107 - Current Issues in Executive Compensation

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COMPENSATION COMMITTEE GUIDE & BEST PRACTICES

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About this Guide

This Guide provides an overview of the key rules applicable to compensation committees of NYSE- and NASDAQ-listed U.S. companies and best practices that compensation committees should consider in the current environment. This Guide outlines a compensation committee member's responsibilities, reviews the composition and procedures of the compensation committee and considers important legal standards and regulations that govern compensation committees and compensation committee members. Although generally geared toward directors who are members of a public company compensation committee, this Guide is also relevant to members of a compensation committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

In particular, this Guide is written to help compensation committee members fulfill their duties in the post-Enron environment. To this end, this Guide proposes specific practices designed to promote effective compensation committees. A well-run compensation committee—*i.e.*, a compensation committee composed of independent members who are focused on the right areas of inquiry and intent on asking tough questions of management, internal human resources experts and independent compensation consultants—can assist the company in creating appropriate incentives for its management.

This version of the Guide is an update that incorporates information on equity compensation grant policies and the Securities and Exchange Commission's executive compensation disclosure rules adopted on August 11, 2006.

This Guide is not intended as legal advice and cannot take into account particular facts and circumstances. Nor does this Guide address individual state corporation laws. That said, we believe this Guide will offer directors sound guidance in terms of the general rules and practices that compensation committee members should follow.

About the Exhibits

The Exhibits to this Guide are sample compensation committee charters and a sample tally sheet. All of these are to some extent useful in assisting the compensation committee in performing its functions. However, it would be a mistake to simply copy published models. The creation of charters and tally sheets is an art that requires experience and careful thought. In order to be "state of the art" in its governance practices, it is not necessary that a company have everything another company has. When taken too far in the case of charters, a tendency to expand the scope can be counterproductive. For example, if a charter requires review or other action and the committee has not taken that action, the failure may be considered evidence of lack of due care. Each company should tailor its own compensation committee charters, tally sheets and written procedures to what is truly necessary and what is feasible to accomplish in actual practice. These materials should be carefully reviewed each year to prune unnecessary items and to add only those items that will in fact help directors in discharging their duties.

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Introduction

Compensation Matters Take Center Stage

The continuing publicity of executive compensation arrangements, recently enacted and proposed executive compensation legislation and the unremitting pressure being exerted by shareholder activists ensure that executive compensation will remain one of the hottest issues in corporate governance in the coming years. In light of this and the importance of human capital to the success of public companies, compensation matters, and the role of the compensation committee, have taken center stage.

Compensation committees must strive to stay abreast of the changing rules and developing environment. Over the past year alone, the executive compensation landscape has evolved in the following ways:

- The Securities and Exchange Commission (the "SEC") adopted comprehensive new rules regarding the disclosure of executive compensation;
- The Financial Accounting Standards Board ("FASB") began requiring that companies expense stock options;
- A number of public companies have come under scrutiny in connection with their stock option grant practices, triggering financial restatements and SEC investigations;
- Proposed regulations and notices were issued under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), attempting to clarify the new rules governing the taxation of deferred compensation arrangements;
- The Pension Protection Act of 2006 was enacted, which changes the rules governing executive and broad-based pension plans;
- Shareholder proposals pushing activist's executive compensation agendas and withhold-the-vote campaigns are on the rise;
- Bills were introduced in the U.S. House of Representatives that seek to enhance further the required disclosure of executive compensation arrangements; and

- The SEC reformed the tender offer rules to provide relief for companies that wish to provide management-shareholders with compensation arrangements in the context of a tender offer without running the risk of violating the securities laws.

It is against the backdrop of these developments that compensation committees must find the most effective and appropriate way to compensate their companies' executives. In response to pressures brought about by the media and activists on executive compensation, many advisors now provide countless suggestions for directors to follow in an effort to avoid further criticism by these groups. While frequently well-intentioned, this advice can distract directors from their basic responsibilities with respect to executive compensation. The tendency to curtail recommendations with respect to compensation that may be in the best interest of the corporation is ill-advised.[1] In many cases, proposed "reforms" merely reflect the narrow agendas of "special interest" shareholders, such as unions and pension funds run by politicians who may have interests in advancing reforms that are antithetical to those of other investors.[2] While certain of the

[1] Michael S. Katzke and Jeremy L. Goldstein, *Executive Compensation, Board Liability and Corporate Governance in a Post-Disney World*, Corporate Governance Advisor (November/December 2005).

[2] *See*, *e.g.*, Stephen M. Bainbridge, *Pension Funds Play Politics*, Tech Cent. Station (April 21, 2004) *at* http://www.techcentralstation.com/042104G.html:

> The interests of large and small investors often differ. As management becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors. If the large shareholders with the most influence are unions or state pensions, however, the problem is exacerbated. The interests of unions as investors differ radically from those of ordinary investors. The pension fund of the union representing Safeway workers, for example, is trying to oust directors who stood up to the union in collective bargaining negotiations. Union pension funds have used shareholder proposals to obtain employee benefits they couldn't get through bargaining (although the SEC usually doesn't allow these proposals onto the proxy statement). AFSCME's involvement especially worries me; the public sector employee union is highly politicized and seems especially likely to use its pension funds as a vehicle for advancing political/social goals unrelated to shareholder interests generally. Public pension funds are even more likely to do so. Indeed, the LA Times recently reported that CalPers' renewed activism is being 'fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a CalPers board member, who is considering running for governor of California in 2006.' In other words, Angelides is using the

(footnote continued)

proposals may well have merit for certain companies, this "one-size-fits-all" approach to compensation policy undermines the very strength of the corporate organization: the delegation of decision making power from stockholders who have limited information and often conflicting interests to well-informed directors acting with due care in the best interests of the corporation.

* * * * * *

This Guide eschews the "one-size-fits-all" approach to executive compensation and instead seeks to focus directors on the issues that are essential to the optimization of business operation and to assist them in exercising their business judgment to resolve such issues. Directors cannot ignore the realities of the marketplace. Particularly in times of economic expansion, there is a vibrant and competitive market for human capital, which requires some flexibility in compensation matters. Sound business judgment almost always leads to better results than blindly following the herd. Changing a company's approach to compensation should be based on informed decisions that take into account the needs of the company and the effectiveness of the existing practices, rather than complaints of corporate critics and shareholder activists about specific means of compensation. This Guide advises directors to engage in a thoughtful and informed process regarding the manner in which they wish to compensate their executives, discuss and understand the relevant issues, reflect such discussions appropriately in compensation committee minutes, listen to experts (whether internal or external), if appropriate or necessary, and review documentation and cost estimates.

This Guide is intended to provide individuals who are currently serving, or are interested in serving, on compensation committees of public companies with a concise explanation of their duties and responsibilities and to provide them with information and advice that will enable them to carry out effectively those duties and responsibilities. In particular, this Guide begins with a discussion of the responsibilities of the compensation committee, the rules, laws and other authorities applicable to compensation arrangements and fiduciary duties of compensation committee members. It then discusses different means of compensating executives and change-of-control employment arrangements. Next

(footnote continued)

retirement savings of California's public employees to further his own political ends.

is a discussion of charters, meetings and who may serve on a compensation committee. Finally, the Guide addresses compensation of directors.

CHAPTER 1

Key Responsibilities of Compensation Committee Members

The SEC, the New York Stock Exchange (the "NYSE") and the NASDAQ require a compensation committee of a publicly held company to assume a number of compensation-related responsibilities. It is also advisable for compensation committees to assume certain additional responsibilities. It is important therefore that the compensation committee understand what is now expected of it and that it be diligent in ensuring that it appropriately and faithfully fulfills its expanding mandate.

I. Responsibilities Imposed by the Securities Markets[3]

A. New York Stock Exchange Requirements

The NYSE requires that all listed companies subject to its corporate governance listing standards have a compensation committee, with a written charter,[4] composed entirely of independent directors.[5] The NYSE further requires that the compensation committee carry out a number of minimum responsibilities. While the responsibilities of the compensation committee may be delegated to subcommittees, the subcommittees must still be composed entirely of independent directors and have a published charter.[6]

The compensation committee must (1) review and approve goals and objectives relevant to CEO compensation, (2) evaluate the CEO's performance in light of such goals and objectives and (3) either as a committee or together with the other independent directors, determine and approve the CEO's compensation

[3] For additional discussion of the NYSE and NASDAQ requirements, including the text of their respective rules, *see* David C. Karp, *Other Key Oversight Committees: The Nominating and Corporate Governance Committee and the Compensation Committee*, *in* 2 The Practitioners Guide to the Sarbanes-Oxley Act, Part V, Ch. 2 (2005).

[4] Under recently adopted revisions to the NYSE corporate governance rules, a listed company is required to maintain a website which must include, among other things, a printable version of the compensation committee charter. *See* NYSE Listed Company Manual Section 303A.14.

[5] The NYSE definition of "independent" is explored in detail in Chapter 6.

[6] A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

level based upon such evaluation. In determining the long-term incentive component of CEO compensation, the NYSE requires the compensation committee to consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years.[7] The compensation committee responsibilities regarding CEO compensation do not preclude discussion of CEO compensation with the board of directors generally.

In addition, under NYSE rules, the compensation committee must recommend non-CEO executive officer compensation to the board of directors. This means that a listed company's compensation committee must recommend compensation of the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice president of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions. The compensation committee is also charged with recommending to the board the approval of incentive and equity-based compensation plans that are subject to board approval.

If the compensation committee desires to have the aid of a compensation consultant, the compensation committee must be vested with the sole authority to (1) retain and terminate such consultant and (2) approve the consultant's fees and other retention terms. Additionally, the NYSE reiterates and adopts the SEC requirement that the compensation committee produce a report on executive officer compensation required to be included in the listed company's annual proxy statement or annual report on Form 10-K.

Last, the compensation committee must conduct an annual self-evaluation of its performance. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants have also established an advisory service in which they meet with committee members to lead them through the evaluation process. The compensation committee must decide how to conduct its evaluation. In making the decision, it is not required that the directors receive outside assistance and it is not required that multiple-choice questionnaires and/or essays be the means of evaluation. If the

[7] The NYSE clarifies that the compensation committee is not precluded from approving awards so as to comply with applicable tax laws, such as § 162(m), with or without ratification by the board of directors. For a further discussion of certain implications of § 162(m), *see* Chapter 1.

compensation committee prefers to do the evaluation by discussions at meetings, that is acceptable. Documents and minutes created as part of the evaluation process are not privileged and care should be taken not to create ambiguous records that may be used in litigation against the corporation and its directors.[8]

B. NASDAQ Requirements

The NASDAQ does not expressly require that its registered companies have a formal, independent compensation committee; however, under the proxy rules, a public company must disclose whether or not it has a compensation committee and, as discussed below, the requirements of the new executive compensation disclosure rules, the federal securities laws, the Code and the NASDAQ Marketplace Rules render the creation of an independent compensation committee a practical necessity.

The NASDAQ requires that the compensation of the CEO and other executive officers be determined, or recommended to the board of directors for determination, either by a majority of independent directors or a compensation committee composed entirely of independent directors. The CEO is prohibited from attending meetings while the compensation committee members or the independent directors, as applicable, are deliberating or voting on CEO compensation. The NASDAQ places no such restriction on other executive officer attendance and does not prohibit the attendance of the CEO during compensation committee discussions touching upon matters concerning other executive officer compensation.

The NASDAQ provides, however, that if a compensation committee is composed of at least three members, then, under exceptional circumstances and if certain conditions are met, one director who is not independent under its rules may be appointed to the compensation committee without disqualifying the compensation committee from considering the compensation matters that could ordinarily be entrusted to it had it been fully independent.[9] In addition, the compensation committee or the independent directors must approve equity

[8] For a brief discussion of the factors compensation committees should consider in its annual self-evaluation, *see* David C. Karp, *Other Key Oversight Committees: The Nominating and Corporate Governance Committee and the Compensation Committee*, *in* 2 The Practitioners Guide to the Sarbanes-Oxley Act, Part V, Ch. 2, at 23 (2005).

[9] The specific conditions that must be met in order for such exemption to be available, as well as the precise contours of the NASDAQ definition of "independent," are discussed in Chapter 6.

compensation arrangements that are exempted from the NASDAQ shareholder approval requirement as a prerequisite to taking advantage of such exemption.[10]

II. CEO and Executive Officer Compensation

While both the NYSE and the NASDAQ only require that the compensation committee recommend to the full board non-CEO executive officer compensation, vesting complete authority in the compensation committee for such individuals is advisable given the requirements of Section 162(m) of the Code, the insider trading short-swing profit safe harbor of Rule 16b-3 of Section 16(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and state law fiduciary duty jurisprudence, all of which provide substantial incentives for the compensation of executive officers to be determined by a committee of independent directors. Chapter 2 of this Guide provides a detailed discussion of the requirements of Section 162(m) and Rule 16b-3.

In evaluating and setting executive officer compensation, the compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, the committee should discuss whether, and to what degree, they have been satisfied. In addition, as more fully discussed in Chapter 2, it may be necessary for the compensation committee to certify satisfaction of such performance criteria in order to comply with the tax deductibility requirements of Section 162(m).

Further, in order to ensure that compensation and severance packages are justifiable, members of the compensation committee should fully understand the costs and benefits of the compensation arrangements that they are considering. Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment. It may be useful for the compensation committee to utilize a "tally sheet," which provides the compensation committee with a concise breakdown of the various components of a given executive officer's compensation package.

At *Exhibit C* to this Guide is a model tally sheet. As described in the "About the Exhibits" section at the front of this Guide, the model tally sheet is

[10] The shareholder approval requirements and the relevant exemptions for certain compensation committee approved plans are discussed in Chapter 1.

only a model and companies should customize the model to their particular needs and circumstances.

III. Non-Executive Officer Compensation and Broad-Based Plans

There is no single allocation of compensation responsibilities that is right for every company; however, companies should at least consider whether the compensation committee will have responsibility for employees other than executive officers and for compensation and benefit plans other than incentive and equity compensation plans. Limiting a compensation committee's responsibility to that of executive officer compensation may make sense for many companies because busy directors should concentrate their limited resources on establishing proper incentives for executive officers who are most likely to influence company performance. Ultimately, the full board is charged with allocating compensation responsibilities, but the compensation committee may be best equipped to take the lead in the inquiry.

As noted in Chapter 3, the compensation committee may also have fiduciary responsibilities under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), for employee benefit plans, either as a result of language in plan documents or the committee's own charter, or by virtue of actually exercising such responsibilities. It is possible for plans to state that the full board or the compensation committee is responsible for administering ERISA plans or for managing the investment of their assets. It may or may not be appropriate for the committee to assume such responsibilities, but in any event the committee should ensure that the documentation and actual exercise of fiduciary responsibilities are consistent, and that all who are ERISA fiduciaries are aware of that fact and understand the legal responsibilities it entails. ERISA places special emphasis on "procedural prudence," so it is important for fiduciaries to follow appropriate procedures, to have full access to all necessary information and expert advice pertaining to their duties, and to keep careful records of their deliberations, decisions and actions when acting in a fiduciary capacity. In addition, it is critically important that ERISA fiduciaries be sensitive to the possibility that their ERISA duties and their responsibilities to the company may be in conflict, presenting special legal issues that must be addressed. These issues are particularly fraught when assets of the ERISA plan in question are invested in company stock (as is the case for Employee Stock Ownership Plans ("ESOPs") and many 401(k) plans).

