Carly Fiorina and Hewlett-Packard Severance Policy

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On February 8, 2005, Carly Fiorina was terminated as Chairman and Chief Executive Officer of Hewlett-Packard Company ("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 (the “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.

Following is further 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 (February 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 termination, 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 inconsistent 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.
Endnotes:

1. Ms. Fiorina’s entitlements are described in her severance agreement dated February 8, 2005 (the “Severance Agreement”). The Severance Agreement is included as Exhibit 99.1 to HP’s Form 8-K filed February 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% 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 January 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 webcast 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 September 20, 1999. There is no stated term to the agreement and presumably at some point HP and Ms. Fiorina agreed to terminate the agreement.