



Counsel for  
BOARD AND EXECUTIVES

# Acredula®



July/August 2003

Vol. IV No. 4

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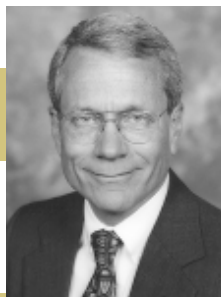
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## Congress: You cannot legislate against excessive compensation

Congress got it partially right in the Sarbanes-Oxley Act of 2002 (SOX). Independent directors are the first and best line of defense against corporate dishonesty. SOX called for independent oversight by directors, regulation of public company accounting firms, and executive accountability. This is not bad legislation. But the Congressional attempt to legislate through the SEC against certain disclosure practices was not good legislation. The attempt to increase reporting of contractual obligations and contingent liabilities and to decrease use of non-GAAP financial measures appears to be resulting in complex SEC rules, with even more incomprehensible financial statements and accompanying notes, meaningless management discussion and analysis of those financial statements, and elimination of some useful, but non-GAAP, selected financial measures.

### EDITOR'S NOTE

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sible regulations like those under §162(m) denying deduction for unreasonable compensation and under §280G denying deduction for excess golden parachute payments.

The American corporate model has served this country well: CEO-led management subject to oversight by independent directors. American business has outperformed its European and Japanese counterparts.

Directors and officers under the American corporate model have well-defined duties of care to act as an ordinarily prudent person in a like position would under similar circumstances and a duty of loyalty to act in or not opposed to the best interest of the corporation. Is there any doubt that Kenneth Lay did not act as an ordinarily prudent person in a like position as CEO of Enron? Is there any doubt that Fastow of Enron or Eggers or Sullivan of WorldCom did not act in the best interests of Enron or WorldCom, respectively?

Rather than legislate against excessive compensation through tax laws, Congress would be more on target to do what it did right in SOX. First, Congress can require oversight of public company executive compensation by independent directors in the same way it required oversight of the audit process.

Second, rather than legislate through the tax laws, Congress should use the PCAOB. Congress could direct the PCAOB to adopt rules that public company accounting firms will only issue audit reports to public companies having such oversight by independent directors.

Third, to prevent (or at least to increase the likelihood of prosecution of executives for) lack

Unfortunately, Congress is frustrated and infuriated again. This time over executive compensation. It is frustrated that executives are reportedly sheltering assets from the reach of their companies' creditors in off-shore trusts. It is infuriated over the compensation package negotiated by NYSE's chairman and CEO and the retirement package negotiated by GE's chairman and CEO. It is even more infuriated that courts are finding that abusive compensation practices with misplaced incentives were the major contributing factors to fraud at Enron and WorldCom. So Congress is reacting by proposing legislation against certain compensation practices. Just as it unleashed the SEC to adopt rules proscribing certain disclosure practices, Congress is proposing to unleash the IRS to proscribe certain compensation practices.

As with SOX, some of this is not bad legislation. But some of it will result in more incomprehen-

## In this issue

- 2 Recent trends in director and executive compensation
- 4 Selling your law practice: a primer for sole practitioners

**A**credula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

of full disclosure by executives of all elements of their executive compensation to independent directors, Congress can require the CEO and CFO of public companies to certify to independent directors responsible for overseeing executive compensation a report disclosing all such elements of compensation.

Fourth, to make sure that shareholders and investors know of public companies' compensation

practices, Congress can require through the PCAOB that the current expensing of all elements of executive compensation, including stock options and retirement benefits, be reported.

Isn't independent oversight from within based upon CEO and CFO certifications of full disclosure with full reporting to shareholders and investors better than incomprehensible IRS regulations?

## Recent trends in director and executive compensation

By  
**John P. Beavers**  
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Although director and executive compensation has received a lot of attention over the last year, Congress, the SEC and the courts are likely to increase this focus in 2004.