IV. Development of Compensation Philosophy

The compensation committee must develop a compensation policy tailored to the company's specific business objectives and means in order to evaluate, determine and meet executive compensation goals. Development of a compensation policy not only makes good business sense, but is necessary to meet the SEC requirement under the new disclosure rules that companies include a section entitled "Compensation Discussion and Analysis" (the "CD&A") in their annual proxy statement. The company must discuss in the CD&A (i) the objectives of the compensation arrangements, (ii) what the compensation program is designed to reward, (iii) each element of compensation, (iv) why a particular element was chosen, (v) how the amount (and, where applicable, the formula) is determined for each element and (vi) how the various components of the compensation arrangements satisfy the company's overall compensation objectives.[11] Having a coherent, well-articulated compensation philosophy will be key to the compensation committee's ability to provide meaningful disclosure under this new rule.

V. Compensation-Related Disclosure Responsibilities

The compensation committee should ensure that all compensation-related disclosure requirements are unambiguously met. This presents a particularly pronounced challenge for the upcoming year now that the SEC has adopted its final executive compensation disclosure rules. Compliance with the new rules will require a great deal of work and the close look at the company's practices that will inevitably result from preparation of the disclosures may give rise to a desire to change some practices. Changes to these practices are best implemented prior to filing the annual proxy as any such changes can be explained in the CD&A. Moreover, because the CD&A is subject to CEO/CFO certification requirements under the Sarbanes-Oxley Act, it will need to be prepared sufficiently in advance of filing so that it can be vetted through the company's disclosure controls and procedures.

Compensation committee members should be requesting that management discuss with them the nature of the new information that will be required to be disclosed in upcoming public filings, including the information relating to compensation committee members themselves. While some companies began to

[11] *See* SEC Release No. 33-8732, *Executive Compensation and Related Party Disclosure* (August 11, 2006), *available at* http://www.sec.gov.

use tally sheets during the past few years, the disclosure required by the new rules may be different from the amounts normally included on tally sheets and will likely increase the need for explanation and discussion.

In general, the new rules apply to Forms 10-K filed with respect to fiscal years ending on or after December 15, 2006 and proxy, information and registration statements, filed on or after December 15, 2006. A summary of the most important features of the rules is set forth below.

A. Compensation Discussion and Analysis

The new rules require the CD&A to be a narrative overview of a company's executive compensation policies and decisions. The CD&A addresses many of the topics historically covered in the Compensation Committee Report, which has been revamped as described below. The purpose of the CD&A is to provide to investors material information necessary for an understanding of a company's compensation policies and decisions regarding the named executive officers. In particular, the CD&A must explain all material elements of the compensation of the Named Executive Officers, including the overall objectives of the compensation programs and the rationale underlying and method of determining specific amounts for each element of compensation. Though warning against boilerplate disclosures, the SEC has provided a non-exclusive list of suggested topics for the CD&A, including post-termination compensation arrangements, tax and accounting considerations, policies regarding treatment of compensation in the event of restatements and whether the company has or intends to have a practice of selecting option grant dates in coordination with the release of material non-public information. Unlike the Compensation Committee Report, the CD&A is not merely deemed furnished to the SEC, but is considered "filed" with the SEC.[12] Because it is considered "filed," misleading statements in

[12] As the SEC's Proposing Release stated:

> In adopting the current rules in 1992, the Commission took into account comments that the Compensation Committee Report should be furnished rather than filed to allow for a more open and robust discussion in the reports. Little that we see in current Compensation Committee Reports suggests that this treatment has resulted in such discussions, or at least the more transparent disclosure that the comments suggested would result. Further, we believe that it is appropriate for companies to take responsibility for disclosure involving board matters as with other disclosure. SEC Release No. 33-8655.

the CD&A could expose the company to the potential liabilities of Section 18 of the Exchange Act. In addition, to the extent that the CD&A is included or incorporated by reference into a periodic report, the disclosure is covered by the Sarbanes-Oxley mandated CEO and CFO certifications. However, if forward-looking information is included within the CD&A, the company may rely on the safe harbors for such information.[13]

B. Compensation Committee Report

While the SEC did not completely eliminate the Compensation Committee Report, the Compensation Committee Report has become under the new rules a recitation of whether the compensation committee has reviewed, discussed and recommended the CD&A. The Compensation Committee Report must be included in the proxy and the annual report on Form 10-K, although incorporation by reference into the Form 10-K from the proxy statement is permitted. The names of the compensation committee members must still appear below the report. Unlike the CD&A, the Compensation Committee Report is still deemed to be furnished to, rather than filed with, the SEC. In light of the requirement that the Compensation Committee Report state whether the compensation committee has reviewed, discussed and recommended the CD&A, the compensation committee will need to have detailed discussions with management concerning the CD&A in advance of the filing deadline.

C. Covered Executives

The new rules expand upon the requirement that the company provide tabular and narrative disclosures explaining the components of executive compensation and also require for the first time tabular disclosure regarding director compensation. The specific requirements for the tabular/narrative disclosures are more fully described in sections G through L below.

As under the previous rules, the tabular/narrative disclosures for executive compensation only apply to the "Named Executive Officers" (the "NEOs"). However, the new rules change the list of officers who may be considered NEOs so that it now consists of the CEO, the CFO, the three most highly compensated executive officers (other than the CFO and CEO) and up to two additional

[13] For more information on preparing the CD&A, *see* Andrew R. Brownstein, Jeannemarie O'Brien, Gregory E. Ostling and Jeremy L. Goldstein, *Top Ten Practical Tips for Preparing the Compensation Discussion & Analysis*, Corporate Governance Advisor (November/December 2006).

individuals with respect to whom disclosure would have been required but for the fact that the individuals ceased serving as executive officers during the last completed fiscal year. No disclosure need be provided for any executive officer, other than the CEO and CFO, whose total compensation does not exceed $100,000. NEO status is based on the amounts includible in the total compensation column of the Summary Compensation Table, which is discussed below, reduced by the amounts includible in the column showing the change in pension value and non-qualified deferred compensation earnings.

The amendments eliminate the historical exception for compensation "that is not recurring and unlikely to continue" based on concerns that the exception lends itself to abuse. The elimination of this exception, coupled with the broadening of the categories of compensation used to determine NEOs (including severance payments), will likely result in more frequent year-to-year shifts in the identities of individuals (other than the CEO and CFO) who constitute NEOs and may cause terminated executives to be included as NEOs as a result of one-time severance and similar payments.

The SEC has requested additional comments regarding its prior proposal to require compensation disclosure with respect to three additional highly compensated employees who are not executive officers, but has adopted no such rule at this time. Set forth below is a description of the tabular/narrative disclosures that are required for NEOs and directors of the reporting company.

D. Summary Compensation Table

The company must provide a Summary Compensation Table ("SCT") in its proxy statement and annual report on Form 10-K to disclose all compensation earned, whether or not actually paid, with footnote disclosure explaining amounts deferred. To that end, the SCT includes new columns (and eliminates the long-term incentive compensation and other annual compensation columns) requiring the disclosure of stock awards, option awards, non-equity incentive plan compensation, change in pension value and non-qualified deferred compensation earnings and total compensation. The "all other compensation" column is intended to be a catchall for all compensation not properly categorized in the other columns.

Companies will not need to restate compensation disclosure for prior reported fiscal years in order to comply with the new requirements. Thus, for example, during the first year in which the SCT is presented in accordance with the new rules, the tabular disclosure need only address the last completed fiscal

year. The new rules and related instructions and commentary with respect to the SCT contain a number of noteworthy items:

Salary and Bonus. Salary and bonus satisfied in non-cash compensation must still be disclosed in the salary or bonus columns of the SCT, but will be footnoted with a cross-reference to the Grants of Plan-Based Awards table where the grant will be identified.

Stock Awards/Option Awards

- Awards are expressed as a dollar value (as opposed to a number of shares) based on an amount that is generally equal to the expense attributable to the awards for the year, determined in accordance with the standards used for stock-based compensation awards for financial reporting purposes under Financial Accounting Standard 123R ("FAS 123R").
- Option repricings/modifications in a given year require inclusion of the *incremental* fair value of the award resulting from the repricing/modification.
- Disclosure of earnings on stock awards or option awards in the "All Other Compensation" column of the SCT is required if future earnings are not included in the original determination of grant date fair value pursuant to FAS 123R.

Non-Equity Incentive Plan Compensation. Reports the dollar value of all amounts *earned* during the fiscal year pursuant to non-equity incentive plans (*i.e.*, awards not covered by FAS 123R), with amounts included based on when an executive satisfies the performance criteria, irrespective of whether payment of the award is subject to additional conditions. No further disclosure is required on actual payment.

Change in Pension Value and Non-Qualified Deferred Compensation Earnings. Discloses the aggregate increase in actuarial value of all defined benefit and actuarial plans (including supplemental plans) accrued during the year and above-market or preferential earnings on non-qualified deferred compensation, with footnote identification and quantification of each component of the reported amount.

All Other Compensation (including Perquisites/Personal Benefits)

- Discloses *all* other compensation that does not fall under any other category, although perquisites/personal benefits may be excluded if the aggregate amount for an NEO is less than $10,000. This category includes, among other items: amounts paid/accrued in connection with any termination of employment or change in control, contributions to defined contribution plans, company-paid life insurance premiums and tax gross-ups.

- Confirms prior guidance that perks are included based on the aggregate incremental cost to the company (as opposed to the value of the benefit conferred) and expands the interpretive guidance on what constitutes a perk:

  - An item is *not* a perk if it is *integrally and directly related to the performance of an executive's duties*.

  - An item *is* a perk if it confers a direct or indirect benefit that has a personal aspect, even if it is provided for a business reason or for the company's convenience, unless it is generally available on a non-discriminatory basis to all employees.

  - If the total value of all perks for an NEO is $10,000 or more, identify each perk by type, regardless of amount, and quantify and disclose in a footnote each item exceeding the greater of $25,000 and 10% of the total amount of the NEO's perks.

- Identify and quantify in a footnote each component of "All Other Compensation" that is not a perk that exceeds $10,000. This footnote disclosure and the footnote disclosure applicable to perks apply only to compensation for the last fiscal year.

Total Compensation. Aggregates the total dollar value of each form of compensation quantified in the other columns.

In addition to the tabular disclosure described above, the new rules require a narrative description of additional material factors and details regarding matters such as repricing or other material modifications of options or other equity-based awards.

E. Grants of Plan-Based Awards Table

The Grants of Plan-Based Awards table supplements the SCT by showing additional details of awards to NEOs made during the last fiscal year, including the grant date, the full grant date fair value of the award (not just the amount recognized as expense for the year as in the summary compensation table) estimated future payouts in respect of equity (number of shares) and non-equity (dollar amount) awards based on three different potential performance levels ("threshold," "target" and "maximum"), the number of shares underlying specific awards and option exercise prices. The table should not include options granted in connection with repricings.

Notably, the rules include a requirement that, if the per-share exercise price of an option or similar instrument is less than the market price of the underlying security on the grant date, a separate column must be added to the table showing the grant date market price with footnote or narrative disclosure explaining the methodology for determining the exercise price. The grant date for purposes of the table is determined by reference to the grant date for financial reporting purposes under FAS 123R, and market price means the last sale price on the principal U.S. market for the security on the grant date. If the date on which the compensation committee takes action to grant an award differs from the date of grant, the table must include a column disclosing the date of committee action. Narrative disclosure with respect to this table would cover matters material to understanding the tabular disclosure, including an explanation of the methodology for determining amounts payable, a description of performance criteria or other conditions and any vesting schedule.

F. Director Compensation Table

The new rules have also established for the first time a requirement that director compensation be disclosed in tabular form. In particular, the new Director Compensation table requires disclosure regarding director compensation during the last fiscal year that is comparable to the SCT disclosure for executive compensation described above, including footnote disclosure, and disclosure with respect to perks, consulting fees and payments or promises in connection with director legacy and charitable award programs. In addition, narrative description of any material factors necessary to an understanding of the director compensation disclosed in the table must also be provided. While noting that material factors will vary depending upon the particular facts and circumstances, the SEC rules state that examples of such factors may, in any given case, include a description of standard compensation arrangements (such as fees for retainer, committee service, service as chairman of the board or a committee and meeting

attendance) and whether any director has a different compensation arrangement, identifying that director and describing the terms of that arrangement.

G. Outstanding Equity Awards at Fiscal Year-End Table

The Outstanding Equity Awards at Fiscal Year-End table discloses detailed information regarding options, unvested stock awards and equity incentive plan awards outstanding as of the end of the fiscal year (the precursor to this table only covered options and SARs). With respect to options, disclosure is generally required on a grant by grant basis. Market value calculations for stock and equity incentive plan awards are based on the product of the closing market price of the company's stock at the end of the last completed fiscal year and the number of shares or units underlying the award.

H. Option Exercises and Vested Stock Table

The Option Exercises and Vested Stock table shows information regarding option awards that have been exercised and stock awards that have vested during the last fiscal year, including the number of shares acquired upon option exercises, the number of shares vested and the aggregate value realized in connection therewith. The precursor to this table only covered options and SARs.

I. Pension Benefits Table

The Pension Benefits table discloses details of each pension plan in which a NEO participates, including the actuarial present value of the NEO's accumulated benefit and any payments during the last fiscal year. The narrative disclosure accompanying the table should describe the material terms and conditions of benefits under the plans, the purpose of maintaining multiple plans (if a company has more than one plan) and company policy regarding matters such as the granting of additional years of service credit.

J. Nonqualified Deferred Compensation Table

The Nonqualified Deferred Compensation table discloses detailed information about each NEO's non-qualified deferred compensation during the last fiscal year, including executive and company contributions, earnings (not limited to above-market or preferential earnings), withdrawals and distributions and the aggregate balance at the last fiscal year end. The narrative disclosure accompanying the table should describe material factors necessary to understand the table, including the types of compensation that the NEO may defer, limitations

on deferrals, how interest or other plan earnings are calculated and other material terms relating to payouts, withdrawals and distributions.

K. Narrative Disclosure Regarding Termination and Change in Control Provisions

In addition to the tabular and related narrative disclosures described above, the new rules require a narrative description of the following information regarding termination and change in control arrangements:

- The specific circumstances that would trigger payment(s) or the provision of other benefits, including health care benefits and perks;
- The estimated payments and benefits (including perks) that would be provided in each circumstance, and whether the payments would be lump sum or annual, disclosing the duration of any obligations;
- The manner of determining payment and benefit levels under various circumstances;
- The material conditions to the receipt of payments or benefits, such as non-compete/non-solicit covenants, including a description of the duration of any such restrictive covenants; and
- A description of applicable tax gross-up arrangements, including with respect to Section 280G of the Code.

