreement**: As promptly as possible following the agreement of the Company and the Executive on the terms hereof, the parties will enter into a formal employment agreement embodying these terms.

Attachment #1

DEFINITIONS

"Cause" shall mean:

(i) the Executive is convicted of a felony involving moral turpitude; or

(ii) in carrying out his duties, the Executive has engaged in conduct that constitutes willful gross neglect or willful gross misconduct resulting, in either case, in material economic harm to the Company, unless the Executive believed in good faith that such action or non-action was in, or not opposed to, the best interest of the Company.

Anything notwithstanding to the contrary, the Executive's employment shall not be terminated for "Cause," within the meaning of clause (ii) above, unless the Executive has been given written notice by the Board stating the basis for such termination and he is given fifteen (15) days to cure the neglect or conduct that is the basis of any such claim and, if he fails to cure such conduct, or such conduct cannot be cured, the Executive has an opportunity to be heard before the full Board and after such hearing, the Board gives the Executive written notice confirming that in the unanimous judgment of all the disinterested directors of the Company "Cause" for terminating the Executive's employment on the basis set forth in the original notice exists.

"Good Reason" shall mean termination by the Executive of his employment after written notice to the Company following the occurrence of any of the following events without his written consent:

(i) a reduction in the Executive's then current Base Salary, Target Bonus or his then-current equity interest in the Company;

(ii) a material diminution in the Executive's positions, duties or authorities, or interference with Executive's carrying out his duties so that, in the reasonable exercise of the Executive's discretion, he is unable to carry out his duties hereunder as contemplated at the time his employment agreement was entered into;

(iii) the assignment to the Executive of duties which are materially inconsistent with his duties or which materially impair the Executive's ability to function as President, Chairman and Chief Executive Officer of the Company;

(iv) the failure of the Company to elect or re-elect the Executive to the positions of President, Chairman and Chief Executive Officer or the removal of the Executive from any such positions;

(v) a change in the reporting structure so that the Executive reports to someone other than the Board;

(vi) requiring the Executive to relocate more than 50 miles from the location of the Company's headquarters;

(vii) a breach by the Company of any material provision of the Executive's employment agreement;

(viii) the failure of the Company to obtain the assumption in writing of its obligation to perform this agreement by any successor to all or substantially all of the assets of the Company within 15 days after a merger, consolidation, sale or similar transaction.

"Change in Control" shall mean the occurrence of any one of the following events:

(i) any "person," as such term is used in Sections 3(a)(9) and 13(d) of the Securities Exchange Act of 1934, other than an individual who is a member of the Felts or McComb families, who owns, directly or indirectly, 5% or more of the Voting Stock of the Company on the Effective Date of the Executive's Employment Agreement, becomes a "beneficial owner," as such term is used in Rule 13(d)-3 promulgated under that act, of 20% or more of the Voting Stock of the Company;

(ii) the majority of the Board consists of individuals other than Incumbent Directors, which term means the members of the Board on the Effective Date; provided that any person becoming a director subsequent to such date whose election or nomination for election was supported by two-thirds of the directors who then comprised the Incumbent Directors shall be considered to be an Incumbent Director;

(iii) the Company adopts any plan of liquidation providing for the distribution of all or substantially all of the Company's assets;

(iv) all or substantially all of the assets of the Company are disposed of pursuant to a merger, consolidation, share exchange, reorganization or other transaction unless the shareholders of the Company immediately prior to such merger, consolidation, share exchange, reorganization or other transaction beneficially own, directly or indirectly, in substantially the same proportion as they owned the Voting Stock or other ownership interests of the Company, immediately prior to such transaction, all of the Voting Stock or other ownership interests of the entity or entities, if any, that succeed to the business of the Company; or

(v) the Company combines with another company and is the surviving corporation but, immediately after the combination, the shareholders of the Company immediately prior to the combination hold, directly or indirectly, 50% or less of the Voting Stock of the combined company (there being excluded from the number of shares held by such shareholders, but not from the Voting Stock of the combined company, any shares received by Affiliates of such other company in exchange for stock of such other company).

For purposes of the Change in Control definition, "the Company" shall include any successor entity after any such entity succeeds to all or substantially all of the business of the Company, "Affiliate" of a person or other entity shall mean a person or other entity that directly or indirectly controls, is controlled by, or is under common control with the person or other entity specified and "Voting Stock" shall mean any capital stock of any class or classes having general voting power under ordinary circumstances, in the absence of contingencies, to elect the directors of a corporation.