Congress is considering mandating expensing of stock options; further limiting severance benefits and deferred compensation to directors and officers; limiting or prohibiting use of Rabbi trusts; and repealing the prohibition by the IRS to make all employee deferrals taxable. The SEC is questioning publicly compensation of executives, including current compensation of the Chairman and CEO of the NYSE and retirement payments to the former CEO of General Electric. After limiting use of non-qualified stock options by directors and executives of tax-exempt organizations, finalizing regulations further increasing the penalties for parachute payments and limiting use of split-dollar insurance arrangements, the IRS is urging Congress to increase the likelihood of taxation of deferred compensation. The SEC, NYSE and Nasdaq are requiring that equity compensation be approved by shareholders and that compensation committees have charters delegating them authority for all executive compensation. These compensation committees must be composed solely of independent directors similar to the structure of audit committees. Courts are finding that abusive compensation practices with misplaced incentives were the major contributing factors to fraud at Enron and WorldCom.

This article summarizes these recent trends and what they mean for the future of director and executive compensation, in light of the foregoing.

### Director Compensation

Buck Consultants, a human resources consulting firm based in New York, released a Board of Directors Compensation Survey in June 2003. We can observe the following trends when comparing the Buck Survey with surveys conducted by

Executive Compensation Advisory Services in 2002 and 2001 and by *Acredula* in 2000.

**Board size.** Trending toward fewer members until 2000, board sizes remain constant and show little deviation based upon company size according to the Buck Survey:

Company size	Median size
Greater than \$10 billion in revenue	12
Between \$3 billion and \$10 billion	10
Between \$500 million and \$3 billion	9
Between \$100 million and \$500 million	8
Under \$100 million	7

**Realigned committee membership.** According to the Buck Survey, realigned committee membership was a recent focus of 46% of the surveyed companies, with 42% of those surveyed seeking new board members with specific expertise for those committees. These results are a significant change in focus from past surveys.

**Composition of board compensation.** According to the Buck Survey, the makeup of board compensation remains about the same. The survey showed that 69% of surveyed companies pay both retainers and meeting fees, 22% pay only retainers, and 3% pay only meeting fees.

**Board retainers.** Retainer amounts have increased from prior surveys for companies with less than \$500 million of revenue. According to the Buck survey, the median retainer based upon company size is as follows:

Company size	Median retainer
Greater than \$10 billion in revenue	\$50,000
Between \$3 billion and \$10 billion	\$35,000
Between \$500 million and \$3 billion	\$30,000
Between \$100 million and \$500 million	\$20,000
Under \$100 million	\$17,500

The Buck Survey also reveals that 16% of surveyed companies are considering increasing board retainers, which is a substantially larger percentage than in past surveys. Zero percent are considering decreasing or removing them, which is a lower percentage than past surveys.

**Board meeting fees.** The Buck Survey shows that meeting fees remain relatively constant, with the median in-person meeting fee holding at \$1,500 and the telephone meeting fee holding at \$1,000. However, as discussed below, more companies are now paying committee meeting fees in addition to board meeting fees. The Buck Survey also indicates that 8% of the surveyed companies are considering increasing meeting fees, which is a substantially larger percentage than past surveys, and less than 1% are considering decreasing or removing them, which is about the same as past surveys.

**Committee chair retainers.** According to the Buck Survey, chair retainers are increasing, with 51% of the surveyed companies paying a separate retainer to either all or selected committee chairs. The committee chair retainers range from a median of \$3,000 for nominating committee chairs to \$5,000 for compensation committee chairs to \$7,500 for audit committee chairs. The Buck Survey shows that 23% of the surveyed companies have recently implemented or increased committee chair retainers and about 9% are considering implementing or increasing committee chair retainers.

**Committee member retainers.** As an addition to board member retainers, more companies are paying committee member retainers. According to the Buck Survey, these retainers range from a median of \$3,500 for nominating committees to \$3,750 for compensation committee membership to \$5,000 for audit committee membership. The survey indicated that 8% of the surveyed companies report paying a special retainer to obtain or retain committee members with specific expertise, such as financial expertise. About 27% of the surveyed companies have recently implemented or increased committee member retainers and about 2% are considering implementing or increasing committee chair retainers.

