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# EXECUTIVE COMPENSATION

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Executive compensation continues to be top of mind for shareholders. The increased attention on executive compensation by shareholders is increasing directors' concern with their liability for compensation decisions and protection from liability, including D&O insurance. Backdating of options has not been as big an issue in Canada as expected, but is likely to increase focus on insider reporting of equity-based awards. Significant changes to the disclosure of executive compensation have been proposed by the Ontario Securities Commission – to take effect for fiscal years ending December 31, 2008, or later.

## DIRECTOR LIABILITY AND DIRECTORS' AND OFFICERS' INSURANCE

### Director Liability

Directors are becoming increasingly concerned about their exposure to claims. They face civil liability for public disclosure and personal liability for executive compensation decisions and statutory liability.

Directors can avoid liability by following proper processes and they can avoid personal exposure by having proper indemnifications and directors' and officers' insurance ("D&O Insurance").

### D&O Insurance

D&O insurance provides protection for directors, particularly where they are not covered by indemnity or the company is insolvent. For years, insurance terms have been viewed as standard, and directors have had little involvement in negotiating the coverage. More recently, realizing that D&O insurance may not provide the expected protections, directors have started paying attention to these policies and negotiating their terms.

#### Basic Features

Directors' and officers' insurance is generally provided on a "claims made," rather than on a "claims incurred" basis. This means that only claims made during the term of the policy are insured, regardless of when the events giving rise to the claims occurred. Accordingly, individuals who cease to be directors are not automatically covered for their acts and omissions while they were directors, particularly if the insurance policy is cancelled.

#### Types of Coverage

Generally, three types of D&O coverage are available: Side A (which protects directors), Side B (which protects both

the company and the directors) and Side C (which protects only the company).

Side A coverage is true director coverage, providing for payment to directors where the company is financially unable or legally prohibited from indemnifying the director. Excess Side A coverage may also be obtained from a second insurer in an amount exceeding the primary Side A coverage. This is usually in one of two forms, either "follow form" or "difference in conditions (DIC)." Follow form excess Side A coverage provides a greater dollar amount of coverage when the underlying coverage is exhausted, but does not provide coverage that is unavailable under the primary policies. DIC Side A coverage fills gaps in the primary Side A coverage – for example, when coverage is denied on the basis of exclusion or rescission – and so provides significant additional protection for directors.

Side B coverage does not provide for payment to directors but instead for reimbursement to the company in respect of the indemnity payments the company makes to directors.

Side C coverage provides for direct coverage for the company in respect of claims by shareholders.

These three types of coverage are usually obtained from the same insurer under the same policy, which gives rise to a number of potential coverage issues relevant to directors.

### D&O Insurance Pitfalls

One of the many problems with combining Side A, B and C coverage is that exclusions and policy limits are usually applied to the whole policy. This can result in coverage limits being exhausted or coverage being excluded for reasons unrelated to the actions of a particular director.

#### Cancellation

The "claims made" nature of D&O insurance makes directors particularly vulnerable if insurance is cancelled or coverage switched to a new carrier. This is particularly an issue following a hostile change of control because the new board may have little motivation to provide tail coverage or renew coverage of former directors. In addition, insurers generally reserve the right to cancel the policy. Cancellation during the term of the policy can usually be negotiated out of the policy.

#### Rescission

Rescission is the right of the insurer to rescind or cancel a policy on the basis of a misrepresentation in the policy application. In the case of Nortel, for example, rescission was claimed on the basis of a material misstatement in the financial statements that were provided with the application for insurance.

Where the same policy of insurance is provided to both the directors and the company, the directors run the risk that the policy will be rescinded against all insured, even the directors who did not participate in the misstatement. This problem can be avoided by a carefully drafted severability clause.

#### Exclusions

Insurance policies exclude certain types of claims from coverage. The exclusions from coverage must be carefully reviewed to ensure that the policy does not exclude claims that directors expect will be insured. The definitions of "claim" and "loss" are key to this review.

The most common exclusion is the "insured versus insured" exclusion, which has been in almost all D&O policies since the mid-1980s. This exclusion denies coverage when one

insured makes a claim against another insured – that is, when the company makes a claim against its directors. Careful review of this exclusion is required to ensure that it does not exclude claims made by the company in a representative capacity, such as a derivative action or by a trustee or receiver in bankruptcy.