EXECUTIVE COMPENSATION

BY JOSEPH E. BACHELDER III

Carly Fiorina and Hewlett-Packard Severance Policy

On Feb. 8, 2005, Carly Fiorina was terminated as chairman and chief executive officer of Hewlett-Packard Co. (HP).[1] This year she will receive approximately $21.4 million in severance payments. This severance includes $14 million of salary and bonus severance[2] plus approximately $7.5 million of accelerated payments under the HP Long Term Performance Cash Program (LTPC Program).[3]

The Severance Package

There are three aspects of Ms. Fiorina's severance package of particular interest:

1. As noted above, Ms. Fiorina received payout in respect of two cash awards under the LTPC Program totaling approximately $7.5 million. As discussed below, it is unclear whether the LTPC awards would have been earned out at the end of their respective three-year periods (in 2006 and 2007). Furthermore, the 2003 LTPC Program (almost $6 million of the approximately $7.5 million represents the 2003 LTPC award), as reported in the 2004 proxy statement, provides that no payout is to occur in the case of an involuntary termination like Ms. Fiorina's.[4]
2. The salary and bonus severance payment of $14 million, according to the HP Severance Program for Senior Executives (the Severance Program) (adopted by the HR and Compensation Committee in October 2003), as described in the 2005 proxy statement, is to be reduced by any other "cash severance benefit." In light of this statement, it is unclear why the $7.5 million (assuming it to be an appropriate payment) does not offset the $14 million salary and bonus severance.
3. The Severance Policy for Senior Executives (Severance Policy), adopted by the HP Board in July 2003, states that if severance amounts (with certain exceptions that do not appear applicable) under agreements with executives entered into in the future (that is, after July 2003) exceed 2.99 times salary and target bonus, HP will seek shareholder approval (which may be before or after the severance agreement is entered into with the executive).[5]

The severance amounts for Ms. Fiorina, as discussed further below, appear to exceed 2.99 times her annual salary and target bonus.[6] Nonetheless, approval of the Severance Agreement was not sought at the March 16, 2005 shareholders meeting. The 2005 proxy statement gives no explanation.

The following is additional discussion of these three points.

Long-Term Performance

A. LTPC Awards: Approximately $7.5 Million. *Was it appropriate to accelerate payment to Ms. Fiorina of certain amounts in respect of her LTPC awards?*

The 2003 LTPC cash award contains two targets: cash flow from operations as a percentage of revenues (determined on a year-by-year basis) and Total Shareholder Return (TSR) relative to TSR for the S&P 500 for the three-year performance period 2003-2006. (A similar formula applies to the 2004 LTPC cash award.) As described in the 2004 proxy statement,

> If cash flow from operations as a percentage of revenue is below the threshold, no amounts will be banked for the [applicable] period [period meaning each of the three years covered by the plan]. Similarly, if TSR thresholds are not achieved for the three-year performance period, no payouts will be made and any banked amounts will be forfeited. [Inserts added.]

The 2005 proxy statement description of the formula is similar.

Graef Crystal, the well-known commentator on executive compensation, discusses the accelerated award under the LTPC as part of the severance package to Ms. Fiorina in his column, which appears as a regular feature in the Bloomberg News Service (Feb. 16, 2005). Following is an excerpt from Mr. Crystal's comments on the accelerated LTPC award:

> Why didn't Hewlett-Packard's compensation committee insist that Fiorina's earnings under the Long Term Performance Cash plan continue to be deferred until April 30, 2006, at which point a determination could be made as to whether she would receive those earnings, a greater amount or possibly nothing?
>
> Even if we assume that the performance period ended on the date of her termination, Hewlett-Packard's less-than-median performance vis-à-vis the S&P 500 companies suggests that she should have received far less than the $7.4 million she actually received. By my approximate computations, she should have received about $1.7 million.

Mr. Crystal may be generous in assuming any payout was appropriate for Ms. Fiorina under the LTPC (at least as to the approximately $6 million 2003 LTPC award). According to the 2004 proxy statement report on the LTPC:

> Generally, if a participant is no longer employed by HP due to being placed in a workforce reduction program, disability, retirement or death, then targeted cash amounts are prorated. In the event of other terminations, any banked amounts will be forfeited.