**Benchmark.** The survey revealed that several companies use the standard hourly rate of consultants in the locale of the company multiplied by the time expected to be spent by a director in preparing for and attending to company business as the benchmark for setting retainer fees and meeting fees for directors.

**Form of payment.** According to the Buck Survey, payment of retainers and meeting fees is increasingly cash only, with 76% of the surveyed companies paying cash only. On the other hand, about 27% of the surveyed companies have stock ownership guidelines suggesting directors purchase

company stock in market transactions. The typical stock ownership guideline is ownership of stock having a market value equal to a multiple of the annual retainer with the median multiple being four-times.

## Executive Compensation

Jeffrey M. Kanter, managing director of Frederic W. Cook & Co., Inc. and Mark A. Borges, principal of Mercer Human Resource Consulting discussed trends in executive compensation in a conference sponsored by the Practicing Law Institute in New York on September 4–5, 2003.

**Emphasizing “performance” rather than “entitlement”** is a trend observed by Mercer and evidenced by comparing surveys of long-term incentive compensation conducted by Cook between 2000 and 2003. According to the Cook Surveys, the portion of a CEO’s long-term incentive compensation that consisted of performance awards increased to 20% in 2003 from 12% in 2002. As discussed below, some surveyed companies are reducing severance pay if performance levels are not met.

**Shifting from stock options to restricted stock awards or units** is a trend observed by Mercer and evident in the Cook Surveys. According to the Cook Surveys, the portion of a CEO’s long-term incentive compensation that consisted of restricted stock awards or units increased to 16% in 2003 from 10% in 2002. Likewise, the percentage of surveyed companies granting restricted stock awards or units increased to 61% in 2003 from 51% in 2000.

**Decreasing granting of incentive stock options** is a trend observed by Mercer and evident in the Cook Surveys. According to the Cook Surveys, the percentage of surveyed companies granting incentive stock options to executives decreased to 12% in 2003 from 28% in 2000.

**Increasing consideration of the reasonableness** of the amount of executive compensation and of the incentives being awarded by compensation committees is a trend observed by Mercer. The consideration is no longer solely what is “deductible” or “legal.”

**Putting a term on severance agreements** is a trend observed by Mercer. Rather than an evergreen term, the trend is toward limiting the severance agreement to a fixed term at the end of which the agreement would be renegotiated to take into account performance of the executive. Other surveyed companies are adding “hair cuts” to reduce severance pay if performance levels are not met.

## Compensation Committees

Both Cook and Mercer had the following observations on trends in governance, composition and operation of compensation committees:

**Compensation lawyers and consultants** are being hired by more committees in order to satisfy the committee members' state law duties of care and loyalty. Under most state laws, a committee member is protected if the committee relies upon the opinion or report of an expert for matters on which the consultant is reasonably believed to be competent and reliable.

**Avoiding dual experts** (i.e., one expert hired by the company and a different expert hired by the compensation committee) is being accomplished by authorizing compensation committees to hire, fire, and determine the compensation and scope of work of the company's compensation committee in the same manner that the company's audit committee hires, fires, and determines the compensation and scope of work of the company's external auditor.

**Rotating compensation committee members** (other than the compensation committee chair) every two or three years is a procedure that boards are taking to assure a "fresh look" at executive compensation. In order to maintain some consistence, compensation committee chairs are being rotated less frequently, such as every five or six years.

**Report at the annual shareholders meeting** by the compensation committee chair is another procedure being adopted by companies to increase shareholder understanding.