#### *Exhausting Coverage*

The other key problem with D&O insurance provided to both the directors and the company (with Side B and Side C coverage) is that policy limits may be exhausted by management and the company before the directors' claim is covered.

#### **Insurance Solutions for Directors**

For D&O insurance to provide the expected coverage, the wording of the policy needs to be precise, as court decisions have made clear.

#### *Non-Cancellable*

A director's contractual indemnity can require the company to obtain and maintain D&O insurance on specified terms and at specified coverage levels during the director's tenure and for a specified period thereafter. This effectively makes the coverage non-cancellable from the director's perspective. However, this does not assist the director if the company is financially unable to continue the coverage. Accordingly, where there is reason to do so, companies may negotiate non-cancellable insurance for a specified period. In addition, directors may negotiate for premiums to be pre-paid for the non-cancellable period.

#### *Tail Coverage*

Claims-made policies are usually renewed annually with the same insurer. If the policy is not renewed, coverage is lost for claims that have not been made during the life of the policy unless the policy provides or gives the company the right to purchase "tail coverage." Tail coverage provides coverage for claims arising from wrongful acts that occurred during the period covered by the prior policy. Tail coverage can be very important because new insurers sometimes exclude claims arising from acts that have occurred in the past. Tail coverage can be expensive but is one way of filling the gap created by the new policy exclusion for these claims. Like all other provisions of the policy, tail coverage provisions differ and should be carefully reviewed. Companies should not switch insurers or allow policies to lapse without first getting legal advice.

#### *Severability*

A carefully drafted severability clause will protect innocent directors from rescission of a policy against them, because of a misrepresentation by another insured. This is key to providing protection for directors, particularly independent directors, who will often have no knowledge of the representations made in the policy application or that such representations are misleading. The courts have, to date, focused on the precise language in severability clauses, so it is essential that the language be reviewed and re-drafted, if required.

#### *Separate Insurance*

The difficulties regarding severability, determining priority of payment and exclusion for insured versus insured claims has led some directors to obtain separate insurance from the company.

Directors who provide protection for themselves should consider how their actions will be viewed. However, courts generally defer to business decisions of boards that are made honestly, in good faith and with a view to the best interests of the company. Recent case law in Canada suggests that directors and officers may meet the standard for the application of the

business judgment rule even when a board's decision benefits the directors and officers.

In insolvency proceedings, courts have accepted that in order to retain directors during an insolvency, it may be necessary to approve a charge on the assets of the insolvent company or the establishment of an escrow fund. In the insolvency proceedings of Stelco, for example, the directors obtained a court order setting aside \$10 million in trust for indemnity costs.

## **INSIDER REPORTING OF RESTRICTED AND DEFERRED SHARE UNITS**

Insiders such as executives and directors of a company are subject to insider reporting obligations when participating in a company's equity-based incentive plans. However, the reporting obligations and exemptions vary depending on the type of equity-based award. For example, share ownership and options are treated as securities for insider reporting purposes, and in Ontario are generally governed by the *Securities Act*, which requires insider reporting of these securities.<sup>1</sup> Insider reporting for other types of equity-based awards such as restricted and deferred share units are required under Multilateral Instrument 55-103, *Insider Reporting for Certain Derivative Transactions (Equity Monetization)* [MI 55-103].

#### **Obligations Not Clearly Addressed by Securities Laws**

Insider reporting of share-based compensation, such as restricted share units and deferred share units, is not clearly addressed because there are two bases on which insider reporting could be required for the grant of a restricted or deferred share unit: (i) the unit may be subject to MI 55-103, or (ii) the unit may be a security under the *Securities Act*.

#### **MI 55-103**

MI 55-103 and its companion policy impose reporting obligations for and provide exemptions from a variety of arrangements or transactions that change an insider's economic interest in the company's securities or the insider's economic exposure to the company. MI 55-103 applies to grants under plans that provide only for cash payment based on the value of a reporting issuer's shares and do not provide for the issuance of shares. Restricted and deferred share units are clearly subject to the reporting obligations of MI 55-103.

If the terms of a grant of restricted or deferred share units are described in annual financial statements or public filings, they are exempt from the reporting requirements.