So far as is known, Ms. Fiorina was not terminated for any of the reasons given in the first sentence of the quote.

The 2005 proxy statement description of the LTPC (not just the formula description noted above)—under the heading "Long Term Incentive Plans—Awards in Last Fiscal Year [2004]" [Insert added]—is almost the same as the description in the 2004 proxy statement. One exception is the description of the consequences of different employment terminations. This provision has been changed to read as follows:

> Notwithstanding the foregoing, if a participant is no longer employed by HP due to *involuntary* termina-

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tion, disability, retirement or death, targeted awards are paid subject to certain adjustments. In the event of voluntary terminations, any banked amounts will be forfeited and no payment is made. (Emphasis added to indicate two of the changes from the 2004 proxy statement.)[7,8]

Even if the quoted 2005 proxy statement language accurately reflects an amendment to the LTPC Program, there is no suggestion in the proxy statement that it applies to the award made in 2003 (approximately $6 million of the $7.5 million of accelerated LTPC payment). As already noted above, the heading to the section in the 2005 proxy statement in which the quoted language appears reads "Long-Term Incentive Plans—Awards in Last Fiscal Year [2004]." [Insert added.]

No question is raised here as to the authority of the Compensation Committee to waive the forfeiture restrictions or to simply have awarded Ms. Fiorina an additional $7.5 million of severance. (There might have been complaints, of course, about making a special $7.5 million award to a CEO being fired.) The point, once again, is that the 2004 proxy statement language describing the 2003 LTPC award ($6 million) is explicit. In the event a termination like the termination in Ms. Fiorina's case occurs, the LTPC amounts (at least $6 million of them in her case) "will be forfeited." Yet, there is no indication in the proxy statement that the LTPC Program was amended as to either award or that the Compensation Committee waived the forfeiture restrictions.

Without the approximately $7.5 million (or most particularly the approximately $6 million attributable to the 2003 award) under the LTPC Program treated as severance under the 2003 Severance Policy and added to the $14 million of salary and bonus severance, Ms. Fiorina's package does not exceed 2.99 times the salary and bonus threshold requiring shareholder approval under the Severance Policy.[9] This issue is further discussed in Section C below.

Severance Program

B. Severance Program: Payment of $14 Million Without Offset. *Even if we assume the LTPC payout ($7.5 million) was appropriate, why was it made as an addition to (and not an offset against) the $14 million paid to Ms. Fiorina under the Severance Program?*

The Severance Program as described in the 2005 proxy statement provides:

> Any payments under the severance program will be reduced by any cash severance benefit payable to the participant under any other HP plan, program or agreement, including cash amounts payable for the uncompleted portion of employment agreements and prorated cash bonuses under the applicable short-term bonus plan.

The next section of the proxy statement contains a statement describing Ms. Fiorina's severance package. It includes the following statement:

> Pursuant to the [Severance] Agreement, and in accordance with the terms of the HP Severance Program for Senior Executives adopted in 2003 (as described above), HP will make a cash payment of $14,000,000 to Ms. Fiorina, which represents 2.5 times her base salary and targeted annual cash bonus. [Insert added.]

Two sentences later this section, in setting forth her severance package, describes her receipt of approximately $7.5 million pursuant to the LTPC Program. Referring to these amounts at the annual meeting of shareholders on March 16, Ms. Patricia C. Dunn, chairman of the board of HP, stated:

> The first [question]...was on severance and what was the basis for—the number—$21.4 million payment to Carly Fiorina as severance. Carly did not have a contract at HP. She worked under the same plan for severance as all executives, which was adopted by the board's compensation committee in 2003. That plan was appropriately disclosed and the payments due and payable under that plan were also made public since its adoption.[10,11]

In light of the proxy statement provisions, quoted above, that salary and bonus severance ($14 million) is to be offset by any other "cash severance benefit" (approximately $7.5 million), it is difficult to reconcile the quoted provision of the proxy statement (and Chairman Dunn's statement) with the absence of an offset in Ms. Fiorina's case.

Senior Executive Severance

C. Senior Executive Severance Policy: Shareholder Approval. *Why was Ms. Fiorina's severance package not submitted to shareholders for approval?*

As noted at the outset of the column, in July 2003 the HP Board adopted the Severance Policy that would appear to require shareholder approval of Ms. Fiorina's severance package. As also noted above, Ms. Fiorina's severance package was not submitted to shareholders for approval at the March 16, 2005 shareholder meeting.