Companies must quantify the value of the payments (including any tax gross-up payments) and benefits based on reasonable estimates (including, if desired, an estimated range) and must disclose the assumptions underlying the estimates. In quantifying the value of the payments and benefits, companies should assume that the triggering event takes place on the last business day of the company's last completed fiscal year and that the price per share of the company's securities is the closing price on that date. Companies should quantify health care benefits based on the assumptions the company uses for GAAP financial reporting purposes. The estimates included in this disclosure will constitute forward-looking statements entitled to the safe harbors for such information. To the extent that the form or amount of payments or benefits that would be provided in connection with a triggering event is fully disclosed in the

pension benefits table or the deferred compensation table and the related narrative disclosure, reference may be made to that disclosure.

L. Narrative Disclosure Regarding the Compensation Committee

The new rules also require narrative disclosure regarding the governance of the compensation committee.[14] In particular, the narrative disclosure must provide a description of the company's processes and procedures for the consideration and determination of executive and director compensation, including: the scope of authority of the compensation committee; the extent to which the compensation committee may delegate its authority to other persons, specifying what authority may be so delegated and to whom; any role of executive officers in determining or recommending the amount or form of executive and director compensation; and any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. In disclosing any such role of compensation consultants, further disclosure must be provided by identifying such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, and describing the nature and scope of their assignment and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.

VI. Internal Controls

The compensation committee must work to ensure it attains sufficient understanding of, and compliance with, current legal rules affecting compensation. Companies should supplement their disclosure controls and internal controls with a system to track and gather the information required under the new disclosure rules. Because the individuals to be included in the summary compensation table will be determined by reference to total compensation (excluding the amounts included in the change in pension value and non-qualified deferred compensation columns), companies should make sure that they have systems in place to track all of the includible components of compensation for their executive officers, including the value of perquisites, tax gross-ups and

[14] If the company does not have a standing compensation committee (or committee performing similar functions), the company must state the basis for the view of the board that it is appropriate for the company not to have such a committee and must identify each director who participates in the consideration of executive officer and director compensation.

amounts paid/accrued in connection with a termination of employment or a change in control. This will likely require tracking categories of compensation and benefit values in a manner that may differ from current practice and for a larger group of executives. In addition, companies should keep in mind that disclosure for up to an additional three executives who are not named executive officers but who are more highly compensated than any named executive officer may be required by title if the SEC adopts the so-called "Katie Couric" rule as proposed.

The need for vigilance in internal and disclosure controls is evidenced by the widely publicized options backdating scandal. Some companies have indicated an inability to file their periodic reports in a timely manner as a result of options backdating, the SEC has indicated that it is currently investigating over 100 companies to determine whether they improperly backdated stock options[15] and the SEC and the Department of Justice have charged and or settled with several senior executives of public companies for alleged civil and criminal violations of the federal securities laws (including with respect to internal controls).[16] As a result, the compensation committee should adopt compensation-related internal controls to facilitate compliance with applicable law.

VII. Equity Compensation Grant Policy

In light of the general environment in which the internal controls of a number of companies have come under increased scrutiny and the requirement under the SEC's executive compensation disclosure rules that companies include a description of their practices regarding the timing and pricing of stock option grants, many companies have begun to review the manner in which they grant equity compensation awards to their employees and directors. While any given company's equity grant practices will need to be tailored to the company's

[15] *See* "Testimony Concerning Executive Compensation and Options Backdating Practices," Linda Thomson, Director, Division of Enforcement U.S. Securities and Exchange Commission, September 6, 2006, before the U.S. Senate Committee on Finance, *available at* http://www.sec.gov/news/testimony/2006/ts090606lt.htm.

[16] *See, e.g.*, SEC press release, dated October 24, 2006, "David Kreinberg, Former CFO of Comverse Technology, Inc., Agrees to Settle SEC Charges in Options Backdating Case," *available at* http://www.sec.gov/news/press/2006/2006-180.htm; SEC press release, dated August 9, 2006, "SEC Charges Former Comverse Technology, Inc. CEO, CFO, and General Counsel in Stock Option Backdating Scheme; U.S. Attorney's Office for the Eastern District of New York Files Separate Criminal Complaint," *available at* http://www.sec.gov/news/press/2006/2006-137.htm.

particular business and administrative needs, set forth below are general guidelines for companies to consider when reviewing their equity compensation award practices.

A. Written Grant Policy

To ensure that there is a clear understanding of the company's approach to granting awards, companies should adopt a written equity compensation award policy. The policy should comply with, and specify that grants will be made in accordance with, state law, the compensation committee charter and the applicable equity compensation plans. All parties involved in the granting of awards should be provided with copies of the policy and should familiarize themselves with its key terms.

B. Designate an Equity Compensation Compliance Person

The compensation committee should consider designating a single individual at the company as the person responsible for ensuring equity compensation compliance and should consider requesting periodic updates on the company's compliance procedures and practices. The compensation committee may wish to designate the same person as the person who is responsible for ensuring compliance with Section 162(m) Code and/or Section 16 (*see* Chapter 2).

C. Regular Grants at Fixed Meeting Dates

The company should consider specifying in its equity compensation award policy that regular equity awards (*e.g.*, annual grants) will only be made at fixed meeting dates that are specified well in advance of the actual meeting. The company should also consider specifying that these meeting dates will occur during "window periods" in which officers and directors can trade. The committee should approve at its meeting individual awards for Section 162(m) "covered employees" and Section 16 officers (as described below) and, ideally, and to the extent practicable, will make grants at the meeting for all employees who are to receive awards. While this approach will likely require more advanced planning and coordination among management, business units heads and the compensation committee, having the compensation committee approve all individual grants at a regular meeting should streamline the award process, avoid an appearance that management received awards on a more favorable grant date than employees generally and eliminate discretion for choosing a grant date. Alternatively, the equity pool for non-executive employees can be delegated to

officer(s) or board member(s), but if such delegation is made, the guidelines for delegation set forth in section G below should be considered.

D. *Ad Hoc* and New Hire Grants

Because decisions with respect to grants made outside the company's regular grant cycles often need to be made quickly, equity grant policies can be essential for corporate governance purposes but may also result in the imposition of procedural hurdles. For this reason, *ad hoc* and new hire grants are perhaps the most difficult issues that will need to be addressed by a company's grant policy. How tightly a company ultimately elects to craft their policy will depend on, among other things, how competitive the market for human capital is in the company's industry. In that regard, a company may wish to consider a policy whereby exercise prices of grants are set as of pre-established fixed dates (*e.g.*, the fifth business day of each month) that next follow the date that the company expressed an intent to make the grant (*e.g.*, the date of hire or promotion). Offer letters or employment agreements that memorialize the commitment to make such grants may specify the number of shares to be granted, that the grant will be made in the future (*i.e.*, the employee will receive the grant on the grant date specified in advance) and that the award will be granted with an exercise price equal to the fair market value on the actual date of grant. The other terms of such awards should comply with the pre-approved form of equity award agreement or, to the extent that the awards deviate, the terms should be approved by the compensation committee. The vesting schedule of the award can relate to the date of the commitment to make the grant (*e.g.*, the date of hire or promotion) instead of the date of grant.

E. Form of Equity Award Agreements

Equity awards are considered granted for accounting purposes on the date the award is approved so long as the terms of the award are communicated to employees within a reasonable period of time following such date. Accordingly, the compensation committee should approve the form of award agreement at or prior to the time of its meeting at which individual grants are approved to ensure that the terms of the awards can be communicated to grantees as quickly as practicable after the grant is made.

F. Grants at Actual or Telephonic Meetings

It is preferable that all grants be made during an in-person or telephonic compensation committee meeting and not by unanimous written consent. Under many state laws, unanimous written consents are only effective when the last

consent is received (notwithstanding that an earlier effective date is written on the consent). This can give rise to delay of the grant date (possibly to a date that is outside a specified "window period") and may, in hindsight, potentially give the appearance of grant date manipulation.

G. Delegation

Any delegation of authority to make grants should comply with state law, the compensation committee charter and the applicable equity compensation plans. The delegation should specify the aggregate and individual maximum numbers of shares that may be subject to specific types of awards, such as stock options, restricted stock and restricted stock units, and the terms of such awards. The compensation committee's authority to make grants intended to comply with Section 162(m) and/or the safe harbor under Section 16, as described below, cannot be delegated to a committee that does not satisfy the requirements of these rules (*see* Chapter 6).

H. Section 16 of the Securities Exchange Act

Section 16 establishes a safe harbor from the short-swing profits recovery rules for grants of options and other stock-based compensation to directors and officers if the transaction is approved by, among other alternatives, the board of directors or a committee thereof that is composed of two or more non-employee directors. The company's equity compensation award policy should, therefore, require that grants to directors and officers will be made by the full board or a committee that satisfies the requirements of Section 16.

I. Section 162(m) of the Internal Revenue Code

As more fully described in Chapter 6, Section 162(m) of the Code disallows a publicly traded company's federal income tax deduction for certain compensation to "covered employees" in excess of $1 million during a company's taxable year unless certain conditions are met, including, among others, that the compensation be approved by a compensation committee comprised solely of outside directors. Consequently, the company's equity compensation award policy should require that, unless otherwise determined by the compensation committee, any grants to individuals who the compensation committee determines may be "covered employees" under Section 162(m) will be made by a compensation committee comprised solely of outside directors. "Covered employees" under Section 162(m) are the company's CEO and the next four most-highly compensated executive officers determined based on the SEC's executive compensation disclosure rules. The recent changes to those disclosure rules have

resulted in some confusion about who will be covered employees going forward. While the IRS has indicated that it will issue guidance during the first quarter of 2007, some uncertainty will likely continue because the use of total compensation (instead of base salary and bonus) to determine who are the most-highly compensated executive officers under the SEC rules will likely lead to more frequent year-to-year shifts in Section 162(m) covered employees. As a result, companies should consider broadening the group of executives who are categorized as potential covered employees for Section 162(m). As always, companies should keep in mind that compensation is generally taken into account for purposes of Section 162(m) in the company's taxable year in which it would otherwise be deductible (*i.e.*, equity awards granted to a non-covered employee may become deductible upon exercise or settlement of the award if and when that individual becomes a covered employee). For these reasons, the group of executives who are categorized as potential covered employees for Section 162(m) should be at least as broad as the Section 16 officers at the time of grant. Whichever executives the company ultimately elects to treat as potential covered employees, the company should implement appropriate controls in its equity tracking systems so that it can identify whether a grant has been made in compliance with Section 162(m).

J. Stock Option Exercise Price

Because the new disclosure rules require disclosure if (1) an option exercise price differs from the closing stock price on the grant date or (2) the date on which the compensation committee took action to grant an award differs from the grant date, companies should review the grants made to executive officers during the 2006 fiscal year to assess whether any such disclosure will be required. In addition, in light of these disclosure requirements, to the extent that an equity plan does not define fair market value for purposes of an option's exercise price as the closing price on the date of grant, companies should consider amending the definition for future grants. Companies should make sure, however, that the proposed change to the method of determining an option's exercise price is not a material amendment requiring shareholder approval under the NYSE or the NASD rules or the terms of the applicable plan and would not have other unintended consequences.

VIII. Management Succession

To the extent companies have not given responsibility for succession issues to their Nominating and Governance Committees, companies should consider charging the compensation committee with the responsibility of ensuring the existence of an appropriate management development and succession strategy.

Planning for management succession is required by the NYSE to be set forth in the company's corporate governance guidelines. In so doing, the compensation committee can review and discuss, with input from the other members of the board and the company's senior executive officers, plans for corporate development and corporate succession plans for the CEO and other senior officers.

There are no prescribed procedures for planning succession; therefore, the compensation committee should fashion the principles and procedures it deems appropriate. In fulfilling its succession function, the committee should recognize that competence alone is not enough. The integrity and dedication of the CEO and senior management are critical in enabling a board to meet all of its duties. In large measure, the success of each of the board and the CEO is dependent on the other.

IX. Shareholder Proposals

Institutional investors, individual shareholder activists and academic activists continue to submit shareholder proposals on executive compensation. In 2005, these proposals generally focused upon performance-based equity grants, "claw-back" provisions, stock option expensing and requiring severance arrangements to be subject to shareholder approval. Based upon results for the more than twenty entities where requiring shareholder approval of golden parachute arrangements was on the ballot in 2005, shareholder support for the resolutions averaged approximately 55%.[17] Several companies, including Corning, CSX, Delta Air Lines, Verizon, Bank of America, Norfolk Southern Corp. and McKesson Corp., have agreed to seek shareholder approval for certain levels of golden parachute pay.[18]

The compensation committee should evaluate and determine the appropriateness of compensation-related shareholder proposals submitted for inclusion in company proxy statements. The full board of directors, however, should be consulted on such matters. In evaluating such shareholder proposals,

[17] *See* ISS, *2006 Postseason Report, Spotlight on Executive Pay and Board Accountability* (2006). Majority support for the proposals were received at Lucent Technologies, Inc., Occidental Petroleum Corp., Mattel Inc., Erickson International, Chevron Texaco, Home Depot Inc., PG & E Corp., Hilton Hotels Corp., Waste Management Inc., Kohl's Corp., and Albertson's Inc.

[18] Stephen Taub, *Gillette, Bank of America Parachutes Raise Ire of Critics*, Compliance Week (February 8, 2005).

the compensation committee, together with the full board, should weigh carefully opposition to shareholder proxy resolutions that can be accommodated without significant difficulty. Today, it is prudent to perform a risk-reward analysis of shareholder resolutions, rather than to routinely oppose them. As companies spend more time and effort to consider shareholder proposals, it might make sense to formalize the process by which this is done. By paying serious attention to shareholder proposals, and by being proactive in shareholder communications and disclosure, boards are most likely to create the right environment for acting on shareholder resolutions even when the ultimate determination may be to reject them.[19]

[19] For more on this, *see* Lawrence S. Makow and Jeremy L. Goldstein, *U.S. Bancorp Stockholders Reject Stockholder Proposal for Advisory Vote on Compensation Committee Report*, Wall Street Lawyer (July 2006) and Securities Litigation Report (July/August 2006).

CHAPTER 2

Compensation Rules, Laws and Other Relevant Authorities

I. Section 162(m) of the Internal Revenue Code

A. General

Section 162(m) of the Code generally disallows a publicly traded company's federal income tax deduction for compensation paid to "covered employees" in excess of $1 million during a company's taxable year. The $1 million deduction limit covers all types of compensation, including cash, property and the spread on the exercise of options. However, there are important exceptions to the deduction limitation, including performance-based compensation keyed to a pre-established, objective, nondiscretionary formula, which are described in detail below.

In light of Section 162(m), a publicly traded company is generally left with two choices: (1) forgo a federal income tax deduction for compensation during a taxable year in excess of $1 million to any one of its top five officers or (2) adopt compensation practices so that any compensation in excess of $1 million either (a) consists of performance-based compensation structured to comply with the requirements of the performance-based compensation exception or (b) is deferred to a time when the recipient is no longer one of the company's top five officers.