#### **Security Analysis**

An insider must complete a second analysis in addition to the analysis under MI 55-103 to determine whether the restricted or deferred share unit is a security. If the award does not involve an investment decision by the insider (usually because the insider has no say in the amount or timing of the grant or, in the case of deferred share units, there is a lengthy hold period determined by income tax requirements) or capital outlay, the award may not be a security. This analysis is strengthened if the award is satisfied in cash or the company has the discretion to do so. Market practice will also be relevant to determining whether a restricted or deferred share unit is a security. Currently, there is no predominant market practice regarding insider reporting of restricted or deferred share units. Accordingly, an insider may decide to follow a conservative approach by reporting these awards to ensure that he or she will not be subject to criminal and civil penalties for failure to insider report in a timely fashion.<sup>2</sup>

## NEW CANADIAN EXECUTIVE COMPENSATION DISCLOSURE RULES

Canadian securities regulators have proposed revised rules on executive compensation disclosure. The rules are likely to be finalized in the next few months and are intended to apply to the 2009 annual meeting season. The regulators believe that the current requirements have not kept pace with evolving compensation practices and make it difficult for investors to assess the total compensation paid to executive officers and to evaluate a key aspect of a company's corporate governance. The proposed rules are intended to alleviate these concerns by improving the overall quality of executive compensation disclosure. The proposals are similar – but not identical – to the SEC's rules on executive compensation disclosure that came into effect in 2007.

### Objective of the Proposed Rules

The proposed rules require companies to disclose all direct and indirect compensation provided to named executive officers (NEOs) and directors, regardless of the way the compensation is structured or whether it fits into a particular column of a table. These rules state that companies must focus on substance over form when preparing their disclosure, since the rules do not specify every form of compensation.

### Compensation Discussion and Analysis

The current Report on Executive Compensation would be replaced by a "compensation discussion and analysis" (CD&A) that puts into perspective the detailed disclosure in the tables. Much like the detailed analysis in MD&A, the CD&A should disclose and analyze the significant factors underlying the company's compensation policies and decisions. For example, if a company's process for setting executive compensation is very simple, relying solely on board discussions without any formal objectives or criteria, this should be clear from the CD&A.

The CD&A would have to cover all significant aspects of NEO compensation, including

- the objectives of the company's compensation program;
- what the program is designed to reward;
- each element of compensation;
- why the company chooses to pay each element;
- how the company determines the amount (and, where applicable, the formula) for each element; and
- how each element of compensation and the company's decisions about that element fit with the overall compensation objectives and affect decisions about the other elements.

Where applicable, companies would have to describe any new actions, decisions or policies that were made after year-end that could affect a reasonable understanding of an NEO's reported compensation.

### Compensation Benchmarks and Performance Targets

Companies would have to disclose their compensation benchmarks and explain the relevant components, including the identity of any companies included in the benchmark and selection criteria.

Performance targets would also have to be disclosed if based on objective, identifiable measures, such as the company's stock price or earnings per share. If targets are subjective, the company may describe them without providing specific measures. There is an exception if disclosure would seriously prejudice the company's interests, but in that case, disclosure would be

required of the percentage of the NEO's compensation that relates to the undisclosed information and how difficult it could be for the NEO, or how likely it would be for the company, to achieve the undisclosed target. If any targets constitute non-GAAP financial measures, disclosure would be required of the way the company calculates the targets in its financial statements. Companies should consider these disclosure requirements in formulating targets and adopting new compensation plans.

### Performance Graph

The proposed rules maintain the requirement that companies provide a performance graph comparing their cumulative total return over the past five years with the return of at least one broad equity market index. Companies that have been reporting for less than one year would be exempt. The proposals also require companies to discuss how the trend shown by the performance graph compares with the trend in executive compensation.

### Option Awards

Companies would have to describe the process used to grant options to NEOs, including the role of the compensation committee and executive officers in setting or amending any option program and whether previous grants are taken into account when considering new grants.

### Summary Compensation Table

The summary compensation table would remain the main vehicle for executive compensation disclosure. It would be accompanied by a narrative description of any material factors that are necessary to understand the information in the table. A new column at the end of the table would show the total compensation for each NEO. The elements of the summary compensation table would be as follows:

- salary;
- dollar amount of share awards, based on grant date fair value;<sup>3</sup>
- dollar amount of option awards, based on grant date fair value;
- non-equity incentive plan compensation, which is subdivided into annual and long-term incentives (bonuses will be reported in this column, whether discretionary or non-discretionary);<sup>4</sup>
- pension value, which includes compensatory amounts for both defined benefit and defined contribution retirement plans;<sup>5</sup> and
- all other compensation – for example, perquisites,<sup>6</sup> tax gross-ups, premiums for certain insurance policies, payments resulting from termination, resignation, retirement or a change of control, and all other amounts that cannot be properly reported in another column.