The July 2003 Severance Policy, as described in the 2005 proxy statement, provides as follows:

> HP will seek stockholder approval for future severance agreements, if any, with senior executives that provide specified benefits in an amount exceeding 2.99 times the sum of the executive's current annual base salary plus annual target cash bonus, in each case as in effect immediately prior to the time of such executive's termination.

The HP Severance Policy makes exceptions for certain benefits from the calculation as to whether severance benefits exceed 2.99 times salary and bonus. It excludes a variety of severance payments and benefits if they are consistent with "Company Practices." For this purpose, "Company Practices" are defined as meaning "HP practices applicable to one or more groups of employees in addition to, or other than, the Senior Executives." Included in the category of payments covered by the Severance Policy (i.e., included in the "2.99 times salary and bonus" calculation) is "the value of any accelerated vesting of...long-term cash incentives that is *in*consistent with Company Practices." [Emphasis added.]

The question naturally arises whether the approximately $6 million 2003 LTPC award is "consistent with past practices" for any other employees. In fact, as noted above, the 2003 LTPC award is described in the 2004 proxy statement as being forfeited upon a termination like Ms. Fiorina's. It is difficult to read the 2004 proxy statement and not conclude that payout of at least $6 million was inconsistent with practices as described in that proxy statement. If this conclusion is correct, there appears to be no satisfactory explanation as to why Ms. Fiorina's severance package was not submitted to HP shareholders for approval.

• *The question we are left with.* For the reader of the last two HP proxy statements, it is difficult to reconcile certain aspects of Ms. Fiorina's severance package with the proxy statements describing the LTPC Program, the HP Severance Policy and the HP Severance Program. Particularly troubling are the issues as to (i) how the

Compensation Committee could conclude it was proper to make payment to Ms. Fiorina of approximately $7.5 million of awards under the LTPC Program, (ii) even if the Compensation Committee thought the $7.5 million payment was appropriate, how it could avoid the provision of the Severance Program that payments such as the LTPC should offset the $14 million severance payment of salary and target bonus and (iii) how HP could conclude it was not called upon to seek shareholder approval in light of the July 2003 Severance Policy adopted by the board.

Currently at issue in the *Disney* case pending before the Delaware Court of Chancery is the responsibility of directors to handle their role as fiduciaries for shareholders in a good faith manner.[12] A reader of the HP proxy statements for the past two proxy seasons might question whether Ms. Fiorina's severance package, including the failure to submit it to HP shareholders for approval, reflects action taken in good faith by HP's directors based on their prior actions and statements as reported in those proxy statements.

1. Ms. Fiorina's entitlements are described in her severance agreement dated Feb. 8, 2005 (the "Severance Agreement"). The Severance Agreement is included as Exhibit 99.1 to HP's Form 8-K filed Feb. 22, 2005.

2. The $14 million of severance payments is the result of multiplying 2.5 times $5.6 million (the sum of her salary ($1.4 million) plus her target bonus (300 percent of salary, $4.2 million)).

3. In addition to the severance payments, approximately 2 million previously unvested options vested. This, together with the severance payments and certain other benefits and perquisites, brings the total value of Ms. Fiorina's termination arrangements to over $25 million.

4. The 2004 proxy statement reports on the 2003 LTPC award. The original award, with a target value of almost $6 million, represents most of the approximately $7.5 million LTPC severance payment (the entire 2003 award target amount being paid out). The 2005 proxy statement reports on the 2004 LTPC award. The original award, with a target value of approximately $6 million, was paid out on a pro rata basis. Approximately $1.5 million of the $7.5 million LTPC severance payment is attributable to the pro rata payment of the 2004 award.

5. The resolution by the HP Board establishing the Severance Policy was in response to a shareholder resolution adopted at the March 2003 annual meeting. The resolution was introduced by the Service Employees International Union AFL-CIO, CLC.

6. Salary and bonus severance of $14 million plus approximately $7.5 million of LTPC severance (approximately $21.5 million) exceeds 2.99 times salary and bonus ($16.75 million).

7. The change from the 2004 proxy statement to the 2005 proxy statement is noteworthy in two respects:

(i) "Involuntary termination" has been put in the category of terminations that are eligible for award payouts (that is, along with retirement, disability and death); and

(ii) In the case of eligible payments, the change takes away the pro-rata limitation as to amounts eligible for payout.