B. "Covered Employees" Subject to the Limitation

Currently, the $1 million deduction limit of Section 162(m) only applies to compensation paid to an executive who is, on the last day of the taxable year, the CEO (or an individual "acting in such a capacity") or among the four highest compensated officers (other than the CEO). Companies should consider, however, that the individuals whose compensation is subject to the limitations imposed under Section 162(m) may change as a result of the new executive compensation disclosure rules. Section 162(m) provides that the determination of the four most-highly compensated executive officers is based on the SEC's executive compensation disclosure rules. Because the CFO will now be required to be included on the summary compensation table (without regard to whether he is among the four most-highly compensated executive officers), it may no longer be the case that the five executive officers for purposes of the summary compensation table will always be the "covered employees" for purposes of Section 162(m). The use of total compensation as discussed above (instead of only base salary and bonus) to determine the most-highly compensated executive

officers under the disclosure rules is also likely to change who is a covered employee under Section 162(m) and will likely lead to more frequent year-to-year shifts in the Section 162(m) covered employees. Unless and until this unintended result is corrected (the Joint Committee on Taxation has noted the issue in a report prepared for a Senate hearing on executive compensation), companies should consider broadening the group of executive officers who are categorized as potential covered employees for Section 162(m), and, as always, should keep in mind that compensation is generally taken into account for purposes of Section 162(m) in the company's taxable year in which it would otherwise be deductible (*i.e.*, equity awards granted to a non-covered employee may become nondeductible when that individual is a covered employee).

C. Performance-Based Compensation Exception

The $1 million deduction limit does not apply to compensation that meets the following requirements:

- the compensation is payable solely on account of attaining one or more pre-established, nondiscretionary and objective performance goals (options and stock appreciation rights ("SARs") granted with a strike price at or above fair market value meet this requirement);
- the performance goal is determined by a compensation committee, or a subcommittee thereof, of the board of directors comprised solely of two or more "outside" directors;
- the material terms of the performance goal under which the compensation is to be paid are disclosed to shareholders and approved by a majority of the shareholders voting in a separate vote; and
- before the compensation is paid, the compensation committee certifies that the performance goals and any other material terms were satisfied.

D. Section 162(m) Compliance Procedures

During 2004, the IRS instituted a pilot audit program on Section 162(m) and found that failure to administer bonus plans in compliance with the requirements of Section 162(m) was widespread among the 24 large-cap public companies it audited under the program. The IRS noted that it intends to continue to review the issues under the pilot program as part of its regular package audit.

This is a significant departure from the past IRS practice of benign neglect on executive compensation issues generally and Section 162(m) issues in particular.

This heightened IRS scrutiny of executive compensation arrangements comes at a time when compliance with the requirements of Section 162(m) is increasingly important. Executive compensation at many public companies has risen dramatically since the adoption of Section 162(m) in 1994. In addition, as discussed further below, many companies are granting restricted stock and other "full value" equity awards, such as restricted stock units ("RSUs"), instead of stock options. It is relatively easy for stock options to qualify for the "performance-based" compensation exception, because if an option's exercise price is at least equal to the fair market value of the underlying stock on the date of grant, the procedural requirements for establishing and certifying performance goals under Section 162(m) do not apply. By contrast, full value awards can only qualify for the exception if vesting or award of the shares is based not merely on an employee's continued service, but also on the achievement of objective performance goals that comply with the substantive and procedural requirements of Section 162(m) that are described above.

We recommend that all compensation committees have their incentive compensation plans and arrangements and the manner in which they are administered reviewed by counsel to determine whether they are in fact complying with the requirements of the performance-based exception from Section 162(m). In addition, compensation committee members should familiarize themselves with the basics of Section 162(m) and take them into account in structuring executive compensation. Moreover, the compensation committee should be sure that the proxy statement disclosure relating to Section 162(m) is accurate and should implement the proper internal controls to ensure compliance in these areas. In particular, the compensation committee should consider designating a single individual at the company as the Section 162(m) compliance person and should consider requesting periodic updates on Section 162(m) so that its requirements are fully understood.

II. Section 409A of the Internal Revenue Code

In late 2004, Congress passed Section 409A of the Code, which imposes penalties on participants in deferred compensation arrangements that do not comply with the strict requirements of the rules. Given the far-reaching impact of the legislation, companies are rightly devoting a great deal of time and resources to implementing and operating programs in compliance with Section 409A of the Code. While the compensation committee should satisfy itself that the company is aware of and is complying with the legislation, the board need not spend

inordinate amounts of time trying to understand the intricacies of the rules that have no impact on the arrangements' commercial terms.

The deadline for documentary compliance (*i.e.*, amending plans as needed to comply) is December 31, 2007 (operational compliance is already required). Accordingly, companies should be reviewing their compensation arrangements with an eye toward making any changes that may be necessary or advisable in light of the legislation. Companies should not delay addressing the effects of the new law until late this year as documentary compliance may be a significant undertaking.

III. Stock Exchange Rules Regarding Shareholder Approval of Equity Compensation Plans

A. General Rules

The NYSE and NASDAQ rules relating to shareholder approval of equity compensation plans were approved by the SEC in 2003. The NYSE and NASDAQ rules require listed companies to obtain shareholder approval of most equity compensation plans. The compensation committee should be aware that these rules may require shareholder approval of all proposed plans and plan amendments when considering adopting them.

The NYSE and NASDAQ rules exclude the following types of plans from the shareholder approval requirement:

- Arrangements under which employees receive cash payments based on the value of shares, rather than actual shares (*e.g.*, cash-settled phantom stock);
- Arrangements that are made available to shareholders generally (such as a typical dividend reinvestment plan);
- Arrangements that merely provide a convenient way for employees, directors or other service providers to purchase stock at fair market value;
- Plans intended to qualify under Section 401(a) (qualified pension, profit-sharing, and stock bonus plans—or Section 423—employee stock purchase plans) of the Code;
- "Parallel excess plans"—a narrowly defined category of excess benefit plans;

- Equity grants made as a material inducement to a person's becoming an employee of the issuer or any of its subsidiaries;

- Rollover of options and other equity awards in connection with a merger or acquisition; and

- Post-acquisition grants, to those who are not employees of the acquiring company at the time of acquisition, of shares remaining under a target company plan that had been approved by the target's shareholders (though use of such share reserves in connection with the transaction will be counted by the NYSE and NASDAQ in determining whether the transaction must receive shareholder approval as an issuance of 20% or more of the company's outstanding common stock).

B. Material Revisions

The NYSE and NASDAQ rules provide the following examples of revisions to equity compensation plans that are considered "material" and therefore require shareholder approval:

- A material increase in the number of shares available under the plan, other than an increase solely to reflect a reorganization, stock split, merger, spin-off or similar transaction;

- An expansion of the types of awards available under the plan;

- A material expansion of the class of persons eligible to participate in the plan;

- A material expansion of the term of the plan;

- A material change to the method of determining the strike price of options under the plan; and

- The deletion or limitation of any provision prohibiting repricing of options.

In light of the rules and the requirement that material amendments be approved by shareholders, the compensation committee should consider requesting that newly adopted plans be drafted to ensure maximum flexibility in the types of awards that can be granted and the terms and conditions thereof.

CHAPTER 3

Fiduciary Duties of Compensation Committee Members

I. Fiduciary Duties Generally

Decisions by members of compensation committees with respect to executive compensation are generally subject to the business judgment rule.[20] Judicial review of directors' actions may be enhanced in the context of a takeover defense. In those cases, the so-called "*Unocal* standard" may be applied.[21] In transactions involving a conflict of interest, the most exacting standard, "entire fairness" review, may apply.

A. Business Judgment Rule

Under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Under this presumption, directors' decisions will not be disturbed unless a plaintiff is able to carry its burden of proof in showing that a board has not met its duty of care or loyalty.[22]

[20] *See, e.g., Campbell* v. *Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 800 (6th Cir. 2001) ("evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts").

[21] *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[22] *See, e.g., Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984). Under 8 Del. Code Ann. § 102(b)(7), a Delaware corporation may in its certificate of incorporation either eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (1) breach of the director's duty of loyalty to the corporation and its stockholders or (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. Many Delaware corporations have either eliminated or limited director liability to the extent permitted by law. The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good-faith omissions. *Arnold* v. *Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

1. Duty of Care

To show that a board has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of "gross negligence." The core of the duty of care may be characterized as the directors' obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of legal and financial experts.[23] Delaware statutory law permits directors in exercising their duty of care to rely on certain materials and information.[24] Accordingly, directors charged with approving compensation arrangements should be familiar with the purpose of the arrangements, the nature of the benefits and reasonably understand the costs; in so doing, directors may reasonably rely on the reports of their committees and advisors.

2. Duty of Loyalty

To show that a board has not met its duty of loyalty, a plaintiff must prove that members of the board engaged in "self-dealing" transactions. If directors appeared on both sides of, or derived an improper financial benefit from, a challenged transaction, the court will, as indicated below, ignore the business judgment rule, and place the burden on the board to defend the challenged transaction by showing that it meets the requirements of "entire fairness" to the company and its stockholders.[25]

[23] *Smith* v. *Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (holding that in the context of a proposed merger, directors must inform themselves of all "information . . . reasonably available to [them] and relevant to their decision" to recommend the merger); *see also Aronson*, 473 A.2d at 812 ("under the business judgment rule director liability is predicated upon concepts of gross negligence").

[24] 8 Del. Code Ann. § 141(e).

[25] *See Ivanhoe Partners* v. *Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *see also AC Acquisitions Corp*. v. *Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) ("where a self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation, it will be required to establish the entire fairness of the transaction to a reviewing court's satisfaction"); *Blasius Indus., Inc*. v. *Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) (holding actions by board after a consent solicitation had begun, designed to thwart the dissident shareholder's goal of obtaining majority representation on the board, violated the board's fiduciary duty).

B. Enhanced Scrutiny

If the adoption of a compensation arrangement is deemed a defensive measure to an actual or threatened takeover, the adoption will be subject to judicial review under an "enhanced scrutiny" standard,[26] which looks both to the board's process and its action. That said, a compensation arrangement will not be subjected to enhanced scrutiny merely because the board adopts a compensation arrangement in the face of a takeover threat; in order for enhanced scrutiny to apply, the board must have entered into the compensation arrangement as a defensive measure.[27] If the arrangement was adopted as a defensive measure, the directors carry the burden of proving that their process and conduct satisfy a two-pronged test (now known as the *Unocal* standard):[28]

- the board must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," which may be shown by the directors' good faith and reasonable investigation; and

- the board must show that the defensive measure chosen was "reasonable in relation to the threat posed," which may be demonstrated by the objective reasonableness of the course chosen.[29]

If the directors can establish both prongs of the *Unocal* test, their actions will receive the protections of the business judgment rule. While the *Unocal* standard still provides the board reasonable latitude in adopting defensive measures,[30] executive compensation plans adopted in response to a takeover threat may result in a court more closely examining the board's process and

[26] *See, e.g., Gilbert* v. *El Paso Co.*, 575 A.2d 1131 (Del. 1990) (analyzing the "golden parachute" employment arrangement among target company's defensive measures subject to enhanced scrutiny).

[27] *See, e.g., Moore* v. *Wallace Computer Servs*., 907 F. Supp. 1545 (11th Cir. 1994) ("In addition... the facts that such agreements are commonplace among chief executives of major companies and that Cronin's severance package was identical to that of his predecessor persuade this Court that the adoption of the golden parachute agreement was not a defensive measure.").

[28] *Unocal*, 493 A.2d at 946.

[29] *Id.* at 955.

[30] *See, e.g., Unitrin, Inc.* v. *American Gen. Corp.*, 651 A.2d 1362 (Del. 1995).

actions.[31] Therefore, we recommend that the company adopt change-of-control employment arrangements in advance of an actual or threatened takeover.[32]

C. Entire Fairness

When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the most exacting standard, "entire fairness" review, which requires a judicial determination of whether a transaction is entirely fair to stockholders.[33] Such conflicts may arise in situations where the directors (1) appear on both sides of a transaction, as in adoption of compensation arrangements for the directors themselves or (2) derive a personal financial benefit that does not generally benefit the corporation and its stockholders.[34]

When analyzing a transaction to determine whether it satisfies the entire fairness standard, a Delaware court will consider both process—"fair dealing"—and price—"fair price"—although the inquiry is not bifurcated.[35] In *Technicolor*, Chancellor Allen formulated the issue as follows:

[31] *See Gilbert*, 575 A.2d at 1141 (applying *Unocal* standard in reviewing defensive measures, including golden parachutes and ESOPs, where "everything that [defendant directors] did was in reaction to [the] tender offer"); *Int'l Ins. Co*. v. *Johns*, 874 F.2d 1447 (11th Cir. 1989) (stating that the intent of the corporation's board in enacting a golden parachute is determinative of the standard used; when enacted in response to a takeover threat, the *Unocal* enhanced scrutiny standard applies).

[32] *See Buckhorn, Inc.* v. *Ropak Corp*., 656 F. Supp. 209 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987) (applying *Unocal* scrutiny to ESOPs and golden parachutes enacted in response to a tender offer, but applying the business judgment rule to protect amendments to those employment contracts enacted before the tender offer); *Moore Corp. Ltd*. v. *Wallace Computer Servs., Inc.*, 907 F. Supp. 1545 (D. Del. 1995) (refusing to apply *Unocal* scrutiny to golden parachutes negotiated before a tender offer, but applying *Unocal* enhanced scrutiny to the failure to redeem a poison pill); and *In re Western Nat'l Corp. S'holder's Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000) (applying business judgment rule to board approved employment agreement granting large severance payment and accelerated vesting of options because applicable employment agreement was adopted before potential acquiror was a shareholder and agreement was negotiated and recommended by disinterested directors).

[33] *See, e.g., Weinberger* v. *UOP, Inc*., 457 A.2d 701 (Del. 1983).

[34] *See, e.g., Ivanhoe Partners*, 535 A.2d at 1334.

[35] *Weinberger*, 457 A.2d at 711. *Accord, Kahn* v. *Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (quoting *Weinberger*).

> Thus in assessing overall fairness (or entire fairness) in this instance the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide.[36]

In the context of director and executive compensation, entire fairness scrutiny is most likely to apply where the directors have approved a compensation plan specifically applicable to themselves. Even if the compensation arrangements directly benefit directors, their approval should still be protected by the business judgment rule if approved by an independent committee or by the disinterested directors.[37] However, when the directors who are directly benefited by a proposed plan are delegated with the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plans as they relate to the company's shareholders.[38] In light of this, we generally recommend that the responsibility for adopting director compensation be delegated to the company's corporate governance and nominating committee, subject to the approval of the entire board.

II. Disney, Emerging Duty of "Good Faith" and Special Implications for Compensation Committees

In *Disney*,[39] shareholders filed suit alleging that the board breached its fiduciary duty of good faith in approving the roughly $140 million employment and termination package of former Disney president Michael Ovitz. While the court ultimately exonerated the board, the court caused a great deal of controversy in the initial stages of the case when it denied the directors' motion to dismiss. According to the court's initial opinion, if the facts alleged in the complaint were proven at trial, the directors would have been found to have breached their

[36] *Cinerama, Inc.* v. *Technicolor*, 663 A.2d 1134, 1140 (Del. Ch. 1995).

[37] *See Tate & Lyle PLC* v. *Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, *20 (Del. Ch. May 9, 1988) (permitting outside directors to approve compensation for insider directors after conducting reasonable inquiry and obtaining full board approval); *Puma* v. *Marriott*, 283 A.2d 693 (Del. Ch. 1971) (applying the business judgment rule instead of *Unocal* to review a company transaction with a controlling shareholder where the transaction was approved by independent directors).