### Conclusion

This is likely only the beginning. Between now and the next proxy season, we expect to see additional trends, such as:

- Greater reliance on cash compensation for both directors and executives;
- Decrease in retention or "stay" bonuses that could be viewed as "entitlements" rather than "pay for performance";
- Mandatory expensing of stock options;
- Decrease in deferred compensation and especially SERPS for directors;
- Change in design of SERPs from a defined-benefit obligation on the part of the company to become more like defined-contribution or individual-account plans; and
- More frequent submission by directors of large executive severance and golden parachute arrangements to shareholders.

We also expect the NYSE and Nasdaq to finalize their rules for compensation committees which will likely require compensation committees of public reporting companies to have greater authority and independence than currently required under federal tax and securities laws.

Between now and the next proxy season, we expect to see greater reliance on cash compensation for both directors and executives.

## Selling your law practice: a primer for sole practitioners



By **Michael F. Sullivan**  
Bricker & Eckler LLP

For the first time in Ohio, attorneys can buy and sell entire law practices. On February 1, 2003, the Ohio Supreme Court amended its disciplinary rules\* to allow lawyers to buy or sell a legal practice, including client rosters and current caseload. The new rules allow lawyers to be fairly compensated for the valuable practices they have established, while safeguarding the rights of clients. Potential buyers must sign confidentiality agreements prior to receiving client information and all clients must be notified of the impending sale and given an opportunity to seek other counsel. Now that lawyers can sell their practices, they need to know how to prepare for and execute the sale.

### Preparing Your Practice

The first step in selling your practice is to begin cataloging your business assets, making sure that personal and business items are separated. Unless there is an agreement regarding asset ownership,

the buyer may rightly assume that everything contained in the office will become his, even valuable personal items like your grandfather's painting hanging in your office.

Next, you need to document your profits to show the buyer the income-generation potential of your practice. Start by assembling income tax returns. Then, catalog and summarize any contingent fees or other payments that you may receive in the future and determine whether they will be included in the purchase price or whether the contract will contain provisions for your successor to assist you in collecting these payments. Consider making an inventory of wills your practice has accumulated that may give rise to future fee income for you or your successor as the counsel for the estate. Keep records of referrals that you have made to other lawyers and estimate the likely fees which those referrals generated.

In addition, you should identify economies that a buyer could effect that would translate to increased bottom-line income. For example, if a buyer is already operating a firm in the same town, buying your practice will eliminate your costs of bookkeeping, income tax preparation and governmental filings, while not significantly increasing the buyer's costs.

## Marketing Your Practice

The new rules allow lawyers to advertise the sale of their practice in mass print and broadcast media, in trade publications and in direct mailings. To properly market your practice, start by making some preliminary decisions:

- Will you approach a select handful of likely buyers in your community or practice area?
- Will you initiate a widespread auction process by placing an ad in bar publications?
- Will you seek the services of a third party to assume the responsibility of looking for a purchaser and presenting the practice? While the law prohibits persons serving as brokers (buying a practice for resale), there appears to be no prohibition against serving as an advisory agent.

Consider creating an offering memorandum describing your practice in a manner that maximizes its value to you. This memorandum should include the following:

- A description of your community, including its stability, growth prospects and demographics.
- A description of your practice, including areas of law covered and those referred out.
- A general description of the assets that will be transferred upon the sale.
- A description of the lease and renewal options for your current space.
- A description of your staff.
- A statement regarding your availability for transition services and expected compensation.
- A summary of financial information regarding the profit history of your operations.
- The reasons why a buyer might be able to enhance historical profitability through cost-savings and reduction of work referred outside.

## Valuing Your Practice

Assigning value to any personal service business is extremely difficult. Law practices may be even harder to value because of the unique skill sets some attorneys bring to their practices. However, lawyers who produce a standardized product, servicing individual clientele in a practice in which litigation is not the predominant activity, will face fewer problems when assessing their practices.