8. Interestingly, the form of award agreement for the 2004 grants as filed Jan. 14, 2005 as Exhibit 10(t)(t) to the 10-K for 2005 (approximately three weeks before Ms. Fiorina's termination) is consistent with the 2004 proxy statement (rather than the 2005 proxy statement) summary of the consequences of different terminations.

9. The discussion in the text does not take into account the value (approximately $4.5 million) of the accelerated vesting of approximately two million unvested option shares. Unless this acceleration was consistent with "Company Practices," this benefit together with the salary and bonus severance also would add up to severance in excess of 2.99 times salary plus bonus, and be covered under the Severance Policy.

10. Ms. Dunn's statement regarding Ms. Fiorina's severance package was in response to a question asked by a shareholder in the Q&A session of the shareholder meeting held on March 16, 2005 at 3:00 p.m. EST. An audio Web cast of the meeting was available at the time of the writing of this column at www.hp.com/hpinfo/investor/stockholder/.

11. Effective July 17, 1999, HP entered into an employment agreement with Ms. Fiorina. This agreement is reported as Exhibit 10(y) to the 2005 10K and was filed as Exhibit 10(g)(g) to the 10-Q filed Sept. 20, 1999. There is no stated term to the agreement and presumably at some point HP and Ms. Fiorina agreed to terminate the agreement.

12. *In re The Walt Disney Co. Derivative Litig.*, currently pending; motion to dismiss denied, 825 A.2d 275 (Del. Ch. 2003). (Trial of the case took place in late 2004 and early 2005.

EXECUTIVE COMPENSATION

Negotiating Options for New Executives

NEGOTIATING STOCK options for senior-level executives moving to a new employer can be a difficult matter. It involves the valuation of options being left behind at the executive's prior employer. It involves debate over what it takes (and what the new employer is able and willing to do) to make the executive whole in this regard.[1] This is in addition to negotiating what represents competitive option grants going forward.

In almost every case, an executive leaving an employer (Company A) voluntarily will forfeit his stock options. For those options not yet exercisable when the executive leaves his old employer, the executive will forfeit the spread (since he cannot yet exercise the options).

Even in the case of exercisable options (which the executive may exercise before leaving), the gain realized may be subject to a clawback if the executive leaves voluntarily and/or goes to work for a competitor. In the event of a clawback, the executive presumably will seek protection from his new employer (Company B) with the make-whole award being the same as for an option not exercisable at the time of departure.

As to both exercisable and not-yet-exercisable options, the executive will forfeit the opportunity for future growth over the remaining term of the option and will want to be made whole as to that future growth by the grant of replacement options by his new employer.

In addition to the foregoing, the executive will want to be assured that in the future he will have the opportunity for ongoing option grants at his new employer at least equal to (if not greater than) the ongoing option opportunity he would have had if he had remained at his prior employer.

The following discussion will cover, first, the make-whole issues and, second, the issues as to future awards.

Make-Whole Issues

1. Making the Executive Whole, Part One: Forfeited Spread.

(a) Determining the Amount Forfeited. Ordinarily this is a straightforward calculation of the excess of the current market value over the exercise price of those options not yet exercisable at the time the executive leaves Company A. For example, if the fair market value of the Company A stock subject to an unexercisable option is $50 and the exercise price is $20, the loss in spread for the departing executive is $30. If the executive had 100,000 Company A shares subject to an unexercisable option with an exercise price of $20, the aggregate spread forfeited would be $300,000. (As already noted, the executive also may forfeit gains realized on options exercised just before he leaves if these gains are subject to clawback).

(b) Form of Make-Whole Award. There are several forms that the make-whole award for forfeited spread may take. These include cash and sometimes stock in Company B (usually in the form of "restricted stock" as discussed below).

In recent years, make-whole awards in the form of forgivable loans have been viewed by some as a tax favorable way to give the new executive a make-whole award without incurring an immediate tax. The executive then realizes this value for tax purposes later as the loan is forgiven. However, the Internal Revenue Service has questioned the treatment of forgivable loans for Federal income tax purposes. See TAM 200040004, Oct. 6, 2000. TAM 200040004 was discussed in a column by the author in *The New York Law Journal* on March 21, 2001.