[38] 1998 Del. Ch. LEXIS 61 at 20 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

[39] *In re The Walt Disney Co. Derivative Litig*,, No. Civ. A. 15452, 2005 WL 1875804, at *1-2 (Del. Ch. August 9, 2005), 124.

fiduciary duty of "good faith" in approving the hiring and termination. While some academics and corporate gadflies applauded the court's initial decision, the business world wondered whether the court's decision served as a harbinger of potentially massive personal liability for disinterested directorial business decisions—when analyzed under the lens of 20-20 hindsight—even though the directors derived no personal benefit from those decisions. The court's ultimate decision exonerating the Disney directors quieted these concerns.

The *Disney* decision helps delineate the scope of protection of directors against personal liability for claimed breach of fiduciary duty. Negligence—that is, a failure to use due care—should not result in personal liability unless the director failed to act in "good faith." The court ruled that whether there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities" on the part of a director is an appropriate measure for determining that a director has acted in good faith. The court ruled that a director fails to act in good faith when the director (1) "intentionally acts with a purpose other than that of advancing the best interests of the corporation," (2) "acts with intent to violate applicable positive law," or (3) "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[40]

The *Disney* court also made clear that, although it strongly encourages directors to employ best practices of corporate governance, as those practices are understood at the time a board acts, directors will not be held liable for failure to comply with "the aspirational ideal of best practices." In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self interest, and in so doing they will be free from "*post hoc* penalties from a reviewing court using perfect hindsight." As the court noted, shareholder redress for failures that arise from faithful management "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."[41]

III. ERISA Fiduciary Duties

ERISA is the federal law governing employee retirement and welfare benefit plans. Although its original enactment was spurred by a Congressional concern for adequate funding of traditional defined benefit pension plans, ERISA has from the beginning imposed a comprehensive set of requirements for many

[40] *In re The Walt Disney Co. Derivative Litig*., 2005 WL 1875804, at *1-2.

[41] *Id*. at *2.

types of broad-based benefit plans, including savings plans, such as the well-known "401(k)" plan, ESOPs and medical and other insurance-type plans. A key component of ERISA is the imposition of fiduciary duties and liabilities on all individuals and entities who are named as fiduciaries in plan documents or who actually exercise responsibilities that ERISA considers to be fiduciary in nature. ERISA fiduciary duties are said to be the highest of such duties known to the law. It is critical, therefore, for compensation committee members to understand how fiduciary responsibilities for their company's plans are allocated, and the extent to which they themselves may be ERISA fiduciaries.

A person may become a fiduciary under ERISA by being specifically named as such in a plan document, by being identified as such under a procedure set forth in the plan, or by exercising fiduciary responsibilities. A person who appoints a fiduciary is a fiduciary with respect to the appointment. Further, a named fiduciary may delegate fiduciary responsibilities to another person, who thereby becomes a fiduciary. Compensation committees may, therefore, be considered ERISA fiduciaries for many reasons, including as a result of language in their charters or in plan documents, as a result of exercising administrative responsibilities for ERISA plans, by virtue of involvement in managing the assets funding ERISA plans, or because they appoint plan fiduciaries (which may include employees of the company as well as third-party institutions such as trust companies or investment managers).

ERISA requires that fiduciaries exercise their fiduciary duties prudently and solely in the best interests of plan participants. While it is not impermissible for an individual or entity that acts as a plan fiduciary also to have another role that affects the plan, fiduciaries must be alert to the possibility of conflicts of interest, which can pose particularly difficult issues. Consider, for example, the common situation in which an individual who has responsibility for selecting the investment choices to be offered to 401(k) plan participants—including company stock—learns, in his or her capacity as a member of a board of directors, of confidential information that may, when announced, cause a significant and long-term drop in the company's stock price: the individual's fiduciary duty under ERISA to offer only prudent investment choices to plan participants could come into conflict with the individual's duty not to use confidential information before it is made public, and with the business strategy being pursued on behalf of shareholders generally. This type of fact pattern has generated many lawsuits against board members and executives in recent years. Major corporate transactions can also present situations in which ERISA and corporate

responsibilities may come into conflict, particularly for plans that invest in company stock.[42]

Many companies choose to have company employees and/or independent third parties, rather than members of the board, serve as their ERISA fiduciaries. In such cases, however, the responsibility to appoint those fiduciaries often remains with the full board or the compensation committee. As noted above, those who appoint fiduciaries are themselves fiduciaries and, while they do not have the same breadth of ERISA fiduciary responsibility, must still exercise their appointment powers prudently and solely in the best interests of plan participants. This includes exercising some oversight over the performance of the appointees.

[42] For more on these issues in the context of mergers and acquisitions, *see* Jeremy L. Goldstein, *Employer Securities in Mergers & Acquisitions: What You Need to Know*, M&A Lawyer (July/August 2005).

CHAPTER 4

Methods of Compensation

I. Understanding and Pursuing Compensation Goals and Objectives

Pay-for-performance has been the past decade's mantra for "best practices" in executive compensation. While compensation programs should be designed so that compensation increases as corporate or individual performance metrics are met or exceeded, compensation programs also need to be designed to attract and retain key employees. Attracting and retaining key employees in a competitive marketplace is essential to the success of any business enterprise and, at the end of the day, compensation is consideration for individuals to provide services to the corporation—not to guarantee a certain level of performance.

The highest priority for a company in designing a compensation program should be the economic incentives that are created by the program and the behavior that these incentives elicit. Companies should balance the need to retain employees with the need to incentivize them and should balance the need to compensate employees in a manner that rewards growth and appropriate risk-taking with the need to preserve the business. With respect to performance-based compensation, companies should select performance measures that reflect true measures of operating performance and should preserve negative discretion for the compensation committee to adjust downward any award amounts in the event of anomalous results.

Careful thought needs to go into the structure and design of compensation programs to ensure that they protect against the creation of short-term windfalls for employees that do not match long-term sustained benefits for shareholders. Moreover, the compensation committee should design programs that it believes are in the best interest of the company and not design programs that are merely intended to appease individual shareholder critics and the media at any given moment. These groups may have short-term interests that do not take into account the future well being of the company and may have interests that are inconsistent with the interests of shareholders generally.

The different types of compensation described below are not mutually exclusive alternatives. Companies can and should consider granting a mix of types of compensation based on their business needs. The compensation committee should determine, in its business judgment based on the particular needs of the business, the appropriate mix of fixed compensation (*e.g.*, annual base salary) and variable compensation (*i.e.*, short and long-term incentives), as well as the form of compensation (*e.g.*, stock options, restricted shares, RSUs or

cash-based payments). No particular compensation vehicle (*e.g.*, stock options) should be off-the-table simply because it has been criticized in the media or by grandstanding "reformers." The media and activist shareholders should not deter directors from developing appropriately tailored programs that meet the needs of the particular company and serve the best long-term interests of its shareholders and other constituencies.

II. Equity Compensation

The manner in which most companies will provide executives with future equity compensation remains unsettled. Mega-grants of options came under fire earlier in the decade, as institutional investors and the media perceived large option gains as encouraging excessive risk-taking and as windfalls for executives bearing little relation to the long-term performance of the underlying shares. In addition, FASB's adoption of mandatory option expensing and the new executive compensation disclosure rules may have a chilling effect on the use of options as a means of providing equity incentives to employees and executives alike. However, the benefits of granting equity-based compensation awards in a form other than options need to be weighed against the limitations imposed on the flexibility of such awards under Section 409A. These developments, along with the new SEC rules and the potential for media and shareholder criticism of both executives and their employers, have created a challenging atmosphere for boards of directors designing executive compensation programs. It is against this backdrop that companies must familiarize themselves with the economic, tax and accounting implications of granting different forms of equity compensation in order to attract, retain and incentivize employees in the most efficient manner possible. In order to aid companies in understanding the issues involved in the design of equity compensation alternatives, we set forth below the material economic characteristics of various types of equity compensation awards.

A. Options

Options provide employees with the opportunity to buy shares of company stock at a certain price during a specified period of time, allowing the employee to benefit from appreciation in the value of company stock. Stock options typically have an exercise price equal to the fair market value of the underlying stock on the date of grant. Vesting of options is typically made contingent upon an employee's continued employment for a specified period of time (service-based options) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based options) or may result in vesting at an earlier point in time (performance-accelerated options).

The benefits and drawbacks to granting options are as follows:

Benefits

- Generally deductible under Section 162(m) without the need to establish additional performance goals if strike price is equal to fair market value on grant date.
- Generally not subject to Section 409A if strike price is equal to fair market value on grant date, it is based on "service recipient" stock and there is not otherwise any deferral feature.
- Because options are not considered outstanding shares until exercised, they are not counted in the denominator for calculating earnings per share.
- Optionees only realize a benefit from the award if the value of the stock exceeds the exercise price, and do not realize any loss if the stock price never exceeds the exercise price. Accordingly, the potential rewards from options may increase management's incentive to take on risks, which may be considered advantageous for diversified investors.[43]

Drawbacks

- A charge must be recognized following the grant even though no economic benefit may be derived by the optionee.
- Potential disconnect between amount of pay received by optionee and amount of expense to company.
- Because optionees have a long period during which to exercise their options, a well-timed exercise can result in significant gain even where the company's stock does not provide commensurate long-term gain for shareholders.
- The grant of options results in an increase of so-called "over-hang," which ultimately can result in dilution of existing shareholders if the options are exercised. We note that institutional shareholders often measure dilution based on outstanding options or even reserved option shares.
- The accelerated Form 4 reporting requirements under the Sarbanes-Oxley Act have resulted in the implementation of more stringent pre-clearance procedures for exercises and sales by executive officers.
- In a falling stock market, underwater options may lose

[43] On the other hand, it may be argued that creating too large of an appetite for risk may motivate management to take overly aggressive risks. For an undiversified investor, the potential for an increased tendency to take more risks may be viewed as a drawback.

- retentive value for employees who can seek to switch employers to receive new fair market value options.
- Internal controls surrounding grant of stock options has increased in complexity.

B. Stock Appreciation Rights

A SAR provides an employee the right to receive an amount equal to the appreciation in value of company stock over a certain price during a specified period of time. Upon exercise of a SAR, the company pays the employee cash, stock or a combination thereof equal in value to the underlying stock's appreciation. The benefits and drawbacks of granting SARs generally are the same as granting options, except:

Benefits	***Drawbacks***
• SARs that may be settled only in cash are not equity compensation under the NYSE and NASDAQ rules. Accordingly, no shareholder approval is required with respect to plans under which these awards are granted under such rules. • Like options, SARs are not generally subject to Section 409A if the strike price is equal to fair market value on the grant date and the SAR is based on service recipient stock. • The exercise of SARs does not require the holder to tender an exercise price for which he or she may need to borrow against the exercise proceeds or engage in a cashless exercise, potentially in violation of Section 402 of the Sarbanes-Oxley Act. • SARs settled in cash instead of stock do not give rise to subsequent sales required to be reported on Form 4. • SARs settled in cash instead of stock will not result in dilution.	• SARs settled in cash instead of stock will not increase the employee's holdings of company stock. • SARs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the SARs). • SARs settled in cash will require an outlay of cash by the company.

C. Restricted Stock

Restricted stock is a grant of shares of company stock subject to specified vesting provisions and limitations on transfer. Vesting of restricted stock typically is made contingent upon an employee's continued employment for a specified period of time (service-based restricted stock) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based restricted stock) or may result in vesting at an earlier point in time (performance-accelerated restricted stock).

The benefits and drawbacks of using restricted stock are as follows:

Benefits	***Drawbacks***
• Restricted shareholders share in the upside and the downside of an increase or decrease of share price, which aligns the interests of restricted shareholders and shareholders. • From the perspective of employees, restricted stock may represent a more tangible benefit than options. • Restricted shareholders can receive dividends. • The ability of employees to make a Section 83(b) election may enable the employee to achieve a favorable tax result if the value of the property appreciates during the vesting period.	• Employees will still receive value from restricted stock if the stock performs poorly. • Certain institutional shareholders have requested that companies limit the number of "full value" awards such as restricted stock that companies grant to their employees and directors. • Shares of restricted stock are outstanding and would be included in the denominator for computing "diluted" earnings per share. • Restricted stock is not deductible under Section 162(m) unless performance-based.

- Generally not subject to Section 409A.
- Restricted stockholders will realize value even if the price of company stock decreases during or after the vesting period. Accordingly, restricted stock may have greater retentive value than options in a down market.

D. Restricted Stock Units

RSUs consist of awards in the form of phantom shares or units, which are generally valued based on company stock. RSUs may be settled in cash, stock or both. As is the case with restricted stock, vesting of RSUs may be service-based, performance-based and/or performance-accelerated.

The benefits and limitations of using RSUs as a means of compensation are the same as restricted stock, except:

Benefits	***Drawbacks***
• Because RSUs are not "property" under Section 83 and merely represent a general unsecured promise to pay a future amount, the employee may postpone taxation beyond vesting (the company's deduction is similarly delayed) until such time as the RSUs are settled. Accordingly, RSUs can allow employees to retain an interest in company stock and, consequently, company performance for an extended period of time.	• If RSUs may be settled in stock or cash at the company's election, RSUs are not reportable on the proxy statement beneficial ownership table.
• No administrative burden with respect to stock certificates until shares are paid.	• Because RSUs are not property, grantees cannot make a Section 83(b) election.
• RSUs that can be settled only in cash are not equity compensation under the NYSE and NASDAQ rules. Accordingly, no shareholder approval is required with respect to RSUs under such rules.	• RSUs settled in cash instead of stock result in a cash outlay.
• RSUs settled in cash instead of stock will not result in shareholder dilution.	• RSUs are included in the denominator for computing diluted earnings per share.
• If RSUs must be settled in stock or may be settled in stock at the holder's election, so that if the holder were terminated currently he or she would get the underlying stock without the need to satisfy any additional vesting requirements, RSUs are reportable	• RSUs settled in cash instead of stock will not increase the employee's holdings of company stock.
	• RSUs are not deductible under Section 162(m) unless performance-based or the receipt of income from the award is deferred until the executive is no longer subject to Section 162(m).
	• RSUs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the RSU).

on the proxy statement beneficial ownership table.

- Because RSUs are not property (making Section 83(b) election unavailable), companies do not have the difficulty of administering Section 83(b) elections for broad employee populations.

E. Retirement Programs

In addition to the other compensation programs described above, compensation committees often provide executives with retirement benefits under either defined contribution plans (*e.g.*, 401(k) plans) or defined benefit plans (*e.g.*, pension plans that provide a fixed retirement benefit based on years of service and final pay). These arrangements can either be (1) "qualified plans," which are subject to limitations on, among other things, the aggregate benefit payable to executive participants under the plans, and complex rules under the Code and ERISA or (2) "non-qualified plans," which provide executives with additional retirement benefits that are not subject to the limitations imposed under the Code and ERISA.