The fair market value of your practice can be determined by blending the results of several valuation methods, including:

- **Discounted Future Benefits.** This method compares the net benefit received from the existing practice during the period it would take to build a comparable practice from the ground up. It requires an accurate estimate of the expected timeframe, start-up costs and benefits of a new practice.
- **Asset Accumulation Approach.** This approach requires separate appraisals for all tangible and intangible assets to arrive at an adjusted book value.
- **Comparable Sales.** This procedure compares sales of comparable practices. You would need to show at what cost similar practices are actually selling—information which may be relatively sparse in light of the prohibition on sale which was in force so recently.
- **Debt Capacity–Acquisition Value.** This technique calculates the net present value of the projected earnings stream from the practice after acquisition, using an interest rate that reflects the buyer's cost of financing. Projected earnings are calculated by adjusting historical financial information to reflect anticipated changes after acquisition.
- **Excess Earnings Approach.** In this approach, the goodwill value of the practice is calculated by taking “normalized” gross earnings less the cost of replacing the practitioner, less a reasonable return on the hard investment. The goodwill value is capitalized at an appropriate discount rate and added to the net book value to arrive at fair market value.

In all of these analyses, a seller will benefit by consulting an experienced, credible appraiser, who may be the seller's regular accountant.

## Business Sales Similarities

When selling your law firm, you may face many of the same issues arising in garden-variety business sales, such as:

- **Non-Solicitation.** The new law requires the selling lawyer to obtain a confidentiality agreement from the prospective buyer. This agreement may parallel generic confidentiality agreements by prohibiting solicitation of the seller's employees if the acquisition does not occur.
- **Indemnification.** The new law provides that selling and purchasing lawyers will remain liable to clients for their past and prospective actions. Indemnification may be provided by the buyer or seller. It is expected that the buyer would

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indemnify the seller against items that occur subsequent to closing and the seller would indemnify the buyer for matters that arise prior to closing. One issue unique to law firm sales is that the statute of limitations for malpractice may be extended by provision of additional services to the wronged client.

- **Tail insurance.** At least as important as indemnification is tail coverage on malpractice insurance and determining which party shall be responsible for payment of coverage premiums.
- **Earn Outs.** In the usual business negotiation, the seller argues that he should be compensated based on an assumed ever-growing future stream of earnings. The buyer argues that once the seller leaves, the stream of earnings may greatly diminish. This debate can be expected to be quite spirited. A frequent solution is for the seller to pay the buyer a lump-sum representing a pessimistic view of the business, with a provision for additional payments based upon the business' successful operation. When negotiating such a provision, a number of accounting issues must be considered:
  - What expenses of the acquiring entity are properly allocable to the acquired entity?
  - What is the "business of the acquired company" if the acquirer is also bringing a book of business.
  - What expenses are properly chargeable if the earn out is based upon net income, e.g., associate salaries, an addition to the library, debt service incurred in connection with the acquisition.

- **Non-Compete Agreements.** The new rules provide that the sales agreement may include terms that reasonably limit the ability of the selling lawyer to re-enter the practice of law (this restriction excludes academic, government, public service or in-house counsel positions). Acquisition agreements often contain a provision for five-year non-competition in all areas where offices are located, but whether this is reasonable in the sale of a law practice remains to be seen. A "selling lawyer" is defined to include a law firm, leaving open for debate the issue of whether an associate of the firm could be held to a non-compete voluntarily entered into in connection with the sale.
- **Employment Agreements.** In the sale of a law practice, the buyer may require an additional six to 12 months of service to complete transition of clients by the seller. In this circumstance, the buyer's total payments would be allocated between the purchase price of the business and the salary payable to the former owner. Significant negotiation may arise concerning the allocation of payments to the purchase contract versus the employment agreement, since the potential for forfeiture of future benefits will be different.

The Supreme Court has provided a wonderful opportunity for Ohio practitioners to realize some of the value of years of hard work. Those who elect to do so should take the same care in maximizing the benefit as they would counsel a client to take.

For a detailed discussion of the new rules, see Eugene P. Whetzel, *Buying or Selling a Law Practice*, Ohio Lawyer (May-June 2003). p. 24.

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