Occasionally, the make-whole award may take the form of a Company B stock option with an exercise price below the current market price so that the aggregate spread in the new option is equal to the aggregate spread in the options being forfeited. This is unusual, in part because many stock option plans provide that the options must be granted with an exercise price no less than the market price on the date of the grant. On very rare occasions, a new employer will propose granting a stock option with a "Black-Scholes" value equal to the forfeited spread. A new executive will resist this because it represents speculative future value replacing current realizable value (that is, realizable if the executive had not departed Company A). (As to the Black-Scholes valuation method, see discussion below under heading of "Making the Executive Whole, Part Two: Loss of Future Growth in the Options Left Behind at Company A.")

(c) Attaching Conditions to the Awards. Each of the forms of make-whole awards noted above may be granted subject to conditions that prevent the new executive leaving voluntarily for a specified period of time without forfeiting the award (or having the economic value clawed back). The executive, of course, will resist having the awards subject to forfeiture for any period of time beyond that applicable to the awards at Company A that are being replaced.

(i) Cash. Cash may be awarded in the form of deferred cash vesting and paying out over a period of time, subject to forfeiture in all or in part if the executive leaves voluntarily during that period of time. Even a payment of cash up front may be subject to clawback. The problem with a clawback for the executive leaving prematurely is that he will have paid tax on the cash and, if it is clawed back, there may be a question of whether he will be eligible for a full, offsetting tax benefit for the clawback deduction (which he will need in order to come out whole on an after-tax basis).

(ii) Stock. If the award is made in stock, the employer can condition its vesting on the same continued employment over a period of time as noted above in the case of a cash award.[2] Even if the stock is not subject to forfeiture (thus preventing its being sold), it is unlikely that the new executive could sell or convert it immediately. Assuming it is registered stock without restrictions on resale, it is, nonetheless, unlikely that the executive, newly arrived at Company B, will want to report its sale on Form 4 (assuming he is an officer with reporting requirements pursuant to §16(a) of the Securities Exchange Act of 1934) and thus put on the public record that he is selling Company B stock shortly after moving to Company B. Accordingly, the new executive may prefer to get cash (even on a deferred payment basis) in order to be free to reinvest in something other than Company B stock (in which stock he already will have a large stake due to option grants).

Forgivable Loans

(iii) Forgivable Loans. Assuming, notwithstanding TAM 200040004, that the award is in the form of a forgivable loan, the forgiveness schedule likely will be for the same period of time noted above in connection with cash and stock awards. If the executive voluntarily leaves during that period, the loan will not be forgiven (or will have been forgiven

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only in part) and may become payable immediately.

(iv) Options. Assuming the make-whole award takes the form of an option (again, an unusual occurrence), it would be subject to the same conditions noted above. The conditions would presumably be gradual vesting and exercisability over the same period noted above in connection with the other forms of award.

Future Awards

2. Making the Executive Whole, Part Two: Loss of Future Growth in the Options Left Behind at Company A.

The executive has had the opportunity, through his stock options at Company A, to realize future growth in the value of Company A stock. In order for the executive to be made whole going forward (not just made whole for the spread left behind) he must be awarded stock options at Company B that offer equivalent value in future growth opportunity to that which he had in the options left behind at Company A. (Note that this sign-on option grant is in addition to the ongoing awards the executive will receive under the stock option program at Company B, as discussed further below.) This is a much more complex issue than replacing forfeited option spread.

(a) Determining "True" Value of Options. This determination must take into account the "true" value of an option at Company A versus one at Company B. What is the best way to make this comparison? Among approaches taken to making this comparison are the following:

(i) Black-Scholes Option Valuation Method. Black-Scholes is a method of stock option valuation frequently used to fix a value on an executive stock option. Basic to the Black-Scholes valuation is the "volatility" of the stock. This reflects the variability in the price of the stock over a period of time. A stock with a history of significant price variation will have a higher volatility "value" than a stock that has had a more stable price and, accordingly, such volatility will impute a greater value to an option to acquire that stock than would be imputed if the stock had a lower volatility.

In addition to the volatility factor, Black-Scholes takes into account the following:

- Length of the option period (e.g., ten years for the typical executive stock option). The longer the option period, the more valuable the option.
- An interest rate (risk-free) reflecting, in part, the fact that the owner of the option does not have to pay the exercise price until he chooses to exercise the option. Generally speaking, the period of the risk-free rate should be the same as the length of the option period.
- Exercise price. The lower the exercise price, the higher the opportunity to be "in the money" and the more valuable the option. (Most executive stock options are granted with an exercise price equal to the market price of the stock on the date of grant.)
- Dividends paid on the stock (significant dividends over the applicable historic period reduce option value).