## INCENTIVE PLAN AWARDS

In addition to the summary compensation table, the proposed rules call for two tables disclosing information about equity and non-equity incentive plan awards. The significant terms of all plan-based awards would have to be disclosed. The narrative may include a discussion of performance-based or other significant conditions, information on estimated future payouts for non-equity incentive plan awards (threshold, target and maximum amounts), and the closing market price on a grant date if greater than the exercise or base price.

### Outstanding Option and Share Awards

This table would show all awards outstanding at year-end. For each option or similar award, the table must show the number of securities underlying unexercised options, the respective exercise or base prices and expiration dates and the

dollar value of unexercised in-the-money options. For each share award, the table must show the number that have not vested and the respective market or payout value. To make the calculations, companies may assume that an NEO achieved the minimum performance criteria unless his or her performance for the previous year exceeded the minimum, in which case the disclosure must be based on a corresponding assumption.

*Value on Payout or Vesting of Incentive Plan Awards*

This table would show the dollar value realized on the exercise of options or the vesting of share awards. It would also show payouts on non-equity incentive plan compensation.

**RETIREMENT PLAN BENEFITS**

The proposed rules call for two tables related to retirement benefits: one for defined benefit plans and one for defined contribution plans. The defined benefit plans table would show, for each NEO, the number of years of credited service, the annual benefits payable at year-end and at age 65, the accrued obligation at the start of the year, the compensatory and non-compensatory amounts and the accrued obligation at year-end. The defined contribution plans table would show, for each NEO, the accumulated value at the start of the year, the compensatory and non-compensatory amounts and the accumulated value at year-end.

The requirements for these tables respond to the criticism that the current pension benefits table provides only general information on benefit entitlements for selected compensation levels and years of service but does not disclose the particular circumstances or entitlements of each NEO.

**TERMINATION AND CHANGE-OF-CONTROL BENEFITS**

The proposed rules call for detailed disclosure about incremental payments or other benefits for each NEO related to the following triggering events: retirement, resignation, termination, a change of control of the company or a change in the NEO's responsibilities. Companies would have to quantify the potential payments on the assumption that the triggering event occurred at the end of the most recent fiscal year. If the event actually occurred earlier in the year, actual payments and benefits would be disclosed rather than hypothetical payments.

These disclosure requirements are consistent with the US rules but substantially exceed current Canadian requirements and are intended to prevent investors from being surprised after the fact by the size of an NEO's severance or other payment package.

**DIRECTOR COMPENSATION**

The proposed rules call for expanded disclosure of directors' compensation. The table is similar to the summary compensation table, but requires disclosure for only one year rather than three years.

**VENTURE ISSUERS**

Although certain elements of the revised disclosure requirements may not be applicable to debt-only issuers or other companies that qualify as "venture issuers," the regulators declined to grant any blanket waivers from the new rules for these issuers.

**SEC ISSUERS**

SEC issuers that fully comply with the US executive compensation disclosure rules (without taking advantage of any accommodations for foreign private issuers) would be permitted to provide their US disclosure in satisfaction of the new Canadian requirements.

**TRANSITION**

In the first proxy season under the new rules, companies would have to provide only one year of executive compensation information. In other words, this information for earlier periods would not have to be restated. In the second year under the new rules, two years of executive compensation disclosure would be required and after that, three years would be required.

<sup>1</sup> *Securities Act*, R.S.O. 1990, c. S.5, s. 107.  
<sup>2</sup> *Securities Act*, *supra* note 1 at Part XXIII.  
<sup>3</sup> The proposed treatment of share and option awards differs from the US rules, which require disclosure of the compensation cost, as per the financial statements, in the summary compensation table.  
<sup>4</sup> Earned amounts must be reported, even if they are payable at a later date.  
<sup>5</sup> The rules do not require disclosure of changes in actuarial values of pensions, as was suggested in the earlier proposal and as is required under the US rules, which should help reduce the costs of preparing this disclosure.  
<sup>6</sup> The threshold for reporting perks would remain at \$50,000 or 10% of an NEO's salary.



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