When designing non-qualified retirement plans, companies should be sure to understand the cost of the arrangements, including any implications that increases in annual compensation may have on the cost of the arrangements. Moreover, as these programs generally represent a general unsecured promise by the company to pay amounts to executives in the future, they effectively result in executives being creditors of the company. As creditors of the company, executives with large pension benefits may be incentivized to act more conservatively with regard to risk taking and capital investment, especially as they approach the stated retirement age when their pensions become payable.[44] The conservatism that this form of compensation may engender should be balanced

[44] *See* David Yermack and Raghu Sundaram, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation*, New York University School of Law, New York University Law and Economics Working Papers, Paper 22 (May 3, 2005), *available at* http://lsr.nellco.org/nyu/lewp/papers/22 (analyzing data on the CEO pension plans of 237 of the Fortune 500 companies from 1996 to 2002) and Jeremy L. Goldstein, *Deferred Compensation Arrangements: Corporate Governance and Compensating Management with Debt*, Wall Street Lawyer (September 2006).

with compensation awards that encourage appropriate risk-taking to achieve a risk profile that is suitable for the company.

F. Perquisites

No compensation or perquisites should be provided to directors or executive officers without full disclosure to the compensation committee. Any compensation or other benefit received by any director or officer from any affiliated entities (using a low threshold for the definition of an affiliated entity) should also be fully disclosed to the committee and carefully reviewed to confirm compliance with the company's code of business conduct and ethics and applicable law. Perquisite programs and company charitable donations to any organizations with which an executive is affiliated should be carefully scrutinized to make sure that they do not create any potential appearance of impropriety.

General Electric's settlement with the SEC over claims that GE failed to disclose the terms of Jack Welch's retirement package in sufficient detail to satisfy the Exchange Act serves as an important reminder of the importance of ensuring that actions are taken by a well-informed and objective compensation committee, which then appropriately discloses such information to shareholders. The retirement agreement between GE and Mr. Welch was attached as an exhibit to GE's 10-K. The publicly filed agreement provided Mr. Welch with "continued access to company facilities and services comparable to those provided to him before his retirement, including access to company aircraft, cars, office, apartment and financial services." The SEC, however, alleged that investors had no way of understanding the scope of these benefits from GE's other SEC filings; this lack of granular specificity, in the SEC's view, meant GE had failed to file accurate annual reports and proxy statements.

Regulators and institutional shareholders are giving intense scrutiny to executive compensation. While the rhetoric may in many cases be overblown, procedure and disclosure are often as important as the substance of underlying compensation packages. While criticism cannot always be avoided, actions taken by a well-informed and objective compensation committee, which are then appropriately disclosed to shareholders, will be shielded from liability.

CHAPTER 5

Change-of-Control Compensation Arrangements

I. Addressing Executive Uncertainty

Executives of a company that is the subject of a merger proposal often become the focus of a great deal of pressure, including the pressure caused by uncertainty as to their own future if a combination takes place. Executive recruiters often take advantage of the uncertainties created by these situations to attempt to induce executives of a target company to consider alternative employment. To offset these pressures and to recruit and retain executives, we recommend (and most public companies have adopted) executive compensation programs containing change-of-control provisions for senior management. These arrangements have not interfered with any of the mergers with which we have been involved to date. In fact, in our experience, the contrary has been true.

Change-of-control employment agreements are not intended to deter combinations, but by reducing the personal uncertainty and anxiety arising from a merger, they can help to assure full and impartial consideration of takeover proposals by a company's management and can aid a company in attracting and retaining key executives. Indeed, in its Proxy Voting Manual, Institutional Shareholder Services, Inc. states that "parachutes tend to result in higher takeover bids, which lead to greater returns for shareholders."

Appropriately structured change-of-control employment agreements are both legal and proper. Careful attention must be paid, however, to the applicable statutes and regulations to make sure that all tax and other legal concerns are properly reflected in the form of agreement that is adopted.

II. Legality

We advise our clients to adopt (or review and update) change-of-control protections in advance of an actual or threatened transaction. Courts that have addressed the adoption of change-of-control agreements and other benefit protections and the timing of their adoption have, in the absence of conflicts of interest, almost universally found such arrangements to be enforceable and consistent with directors' fiduciary duties.[45] A board of directors' decision to

[45] *See, e.g., Buckhorn Inc.* v. *Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987); *Nomad Acquisition Corp.* v. *Damon Corp.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH), 94,040 (Del. Ch. September 16, 1988) (revised September 20, 1988); *Campbell* v.

(footnote continued)

adopt change-of-control provisions is usually analyzed under the business judgment rule.[46] The scrutiny applied to such arrangements may be heightened if they are adopted during a pending or threatened takeover contest,[47] thereby making careful planning in advance of a merger more important. For a discussion of directors' fiduciary duties and the applicable legal standards, *see* Chapter 3 of this Guide.

III. Arrangements

A. Change-of-Control Employment Agreements

Companies should consider adoption of reasonable change-of-control protections for senior management. Typically, these will include a change-of-control severance or employment agreement. A change-of-control employment agreement will often become effective only upon a change of control or in the event of a termination of employment in anticipation of a change of control. A standard form of agreement usually provides for a three-year term after the change of control during which time the status quo is preserved for the executive in terms of duties, responsibilities and employee benefits. In the event that the status quo is not preserved or the executive's employment is terminated by the company, the executive would be entitled to severance pay (generally a multiple of base salary and annual bonus).

Most change-of-control employment agreements also contain provisions addressing the so-called "golden parachute" excise tax. The federal "golden parachute" tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20% excise tax upon the recipient and non-deductibility of such payments by the paying corporation. Excess parachute payments result if the aggregate payments received by a "disqualified individual" that are "contingent on a change of control" equal or exceed three times the individual's "base amount" (the average annual taxable compensation of the individual for the five

(footnote continued)

Potash Corp. of Saskatchewan, Inc., 238 F.3d 792. *But see Tate & Lyle PLC*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH), 93,764 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

[46] *See, e.g., In re The Walt Disney Company Derivative Litig.*, C.A. No. 15452, 2005 WL 1875804 (Del. Ch. August 9, 2005); *Grimes* v. *Donald*, 673 A.2d 1207 (Del. 1996); *Worth* v. *Huntington Bancshares, Inc.*, 43 Ohio St. 3d 192, 540 N.E.2d 249 (1989).

[47] *See, e.g., Tate & Lyle PLC, supra.*

years preceding the year in which the change of control occurs). In such a case, the excess parachute payments are equal to the excess of (1) such aggregate change-of-control payments over (2) the greater of the employee's base amount or the amount of such change-of-control payments which constitute "reasonable compensation." In other words, the excise tax and non-deductibility rules apply not just to the excess over three times the base amount, but, once triggered, apply to the whole amount in excess of the base amount.

Three approaches to dealing with golden parachute tax penalties in severance agreements are generally taken:

- payments can be "grossed up" so that the employee is in the same after-tax position as if there were no excise tax (as we recommend to the vast majority of our clients);
- payments that are contingent on a change of control can be "cut back" to 299.9% of the base amount, so that no payments are considered parachute payments; or
- payments that are contingent on a change of control can be cut back only if the result is to give the employee a larger after-tax return than if the payment were not cut back.

After an analysis of the amounts involved, many companies have adopted, and we generally recommend, a "gross-up" provision for reasons of equity. Because of the high marginal cost of grossing up parachute payments if they are only slightly over the 299.9% safe harbor, which may result in little after-tax benefit to the executive, an agreement should require a minimum after-tax benefit to be delivered to the executive before the gross-up is operative. In the absence of this threshold being met, a cutback provision is operative. This hurdle may be expressed as an absolute dollar number or as a percentage of an executive's safe harbor. For example, an agreement could provide that no gross-up will be paid unless total payments exceed 110% of the executive's safe harbor.

B. Options and Stock-Based Compensation Plans

In addition to employment agreements, companies should review the status of their stock-based compensation plans for change-of-control provisions. Plans often contain provisions for acceleration of stock options and lapse of restrictions on restricted stock and for the deemed achievement of performance goals on performance stock awards upon a change-of-control. Stock plans also often provide an extended post-termination exercise period for options and SARs

upon terminations of employment following a change of control (*e.g.*, the lesser of three years or the remainder of the original term). Because these provisions may result in parachute payments, plan amendments should be considered and implemented in the context of an overall review of change-of-control employment protections and the associated costs analyzed in that context. In designing employee stock plans, as well as other types of benefit and compensation plans, companies should be sensitive to the need for the retention of key personnel through the closing of a transaction in order to help ensure that the board is delivering to the acquiror an intact management team.

C. Separation Plans

In addition to change-of-control employment agreements with senior executives, many public companies have adopted change-of-control separation plans, or so-called "tin parachutes," for less senior executives, sometimes covering the entire workforce. These separation plans either formalize informal policies or provide enhanced severance in the event of a lay off occurring within one or two years after a change of control. These plans generally provide for severance benefits determined on the basis of seniority/position, pay, and years of service or some combination, and may provide benefits continuation with the company paying all or a portion of the expense and outplacement services. Severance is usually payable following an involuntary termination without cause or a constructive termination, such as relocation, a decrease in base salary or wages or a material diminution in duties.

Due to the large numbers of people involved, separation plans should be adopted after a careful review of the estimated costs, including an analysis of the potential impact of Section 280G on the payments and benefits provided under the plan. The last minute addition of enhanced severance costs may make an in-market merger infeasible. Further, targets should be sensitive to the fact that in an in-market merger involving branch closings or similar reductions in force, an acquiror may be forced to adopt the target's severance policies so that employees of the acquiror who are laid off are not treated worse than similarly situated target employees.

D. Deferred Compensation Plans

Despite the recent Congressional and public debate about the abuses associated with deferred compensation arrangements and the recently enacted Section 409A of the Code, which affects deferred compensation arrangements, it should be understood that non-qualified deferred compensation plans are implemented primarily to provide participants with tax deferral and supplemental

retirement income. The primary reason deferred compensation plans work as a tax matter is because the participant's deferred compensation is merely an unfunded and unsecured promise to pay. This is true even if the company establishes a rabbi trust and fully funds it, although the new deferred compensation legislation seeks to provide that the funding of a rabbi trust under certain limited circumstances would compromise the tax deferred status of such amounts. Due to the credit risk associated with the payment of deferred compensation and other unfunded non-qualified plan benefits, it is often the case that plans provide for, or participants elect, an immediate lump sum payment of the entire account balance upon a change of control without regard to prior elections as to timing and method of distribution.

CHAPTER 6

Compensation Committee Membership

In enlisting qualified directors to sit as members on the compensation committee, attention must be paid to the various membership requirements imposed by the company's securities market, Section 162(m) of the Code, Rule 16b-3 of the Exchange Act and state law.

I. Independence Standards of the Major Securities Markets[48]

The NYSE requires that members of listed company compensation committees be independent. While the NASDAQ does not require that there be an official independent compensation committee, it does mandate that, in the absence of an independent compensation committee, a listed company's executive compensation decisions be decided by a majority of the independent directors of the board.

Both the NYSE and the NASDAQ have adopted specific rules as to who can qualify as an independent director, and both markets require that the board of a listed company make an affirmative determination, which must be publicly disclosed, that each director designated as "independent" has no material relationship with the company that would impair his or her independence. Such disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude the board from determining that an individual is independent. In addition, the revised listing standards of both the NYSE and the NASDAQ set forth circumstances that constitute *per se* bars to a determination of independence.

As a general matter, a director will be viewed as independent only if the director is a non-management director free of any family relationship or any material business relationship, other than stock ownership and the directorship, with the company or its management, and has been free of such relationships for

[48] For additional discussion of the NYSE and the NASDAQ independence requirements, *see* David C. Karp, *Independent Directors*, *in* 3 The Practitioners Guide to the Sarbanes-Oxley Act, Part V, Ch. 3 (2005).

three years. The following relationships bar a director from satisfying the independence standards of the NYSE or the NASDAQ, as applicable:

- the director is, or has been within the last three years, an employee[49] of the company;[50]
- an immediate family member of the director is, or has been within the last three years, an executive officer of the company;
- the director is a current partner (or employee, under the NYSE rules) of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);
- an immediate family member of the director is a current partner of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);
- under the NYSE rules, an immediate family member of the director is a current employee of the company's internal or external auditor and participates in the firm's audit, assurance or tax compliance (but not tax planning) practice;
- the director or an immediate family member was within the last three years a partner or employee of a firm that is the company's external auditor (or internal, under the NYSE rules) and personally worked on the company's audit within that time;
- under the NYSE rules, the director or an immediate family member of the director is, or has been within the last three years, an executive officer of another company where any of the company's present executive officers at the same time serves or served on that other company's compensation committee;

[49] Both the NYSE and the NASDAQ provide that employment as an interim executive officer does not, in and of itself, disqualify a director from being considered independent following such employment. Under the NASDAQ rules, however, such interim employment cannot last more than one year.

[50] Both the NYSE and the NASDAQ define "company" to include a parent or subsidiary in a consolidated group with the company.

- under the NASDAQ rules, the director or an immediate family member of the director is an executive officer of another entity where at any time during the past three years any of the executive officer's of the issuer serve on the compensation committee of such other entity;
- under the NYSE rules, the director is a current employee, or an immediate family member of the director is a current executive officer, of a company that has made payments to, or received payments from, the company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues;
- under the NASDAQ rules, the director or an immediate family member of the director is a partner, controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more;[51]
- under the NYSE rules, the director or an immediate family member of the director has received during any twelve-month period within the last three years more than $100,000 in direct compensation[52] from the company (other than in director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service) and compensation

[51] The NASDAQ excludes from the calculation payments arising solely from investments in the company's securities and payments under non-discretionary charitable contribution matching programs.

[52] The NYSE focuses on direct compensation. Consequently, investment income from the company (such as dividend or interest income) would not count toward the $100,000 threshold. In addition, the NYSE's focus on "direct" compensation means that bona fide and documented reimbursement of expenses may also be excluded. Note, however, that the NYSE considers payments to a director's solely owned business entity to be direct compensation.

received by an immediate family member for service as a non-executive employee);[53] and

- under the NASDAQ rules, the director or an immediate family member of the director received any compensation[54] from the company in excess of $60,000[55] during any twelve-month period within the last three years (other than director or committee fees, benefits under qualified retirement plans, or non-discretionary compensation and payments received by an immediate family member for service as a non-executive employee).[56]

Independence determinations must be based on all relevant facts and circumstances. Thus, even if a director meets all the bright-line criteria set out above, the board is still required to make an affirmative determination that the director has no material relationship with the company. Under the NYSE rules, the principles underlying the determination of independence must also be publicly disclosed in the company's annual report or proxy statement.[57] The NYSE rules also provide that the board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. The company must disclose any such standard the board adopts. Any determination of independence for a director who does not

[53] The NYSE also permits companies to exclude from the $100,000 threshold compensation received by a director for former service as an interim executive officer of the company.

[54] Unlike the NYSE, the NASDAQ rule is not limited to direct compensation. Accordingly, even indirect compensation must be included in the calculation of the $60,000 threshold. For instance, the NASDAQ provides that political contributions to the campaign of a director or an immediate family member of the director would be considered indirect compensation and, as such, must be included for purposes of the $60,000 threshold.

[55] In October 2006, the NASDAQ submitted a rule proposal to the SEC for approval to change the threshold from $60,000 to $120,000. The NASDAQ submitted this proposal in response to the SEC's recently adopted changes to the executive compensation disclosure rules which increased the threshold for related party disclosure from $60,000 to $120,000. The proposed NASDAQ rules are still pending before the SEC.