In addition to the basic factors making up the Black-Scholes valuation method, further adjustments frequently are made for employment-related factors such as the period over which the option vests and the likelihood of the executive remaining employed for the full option period (thus adjusting the length assigned to the option period as noted above).

Determining the forfeited value of the executive's stock option at Company A over and above the spread at the time he departs is somewhat more complicated than valuing a stock option at the time of grant — when the exercise price generally is equal to the market value at the time of grant.

Black-Scholes Value

Assume the Company A stock option has a positive spread in it at the time the executive leaves Company A to join Company B. The spread in the Company A stock option may be realized by the executive (by the executive's exercising the option before he departs if the option is exercisable) or forfeited (if the option is not yet exercisable). The forfeited spread may be made up to the executive by Company B (as noted above it may be paid to the executive by Company B in cash or in some other form of award (e.g., restricted stock)). For purposes of determining the make whole to be paid to the executive by Company B for the forfeited value of the Company A option over and above the spread, the calculation of the Black-Scholes value of the Company A stock option when the executive departs, as just described, involves a three-step process:

(A) The Black-Scholes value of the Company A option is determined taking into account the several factors noted based on the original exercise price and the market price of the stock at the time the executive leaves Company A.

(B) The spread at the time the executive terminates his employment at Company A is determined (as just noted, it is assumed that the executive will get cash or a restricted stock award of equivalent economic value to keep him whole as to the forfeited spread at the time of his termination).

(C) From the value established in (A) is subtracted the value in (B). This net amount represents the "net" Black-Scholes value of the option — as just explained, that is its value over and above the spread in it at the time of valuation. The amount obtained in (C) assumes, of course, that Company B is also making the executive whole as to the forfeited spread in the Company A option.

Valued in Same Manner

It is the amount determined in (C) that should be represented by a stock option of equivalent value in Company B stock in order to keep the executive whole as to the going forward opportunity in the Company A options he is leaving behind. Assuming the Black-Scholes method was used in valuing Company A stock, presumably the stock option to Company B stock will be valued in the same manner.[3]

(ii) An Alternative Theory to Black-Scholes: Projecting Stock Growth at Company A Versus Stock Growth at Company B Over the Next Several Years. Assume that Company B, once a strong stock performer with a high historic volatility and therefore a high Black-Scholes valuation, is currently in a lull in its stock price. If Company A has a low historic volatility but the executive believes its stock price is about to take off, the executive may object to the use of the Black-Scholes method for determining the comparative values of the stock options of Company A and Company B. He might suggest, instead, a comparison of the projected growth in value of the two stocks over the next 5 years. Company B and the executive, of course, may have different views on those projections.

(b) Providing Comparability in Key Terms of Options. As noted in connection with make whole of forfeited option spread, in paragraph 1(c) above, the

executive will want vesting arrangements in his new options at Company B that are no less favorable than those he had at Company A. For example, he might have had 50,000 option shares at Company A that were fully vested with four years left to run. Another 50,000 may have been scheduled to vest in another two years and have eight years thereafter to run. He will probably try to get the options at Company B to mirror those at Company A with regard to these particular terms. Another key provision will be the post-termination exercise entitlements accompanying the options. These will vary depending on the type of termination: death, disability, termination without cause, termination for cause, voluntary termination, etc. (Presumably a termination for cause or voluntary termination will have a limited, if any, post-termination exercise period.) Finally, what happens to Company A options in the event of a change-in-control? For example, do they immediately vest in that case? Again, the executive will seek comparability in the terms of the options granted to him by Company B.

In some cases, Company B may be reluctant to grant requested provisions as a matter of policy or because it cannot do it under the terms of its stock option plan. If, under its stock option plan, Company B is unable to deliver an option substantially like that held by the executive at Company A, or is not able to deliver at all (if for example, there are not enough shares available under the plan), consideration may be given to granting the option outside of the stock option plan. For these considerations see discussion in footnote 1.

(c) Tax Cost of Early Exercise. Not taken into account in paragraph (a) or (b) above is the tax cost to the executive of exercising his exercisable stock options immediately before leaving Company A (to avoid forfeiture). Instead of having the benefit of future growth on the shares subject to the option, the executive is limited to growth on the after-tax value of the spread realized on the premature exercise.

