

## **Fundamentals of Executive Compensation**

### *Breakout Session #2: An "AGAINST" Recommendation*

It's just past 3:00pm on an unusually warm April day, and you're almost convinced that you can shut down your laptop for an hour and take a much-needed walk to enjoy the sunshine and clear your mind. Endless Zoom calls have taken their toll this week, so you grab your dog Casey's leash and head to the back door.

"Ping."

For a second you're tempted to pretend you didn't hear the Slack message. But something tells you to sit back down at your desk. The message is from Mandy Russo, your head of Total Rewards.

"Bad news. ISS is recommending AGAINST us on Say on Pay."

So much for that walk. Casey gives you his best Corgi disappointed pout as you settle in for a long evening.

### **Background**

NTL Industries is a global manufacturer of intermediate and specialty chemicals whose products are used in applications as far reaching as paints, coatings, seating, furniture, automotive interiors, and gasoline additives. The company also has an Agricultural Chemicals (AgChem) business that is focused on herbicides and developing disease-resistant seeds. The AgChem business is small but has high growth projections.

You've been the Chief HR Officer of NTL for three years, after spending 10 years in various HR business partner roles both in the US and Europe. During that time, the company has outperformed its competitors on most financial metrics and has been rewarded with a strong stock price performance. In fact, even the recent CEO transition that you managed did not have a negative impact on the stock.

### **CEO Transition**

Almost a year ago, the company's CEO Bob Kellerston surprised everyone when he announced his retirement – a full two years earlier than expected. While Kellerston had identified a successor – CFO Brandon Sarti – not everyone on the Board was comfortable with the choice, so Brandon was named interim CEO in June. To his credit, he moved quickly to establish himself in the role, and by year-end had convinced the Board to make him the permanent CEO.

When Brandon was named interim CEO in June, the Compensation Committee took the following actions:

- Awarded him a grant of performance units valued at \$600,000
- Awarded him a grant of time-based restricted stock valued at \$600,000
- Raised his annual incentive target to 200% of base salary

Brandon confided in you that he felt the package was "a little light," but was confident that when he convinced the Board to make him permanent, he would be able to more than make up for what he thought was a pay gap between him and Kellerston.

In December, the Board unanimously voted to make Brandon the permanent CEO, citing his innovative strategic plans for the growing AgChem business as evidence that they made the right choice. At the end of an impressive presentation on the new strategic direction, the Chairman of the Board Oscar Inouye called an executive session and persuaded the full Board to make the decision. In the discussions that

## **Fundamentals of Executive Compensation**

### *Breakout Session #2: An "AGAINST" Recommendation*

followed, Brandon convinced Inouye and Compensation Committee Chair Adrienne West that his compensation as interim CEO had been inadequate, and it was appropriate to rectify the situation with additional equity awards. In January, the Board approved the following:

- Base salary of \$1.25 million (estimated at 10% below peers)
- Annual incentive target of \$3.5 million (280% of base, estimated at top quartile of peers)
- Regular annual equity award valued at \$15 million, comprised of
  - 80% performance shares, based on EPS and relative TSR
  - 20% time-based RSUs

Based on the above, Brandon's total direct compensation of approximately \$20 million was targeted at between the median and 75<sup>th</sup> percentile of peer CEOs. In addition to the regular package, the Board approved the following:

- Annual Incentive payment of \$1.5 million to recognize his 6 month performance as interim CEO;
- Special Performance Unit award valued at \$15 million, linked to the same performance measures used in the Annual Incentive Plan (see below);
- Special Performance Unit award valued at \$20 million and tied to increasing the company's stock price by 50% over five years;
- Special Stock Option award valued at \$20 million that vest only if the stock price grows 30%.

Because these actions were approved after year-end, they were not required to be disclosed in the proxy. However, because of the importance of CEO compensation to shareholders, NTL's General Counsel persuaded the Board that the company should file a supplemental proxy disclosure containing the details of the awards and explaining the Board's rationale.

## **NTL's Executive Compensation Plans**

### *The Annual Incentive Plan*

NTL's Annual Incentive plan is based on financial and operational performance.

- 50% of the award is based on performance against Net Income goals. To earn 100% of target, the company must meet the prior year level of net income.
- 50% of the award is based on operational metrics, which include technical, operational, product milestone and ESG metrics. The Company does not disclose the specific metrics nor the goals for this portion of the award, and the Compensation Committee determines the amount earned based on its discretion.

### *The Long-Term Incentive Plan*

NTL's Long Term Incentive Plan consists of Performance Units tied to EPS and relative TSR performance.

- EPS units: half of the award is based on three-year cumulative EPS growth. NTL does not disclose the performance goals for EPS in the proxy, citing competitive concerns.
- TSR units: half of the award is based on relative TSR performance against the S&P Chemicals Index. These units pay out at target if NTL's TSR is at the median of the peer group. An award may be earned if TSR is negative without restrictions or limitations.

## Fundamentals of Executive Compensation

### Breakout Session #2: An “AGAINST” Recommendation

#### The ISS Report

You join a Zoom call to review the ISS report with Mandy and Carl Forster, NTL’s securities attorney. While you knew Brandon’s package was a bit outsized at the time, you felt that NTL’s history of strongly aligned pay and performance, four years of 90%+ positive Say on Pay results, and a host of good governance practices would keep you out of trouble. Unfortunately, ISS didn’t see things the same way and took the somewhat unusual step of recommending AGAINST the Company on Say on Pay even though the compensation was not included in the Summary Compensation Table. They based their decision on the information disclosed in the supplemental filing.

The ISS report left no room for doubt:

*“While pay and performance are reasonably aligned, a vote AGAINST the proposal is warranted due to concerns regarding the pay magnitude and structure of compensation arrangements for the newly appointed CEO.”*

Brandon’s agreement was enough to wipe out all the other actions the company had taken to create a well-designed pay program. The report also pointed out that, in addition to the sheer magnitude of the awards, there was no indication that the grants were intended to cover multiple years of future equity grants, despite being many times larger than a typical year’s grant.

You know you need to break the news to Brandon soon – but you need to come up with an action plan first. You’re somewhat concerned that he will react emotionally to the news – and insist on explaining to everyone who will listen why ISS got it wrong. The best way to contain him is to have a plan in place that clearly defines the best way to respond to the situation.

***In your breakout groups, discuss how you would handle this situation. What are the key aspects of your plan to address the ISS recommendation? Based on ISS’s concerns, what are your major risks going forward? If asked, what would you recommend directors say to investors? What facts work in your favor – and what works against you? Be prepared to discuss your recommendations with the group, including an assessment of the impact on future Say on Pay votes.***