[56] The NASDAQ also permits companies to exclude compensation received by a director for service as an interim executive officer, provided such service did not last longer than one year.

[57] Under the Proposed NYSE Rules, the required disclosures must be directly disclosed and may not be summarized or incorporated by reference into the proxy statement or annual report from another document or the company's website. *See* note 58 below.

meet such standards must be specifically explained.[58] In addition, under the new SEC disclosure rules, for each director that is identified as independent, the company must describe, by specific category or type, any transactions, relationships or arrangements (other than transactions already disclosed as related-party transactions) that were considered by the board under the company's applicable director independence standards (*e.g.*, the NYSE or the NASDAQ independence rules).

In limited circumstances, the NASDAQ permits one director who does not meet its independence rules to serve on the compensation committee without disqualifying the compensation committee from considering the compensation matters that could ordinarily be entrusted to it had it been fully independent. Specifically, if the compensation committee is comprised of at least three members, one non-independent director who is not a current officer or employee or a family member of an officer or employee may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders. If the board takes this approach, it must disclose in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its annual report on Form 10-K or 20-F) the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years. The NYSE does not provide a similar exemption.

In addition, newly listed companies on the NYSE or NASDAQ need only one independent member of the compensation committee at the time of the

[58] Under proposed new rules submitted to the SEC for approval in November of 2005 (the "Proposed NYSE Rules"), a listed company must disclose with respect to each independent director either that the director (i) has no relationships whatsoever with the listed company (other than being a director and/or a shareholder) or (ii) has only immaterial relationships with the listed company. If an immaterial relationship exists, a company must take one of two approaches. Under one approach, the company must disclose a specific description of the immaterial relationship and describe the basis for the board's determination that such relationship did not impair the director's independence. Under an alternative approach, the NYSE would permit a company, in lieu of disclosing specific immaterial relationships, to determine that particular types of relationships are categorically immaterial. A listed company that adopts such a categorical approach must disclose the types of relationships it has determined to be categorically immaterial. Relationships required to be disclosed pursuant to Item 404 of SEC Regulation S-K (certain related party transactions), however, may not be treated as categorically immaterial. The Proposed NYSE Rules are still pending before the SEC.

company's initial public offering, a majority of independent members within 90 days of listing[59] and a fully independent committee within one year of listing.

II. Section 162(m) Membership Requirements

As more fully discussed in Chapter 2 of this Guide, compensation paid to a company's CEO and the four highest paid executives (other than the CEO) is not deductible to the extent such compensation exceeds $1 million, unless, among other things, the compensation is approved by a compensation committee consisting entirely of two or more "outside directors."

A director is an outside director if the director (1) is not a current employee of the company, (2) is not a former employee of the company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year, (3) is not a former officer of the company—whether or not he or she receives compensation for prior services and (4) does not receive "remuneration" (including any payments in exchange for goods or services) from the company, either directly or indirectly, in any capacity other than as a director. A director is deemed to have received remuneration in each of the following situations:

- If any remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50%. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the company) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

- If the company paid remuneration, other than *de minimis* remuneration, in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5% but not more than 50% or to an entity by which the director is employed or self-employed other than as a director, remuneration is considered paid when actually paid or, if earlier, when the company becomes liable to pay it.

[59] If a newly listed NASDAQ company chooses not to have a compensation committee and to have instead a majority of the independent directors discharge the duties otherwise associated with a compensation committee, the company may rely on the NASDAQ's phase in of one year for its separate requirement that there be a majority of independent directors on the board.

Payments are *de minimis* if they do not exceed 5% of the gross revenue of the entity receiving the payments for the entity's taxable year. Notwithstanding the foregoing, remuneration is not *de minimis* if it is in excess of $60,000 or if it is paid for "personal services" to an entity at which the director is employed or self-employed other than as a director. Remuneration is for personal services if:

- The remuneration is paid to an entity for personal or professional services performed for the company, including legal, accounting, investment banking and management consulting services, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

- The director performs significant services (whether or not as an employee) for the corporation, division or similar organization (within the entity) that actually provides the services to the company, or if more than 50% of the entity's gross revenues (for the entity's preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the company.

III. Membership Requirements for the Short-Swing Profit Safe Harbor of Rule 16b-3 of Section 16(b) of the Exchange Act

Section 16(b) of the Exchange Act provides that a company insider, such as a director or officer, is liable to the corporation for any profits resulting from his or her purchase and sale of the company's equity securities within any six-month period. The statute and the rules promulgated thereunder are quite broad, such that, absent an exemption, the granting of equity compensation to an officer of the company may subject the officer to liability for short-swing profits. In an effort to address this issue, the SEC adopted Rule 16b-3, which exempts, among other things, grants and awards by the company of its securities to an officer or director if approved by a committee composed solely of two or more "non-employee directors."

A. Non-Employee Director

Under the SEC's new executive compensation rules, in order to qualify as a non-employee director, the director cannot be an officer or employee of the company (or of a parent or subsidiary of the company); cannot receive in excess of $120,000 in compensation, either directly or indirectly, from the company (or from a parent or subsidiary) for services rendered as a consultant or in any capacity other than as a director; and cannot have an interest in any "related party" transaction for which disclosure in the proxy statement would be required pursuant to Item 404(a) of Regulation S-K.

As amended by the new SEC rules, disclosure under Item 404(a) is required for any "transaction" since the beginning of the company's last fiscal year or any currently proposed transaction in which (i) the company is a participant, (ii) the amount involved exceeds $120,000 and (iii) any "related person" had or will have a direct or indirect material interest. Under the new rules, the term "related person" means any person who was at any time during the relevant period a (1) director or executive officer of the company; (2) any nominee for director (but only if the disclosure is being presented in a proxy or information statement relating to the election of that nominee for director); (3) an immediate family member of a director, executive officer or nominee for director (if the proxy or information statement in which the disclosure is being made relates to the election of that nominee for director) of the company; and (4) beneficial owner of more than 5% the company's voting securities or a an immediate family member of such owner. "Transaction" for purposes of the rule include any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. Employment relationships and director compensation otherwise disclosed under Item 402 of Regulation S-K (*i.e.*, the executive compensation disclosure rules) need not be disclosed.

The new rules also make clear that even if the company disclosed a relevant related-party transaction in the company's filings for the most recent fiscal year, such transaction will not disqualify the director under Rule 16b-3 if the transaction was terminated prior to the director's proposed service as a Non-Employee Director.

B. Ensuring Compensation Committee Membership Compliance

It is possible that a compensation committee member will be independent under the NYSE or the NASDAQ rules, but will not be an outside or non-employee director under Section 162(m) and Rule 16b-3. In the event the

compensation committee has directors that are independent but are not outside and/or non-employee directors, full compliance with Section 162(m) and/or Rule 16b-3 is still possible. As long as the compensation committee possesses at least two directors meeting the definitional requirements of outside and/or non-employee directors, the compensation committee can create a subcommittee consisting solely of two or more outside and/or non-employee directors and delegate responsibility with respect to matters falling within the ambit of Section 162(m) and/or Rule 16b-3 to such subcommittee. Compliance with Section 162(m) might also be accomplished without the formal creation of a subcommittee if the non-outside directors recuse themselves from the deliberations and decisions falling within Section 162(m).

C. Ensuring Independence Under State Law

Transactions between a corporation and its directors are subjected to intense judicial scrutiny under state law because of the inherent conflict between the corporate insiders' personal financial interests and the insiders' fiduciary duty to the corporation and its shareholders. In order to avoid such heightened judicial scrutiny of compensation arrangements, compensation arrangements should be approved by, and negotiated with, directors who are disinterested with respect to the compensation decision at issue.

While Delaware courts have recently appeared increasingly receptive to arguments that economically independent directors were disqualified by alleged non-economic conflicts of interest, the determination of independence under state law is generally understood as requiring only economic independence based on a facts-and-circumstances analysis. In a relatively recent opinion, the Delaware Supreme Court, addressing the independence of certain directors of Martha Stewart Living Omnimedia, Inc.,[60] specifically addressed the persuasiveness of arguments that social connections and personal friendships can result in disqualification from a finding of independence. In deciding the case, the Court held that allegations of a mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. The Court also reiterated its rejection of the concept of "structural bias," the supposition that the professional and social relationships that naturally develop among members of a board impede independent decision-making.

[60] *Beam* v. *Martha Stewart Living Omnimedia, Inc.*, 845 A.2d 1040 (Del. 2004).

No doubt, each case of alleged directorial conflict of interest is different. Nonetheless, the Martha Stewart Living Omnimedia, Inc. decision represents an important restatement of the fundamental principle of corporate governance—the presumption that non-management directors are independent (even if they occasionally play golf with the CEO or attend his child's wedding) unless there is real evidence to the contrary. The concept of the board as remote strangers and as the agency for the discipline of management, rather than as a partner with management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance. The tension between the new norms of independence and the overarching objective of better performance, unless modulated and maintained in perspective, can cause the former to overwhelm the latter.

CHAPTER 7

Compensation Committee Meetings

I. Meetings and Agenda

The compensation committee must meet sufficiently often to perform its duties and should devote adequate time to planning the timing, agenda and attendees at its meetings. The compensation committee should schedule at least one of its meetings before filing the company's annual report and proxy statement to discuss the proposed compensation-related disclosures. The number of meetings the compensation committee should hold depends upon various factors, including the scope of the compensation committee's responsibilities, the size and business of the company and the nature of the compensation arrangements implemented or to be implemented by the company. The SEC requires that companies disclose the number of compensation committee meetings held during the prior fiscal year in the annual proxy statement. Compensation committee meetings, like board meetings, should be sufficiently long to allot adequate time to carry out the duties of the committee. Compensation committees should consider scheduling their meetings for the day before full board meetings, to permit adequate time to consider and discuss agenda items.

The compensation committee should set aside sufficient time without the presence of the CEO and other executive officers to deliberate and determine the officers' compensation levels. For NASDAQ companies, the CEO may not be present during discussions of his or her compensation, but a similar requirement is not imposed for other executive officers. However, the compensation committee should have access to management as it deems appropriate.

The compensation committee should be active in setting its agendas for the year as well as for each committee meeting. While management rather than the board sets the strategic and business agenda for the company, including regulatory and compliance goals, directors should determine the bounds of their oversight and responsibilities. The meetings and annual agendas should reflect an appropriate division of labor and should be distributed to the committee members in advance.

II. Quorum Requirements

For the compensation committee to conduct official business at a committee meeting, a quorum of its members must be legally present. Unless otherwise restricted in the certificate of incorporation, most states consider a

director who participates via telephone or video conference to be legally present (as long as all those present at the meeting can hear and speak to each other). The company's bylaws or a board resolution should set the minimum number of compensation committee members necessary to establish a quorum. If no minimum number is set by the company, then, absent a state law to the contrary, the default minimum quorum requirement for the compensation committee is a majority of its members.[61] Neither the SEC nor the major securities markets have specific guidelines in this regard, although the SEC does require that the proxy statement disclose the number of compensation committee meetings held during the prior fiscal year as well as the name of any director who attended fewer than 75% of the aggregate number of meetings of the full board and the committees on which such director served.

Actions undertaken by the committee in the absence of a quorum are voidable. Thus, the minutes should clearly reflect the presence of a quorum in order to protect valid decisions from attack. To help ensure that a quorum is present: (1) the meeting notices should be sent sufficiently in advance of the meeting and responses promptly reviewed and (2) the chairman of the compensation committee should consult with the corporate secretary in advance of the meeting. In the event a meeting takes place without a quorum, it should be noted in the minutes.

III. Minutes

Compensation committees typically prepare minutes of their meetings, but not of their executive sessions. It is common and prudent practice for such minutes to identify the topics discussed at the meetings rather than attempt to include detailed summaries. Enough information should be recorded, however, to establish that the compensation committee sought the information it deemed relevant, reviewed the information it received, understood each element of the compensation and otherwise engaged in whatever actions and discussions it deemed appropriate in light of the then-known facts and circumstances. The minutes should also indicate which directors attended, whether they attended in

[61] This flows from the general default rule that a committee of the board of directors is subject to the same corporate process requirements applicable to the entire board of directors. *See, e.g.*, § 8.25(c) of the Model Business Corporation Act (2002). Since the default quorum of the entire board of directors is generally a majority of its members, the same holds true for a board committee, such as the compensation committee.

person or via telephone or video conference and whether persons other than the committee members were present.

The committee should approve the minutes at the meeting following the meeting regarding which the minutes were prepared. The minutes should be attached to the agenda for the next meeting and circulated in advance so that the committee members have time to review them before they are approved. If the minutes have not been attached and adequately reviewed before the next meeting, it may be advisable for the corporate secretary to read the minutes to committee members before approval to ensure that the members are aware of the actions that were taken at the last meeting and approve of their characterization in the minutes. Unless otherwise required by state statute or the company's charter or bylaws, it is neither necessary for the minutes to identify the director presenting a motion or resolution nor to separately identify the directors voting for or against a motion or resolution. However, a dissenting or abstaining director should be identified if he or she so requests.

The compensation committee should consider providing a report or a copy of the minutes of each meeting to the full board of directors. Directors who do not serve on the compensation committee should have the opportunity to ask the compensation committee questions relating to the compensation committee's charter or the topics covered at the compensation committee's meetings.

IV. Shareholder and Director Right of Inspection

Careful drafting of minutes is especially important because shareholders may inspect the books and records of the company, including committee meeting minutes. In Delaware, for instance, any shareholder may inspect board and committee minutes upon making a written demand under oath and stating a "proper purpose" for making the request. While the "proper purpose" requirement ensures that shareholders do not have *carte blanche*, activist shareholders are increasingly using this right and a court's willingness to entertain such a demand cannot be foreclosed.[62] A recent Delaware Supreme Court order[63] in remanding a

[62] At least one court, in the recent decision of Delaware Court of Chancery decision, *Polygon Global Opportunities Master Fund* v. *West Corp*., 2006 WL 2947486 (Del. Ch. October 12, 2006), did announce several important limitations on the use of this tool in the M&A context and possibly beyond. In *West Corp*., an activist hedge fund (Polygon) demanded access to West Corporation's books and records after the company announced its intention to undertake a going-private transaction. In denying Polygon's demand, the court held that, in certain circumstances, public information may be sufficient for the shareholder's stated purpose, the books-and-records statute "is not intended to supplant or circumvent discovery proceedings, nor should it be used to

(footnote continued)

lower court decision allowing that a company to demand confidential treatment before divulging sensitive information to dissident stockholders, shows that companies may, in the future, find it more difficult to prevent public disclosure of even ostensibly confidential information. In its order, the Delaware Supreme Court held that the Court of Chancery must first balance a company's interest in confidentiality against the stockholder's communication interest and establish that the confidentiality interest "outweighed" the stockholder's interest.[64]

In litigation, minutes carry added significance given that both Delaware and New York accord corporate minutes a presumption of accuracy. Minutes have been cited in a number of high-profile cases as evidence of directors' alleged lack of care and/or good faith in exercising their fiduciary duties. It is especially important that the minutes are carefully and thoughtfully drafted so that an ambiguous litigation record is not created.