Granting Future Options

3. Going Forward: Granting Future Options on an Ongoing Basis.

The new executive at Company B will want to participate in the ongoing stock option program at a level no less (or perhaps greater) than that at which he was participating at Company A. In addition, if he is being promoted to a higher position (e.g., CEO of Company B after being in a lesser position at Company A) he will want awards that are competitive for his new position based on awards at comparable levels at companies in the same or similar industries and of comparable size to Company B. Not only will the size of the award be a consideration, but also, as noted in paragraph 2(b) above, attention will need to be given to the new executive's entitlements under the option program (e.g., vesting and post-termination exercise rights). Company B may be more flexible in the terms of options granted as make-whole option awards (as described in paragraph 2 above) than it is in modifying such arrangements in the ongoing option grants to be made to the new executive under its regular option program in the future.

Stock Option Grants

4. Sign-on Stock Option Grants in Addition to Make-Whole Awards.

An executive in a strong negotiating position may be able to negotiate a sign-on stock option grant (or other form of award) over and above the make-whole grant awards described in paragraphs 1 and 2 above. Such an award is a "premium" award, similar to the sign-on bonuses to athletes when they join a professional athletic team, to induce the executive to join Company B.

(1) An important consideration will be whether the new employer currently has enough shares authorized under its applicable plans to grant an option for a number of shares equal to the proposed award. Due to the magnitude of some sign-on equity awards (especially stock options), it is not uncommon to discover there is a deficiency in shares authorized under the existing plan or plans. In such case, alternatives may include:

(a) Make the stock option grant (or other equity award) outside any plan. This may avoid the need for shareholder approval depending on a number of things, including: (i) stock exchange requirements for shareholder approval of such plans (but an exemption may apply, such as Rule 312.03 of the NYSE Listed Company Manual applicable to a newly-employed officer); (ii) language of the existing stock option plan (e.g., does it indicate that shareholder approval will be sought before any more stock options are granted under or outside the plan?); (iii) the willingness of the new employer to risk loss of a tax deduction under section 162(m) of the Internal Revenue Code of 1986 (the Code); (iv) the certificate of incorporation and by-laws of the new employer; (v) applicable state corporation law; and (vi) if the new employer is in a regulated industry, applicable regulatory requirements.

(b) Make the stock option grant subject to shareholder approval. Ordinarily this means delay in the effective date of the stock option grant until the next annual shareholders meeting. It also may result in an accounting charge for any increase in stock price between the date of grant (when, presumably, the exercise price is determined) and the date of the shareholders meeting when the necessary shares are authorized. It also jeopardizes the exempt status of the grant under Code section 162(m).

(c) Make the award in some form other than a stock option grant (e.g., a stock unit grant which may not require shareholder approval but will be less attractive to the new employer due to the accounting charge and probable loss of exemption under Code §162(m)).

(2) In general, under §83(a) of the Code, property that is transferred to an employee in connection with the performance of services and is subject to a substantial risk of forfeiture is not taxed until the risk of forfeiture has lapsed. (Pursuant to Code section 83(b), the executive may elect to be taxed sooner.) A substantial risk of forfeiture exists when an individual's rights to property are conditioned upon the future performance of substantial services. Treas. Reg. §1.83-3(c)(1). Whether the services to be performed are substantial depends on the facts and circumstances, including the time spent in performing such services. Treas. Reg. §1.83-3(c)(2). An example contained in the regulations under section 83 indicates that a requirement that an employee continue in employment for two years causes the employee's rights to be subject to a substantial risk of forfeiture. Treas. Reg. §1.83-3(c)(4), Example (1). In another example, of shares transferred, a portion that vests on the first anniversary of transfer is considered subject to a substantial risk of forfeiture. Treas. Reg. §1.83-3(c)(4), Example (3).

(3) The discussion in paragraph 2 of the text, concerning the make whole for loss of future growth in options left behind at Company A, assumes the replacement award will be in the form of a stock option. Occasionally, a new employer will offer some other form of award to replace this lost value. Such replacement value will, presumably, be based on the Black-Scholes value of the Company A options (less any spread recovered prior to departure or replaced by Company B as discussed in paragraph 1) and may be in the form of cash, stock or a loan (but see discussion of forgivable loans as a form of make-whole award in paragraph 1(c)(iii) of the text).