V. Access to Outside Advisors

In order to enable the compensation committee to deal with any special problems that may arise in the course of performing its duties, the committee should be granted the authority to engage compensation consultants where appropriate. The NYSE rules provide that the charter of the compensation committee should give the committee sole authority to retain and terminate any such consulting firm, including sole authority to approve the firm's fees and other retention terms. That said, retaining separate advisors for each of the committee and management when considering issues of executive compensation may do more harm than good. Such an approach can give rise to inefficiencies in compensation discussions, put the board in the awkward position of receiving

(footnote continued)

obtain that discovery in advance of the appraisal action itself" and Polygon's desire to investigate alleged board misconduct cannot be a proper purpose because Polygon would not have standing to pursue any claims (given that it purchased shares in West Corporation only after the announcement of the transaction).

[63] *Roy E. Disney* v. *Walt Disney Co*., No. 380, 2004 (Del. March 31, 2005) (ORDER).

[64] On remand, however, the Delaware Court of Chancery engaged in the prescribed balancing and concluded that the company's interest in confidential treatment outweighed the stockholder's interest and thus the provision of the requested information could properly be conditioned on confidentiality. *See Roy E. Disney* v. *Walt Disney Co*., 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005). Thus, it appears that, at least at the Delaware Court of Chancery level, confidential treatment, under appropriate circumstances, will still be available.

conflicting advice, create a bad record if litigation subsequently arises and, perhaps most importantly, create an antagonistic atmosphere in the boardroom. While we believe that directors should have full access to any consultants that are ultimately retained by the company and have the ability and time to ask focused questions of them, we do not believe that the use of such consultants is required, nor do we believe that a consultant's judgment should be substituted for the board's exercise of judgment after careful and informed deliberation. There is no requirement under Delaware law for directors to consult outside advisors when making decisions on executive compensation and, in the recent *Disney* decision, the Delaware Chancery court showed its deference to the business judgment of directors in matters of executive compensation.

VI. Compensation Committee Chairman

While each member of the compensation committee contributes to its effectiveness, the compensation committee chairman has a special role. The chairman is responsible for ensuring that meetings run efficiently and that each agenda item receives the appropriate level of attention. The chairman is also often the key contact between the compensation committee and the other board members and senior management.

In choosing the compensation committee chairman, the board of directors should seek to select a director with leadership skills, including the ability to forge productive working relationships among committee members and with other board members and senior management. No matter who is appointed compensation committee chairman, as part of the annual review of the compensation committee, the committee and the board should review the combination of talents, knowledge and experience of the compensation committee members to assure that the committee has the right mix.

The time commitment resulting from the current regulatory and shareholder activist environment may require additional compensation for directors, and this pressure is especially acute with respect to service on the compensation committee. Although some companies would prefer not to discriminate in compensation among directors, reasonable additional fees for compensation committee members are legal and may be appropriate. Additional compensation for committee chairs is another way to give fair compensation for those most burdened with responsibilities. Although, as noted in Chapter 9, we generally recommend that the responsibility for director compensation be delegated to the corporate governance and nominating committee, in many public companies the compensation committee reviews the compensation for board

members, including the compensation of directors serving on the compensation committee.

CHAPTER 8

Compensation Committee Charters

Under the new executive compensation disclosure rules, a public company must disclose whether or not it has adopted a compensation committee charter, and any such charter must be made publicly available on the company's website or else attached to the proxy or information statement at least once every three years. In addition, as described below, the NYSE requires its listed companies to adopt a compensation committee charter which must include specified provisions. In light of this, the compensation committee of a publicly-held company should have a charter that complies with applicable regulations and securities market requirements and addresses key responsibilities vested in it by the board. That being said, any such charter should not over-engineer the operation of the compensation committee. If a charter requires review or other action and the board or committee has not taken that action, the failure can be considered evidence of lack of due care. The creation of charters is an art that requires experience and careful thought; it is a mistake to copy blindly the published models.

Each corporation should therefore tailor its own compensation committee charter, limiting it to what is truly necessary and what is feasible to accomplish in actual practice. In order to be "state of the art," it is not necessary that the company have everything other companies have. The charter should be carefully reviewed each year to prune unnecessary items and to add only those items that will in fact help the compensation committee members in discharging their duties.

I. NYSE-Listed Companies Charter Requirements

The compensation committee of a company listed on the NYSE must have a written charter that, at a minimum, contains the required provisions specified by the NYSE listing standards.[65] The charter must be approved and adopted by the company's board of directors and should provide:

- A description of the committee's purpose. In this regard, the charter should indicate that the compensation committee is appointed by the company's board of directors in order to discharge the responsibilities of the board of directors relating to

[65] A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

compensation of the company's CEO as well as the other executive officers. In addition, as applicable, it should indicate that the compensation committee is charged with overall responsibility for approving and evaluating all compensation plans, policies and programs of the company as they affect the CEO, the other executive officers and significant company compensation matters and policies generally;

- That the compensation committee will annually review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. It should also be noted that in determining the incentive-based components of CEO compensation, the compensation committee will consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years;

- That the compensation committee will review and discuss with management the CD&A and, based on this review and analysis, determine whether or not to recommend to the Board the CD&A's inclusion in the company's proxy statement and annual report on Form 10-K;

- That the committee has a duty to furnish the compensation committee report required by the SEC;

- That the committee has sole authority to hire, terminate and pay outside compensation consultants (including setting their fees) to assist it in fulfilling its duties;

- The committee's membership requirements, including the need for member independence;

- How committee members are appointed;

- How committee members may be removed;

- The qualifications for committee membership;

- The committee's structure and operations, including committee authority to delegate to subcommittees;

- The procedures for committee reporting to the board; and

- That the committee will perform an annual self-evaluation of its performance.

It may also be advisable for the charter to provide:

- That the compensation committee will, at least annually, review and approve the annual base salaries and annual incentive opportunities of the CEO and other senior executives. In particular, it should be noted that the compensation committee will review and approve the following as they affect the CEO and other senior executives: (1) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities, (2) any employment agreements and severance arrangements and (3) any change-in-control agreements and change-in-control provisions affecting any elements of compensation and benefits;

- That the committee will receive periodic reports on the company's compensation programs as they affect all employees;

- That the committee will review and approve any special or supplemental compensation and benefits for the CEO and other senior executives and persons who formerly served as the CEO and/or as senior executives, including supplemental retirement benefits and the perquisites provided to them during and after employment;

- That the committee will review and reassess the adequacy of its charter annually and recommend any proposed changes to the board of directors for approval; and

- That the committee has oversight responsibility with respect to shareholder approval of compensation plans.

At *Exhibit A* to this Guide is a model compensation committee charter for NYSE-listed companies. This charter is only a model intended to reflect required and recommended provisions for a compensation committee charter of a NYSE-

listed company. Companies should customize the model to their particular needs and circumstances.

II. NASDAQ-Listed Companies Charter Requirements

For companies listed on the NASDAQ there is no formal requirement that there even be a compensation committee, let alone a written charter. Nonetheless, in accordance with best practice and for practical application of the committee's functions, a compensation committee of a NASDAQ-listed company should have a written charter delineating its responsibilities. The provisions required by the NYSE and the provisions recommended above may be a helpful blueprint. However, because every company is different, the board, in conjunction with the compensation committee, should carefully consider whether inclusion of any provision is helpful in furthering the performance of the compensation committee's duties.

At *Exhibit B* to this Guide is a model compensation committee charter for NASDAQ-listed companies. This charter is only a model intended to reflect recommended provisions for a compensation committee charter of a NASDAQ-listed company. As with the model charter provided for a NYSE-listed company, each company should customize the model to its particular needs and circumstances.

CHAPTER 9

Director Compensation, Indemnification and D&O Insurance

I. Director Compensation

Director compensation is one of the more difficult issues on the corporate governance agenda and is fast becoming the subject of increased attention. On the one hand, more is being expected of directors today in terms of time commitment, responsibility and exposure to public scrutiny and potential liability. On the other hand, the higher the director's pay, the greater the chance that such pay can be used against the director as evidence of a lack of true independence.

Indeed, as discussed in Chapter 1, the SEC's new executive compensation rules now require formatted tabular disclosure of all director compensation. The required new disclosure is comparable to the extensive disclosure that is required for executive officer compensation in the summary compensation table, except that only information concerning the last fiscal year needs to be disclosed. In addition, as described in Chapter 1, narrative disclosure of the company's processes and procedures for the consideration and determination of director compensation must now be provided. These new rules demonstrate that director compensation is no longer immune from the significant public attention devoted to executive compensation.

In particular, as is the case with executive compensation, director compensation is likely to receive scrutiny as a possible influence on good or bad corporate governance practices. The NYSE rules do not specify that responsibility for director compensation must be assigned to any particular committee. However, it should be made the responsibility of either a committee of the board, such as the compensation committee or the governance and nominating committee, or the full board. As discussed in Chapter 3, when the directors who are directly benefited by a proposed plan are delegated with the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plans as they relate to the company's shareholders.[66] In light of this, we generally recommend that the responsibility for adopting director compensation be delegated to the company's corporate governance and nominating committee, subject to the approval of the entire

[66] 1998 Del. Ch. LEXIS 61 at 20 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

board. Although we generally recommend that the responsibility for director compensation be delegated to the corporate governance and nominating committee, many companies allocate that responsibility to the compensation committee. In either case, the committee's decision should always be subject to overall board of director review and override. Care should also be taken that, under normal circumstances, the compensation and benefits of management are not increased at the same time as that of directors, lest doubt be cast on the validity of both actions.[67]

The compensation committee (or other responsible board committee, as applicable) should determine the form and amount of director compensation with appropriate benchmarking against peer companies. It is legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time.

While there has been a current trend, encouraged by institutional shareholders, to establish stock-based compensation programs for directors, the form of such programs should be carefully considered to ensure that they do not create the wrong types of incentives for directors. In the current environment, restricted stock grants, for example, may be preferable to option grants, since stock grants will align director and shareholder interests more directly and avoid the perception that option grants may encourage directors to support more aggressive risk taking on the part of management to maximum option values.

Perquisite programs and company charitable donations to any organizations with which a director is affiliated should also be carefully scrutinized to assure that they do not jeopardize any director's independence or create any potential appearance of impropriety. Any payments to directors for consulting or other services beyond the regular directors fees should be carefully considered and fully disclosed. Note that under Section 301 of the Sarbanes-Oxley Act the receipt of any consulting, advisory or other compensatory fee from the company other than in the capacity of a director or committee member will disqualify a director for service on the audit committee.

[67] *See Tate & Lyle PLC* v. *Staley Continental, Inc.*, C.A. No. 9813, 1988 Del. Ch. LEXIS 61 (Del. Ch. May 9, 1988).

II. Indemnification and D&O Insurance

Whatever the directors' compensation program, all directors should be fully indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular periodic basis to ensure that they provide the fullest coverage permitted by law. Directors can also continue to rely on their exculpation for personal liability for breaches of the duty of care under charter provisions put in place pursuant to Section 102(b)(7) of the Delaware corporation law and similar statutes in other states.

D&O coverage, of course, provides a key protection to directors. While such coverage is becoming more expensive, it is still available in most instances and remains highly useful, despite some recent decisions construing the terms of D&O policies less favorably to the insured. D&O policies are not strictly form documents; they can be negotiated. Careful attention should be paid to retentions and exclusions, particularly those that seek to limit coverage based upon a lack of adequate insurance for other business matters, or based on assertions that a company's financial statements were inaccurate when the policy was issued. Care should also be given to the potential impact of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, many companies are purchasing separate supplemental insurance policies covering only directors and officers and not the company (so-called "side-A" coverage) in addition to their normal policies, which cover both the company and the directors and officers individually.

January 2007

COMPENSATION COMMITTEE CHARTER[68]
(NYSE-Listed Company)

Purpose

The Compensation Committee is appointed by the Board to discharge the Board's responsibilities relating to compensation of the Company's Chief Executive Officer (the "CEO") and the Company's other executive officers (collectively, and including the CEO, the "Executive Officers"). The Committee has overall responsibility for approving and evaluating all compensation plans, policies and programs of the Company as they affect the Executive Officers.[69]

Committee Membership

The Compensation Committee shall consist of no fewer than three members. The members of the Compensation Committee shall meet the independence requirements of the New York Stock Exchange. At least two members of the Compensation Committee shall also qualify as "outside" directors within the meaning of Internal Revenue Code § 162(m) and as "non-employee" directors within the meaning of Rule 16b-3 of the Securities and Exchange Act of 1934.[70]

[68] Charter must be adopted by the Board.

[69] While the NYSE's Listed Company Manual provides that all CEO-related compensation must be determined either by the compensation committee alone or by the compensation committee together with the other independent directors (as directed by the Board), the NYSE Listed Company Manual expressly permits discussion of CEO compensation with the Board generally. *See* NYSE Listed Company Manual Section 303A.5(b) and Commentary.

[70] Only two members need conform to the membership requirements of § 162(m) and/or Rule 16b-3 because satisfaction of such membership requirements may be accomplished by the delegation of the relevant decisions to a conforming two-person subcommittee or by the recusal or abstention of the non-conforming members if at least two conforming members remain. *See* PLR 9811029 (December 9, 1997); American Society of Corporate Secretaries, 1996 SEC No-Act, LEXIS 910 (December 11, 1996).

In addition, compliance with the membership requirements of § 162(m) is only necessary to the extent that the Board determines that it is in the best interests of the Company to qualify for the performance-based exemption to the non-deductibility of individual compensation payments in excess of $1 million made to the CEO and the next four highest paid officers. In addition,

(footnote continued)

The members of the Compensation Committee shall be appointed by the Board on the recommendation of the Nominating & Governance Committee. One member of the Compensation Committee shall be appointed as its Chairman by the Board. Compensation Committee members may be replaced by the Board.

Meetings

The Compensation Committee shall meet as often as necessary to carry out its responsibilities. The Chairman shall preside at each meeting. In the event the Chairman is not present at a meeting, the Compensation Committee members present at that meeting shall designate one of its members as the acting chair of such meeting.

Committee Responsibilities and Authority

1. The Compensation Committee shall annually review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives and determine and approve the CEO's compensation level based on this evaluation. In determining the incentive components of CEO compensation, the Compensation Committee may consider a number of factors, including, but not limited to, the Company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years.

2. The Compensation Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers.

3. The Compensation Committee shall, periodically and as and when appropriate, review and approve the following as they affect the Executive Officers: (a) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities; (b) any

(footnote continued)

compliance with the Rule 16b-3 compensation committee membership requirements is not the only means available to the Board to ensure that grants or awards to company officers fall within the Rule 16b-3 short-swing profit safe harbor from § 16(b) liability. The safe harbor is also available if the grants or awards are approved by the full Board, if the securities issued to the officers are held by the officers for at least six months or if a majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

employment agreements and severance arrangements; (c) any change-in-control agreements and change-in-control provisions affecting any elements of compensation and benefits; and (d) any special or supplemental compensation and benefits for the Executive Officers and persons who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

4. The Compensation Committee shall monitor the Company's compliance with the requirements under the Sarbanes-Oxley Act of 2002 relating to 401(k) plans and loans to directors and officers and with all other applicable laws affecting employee compensation and benefits.

5. The Compensation Committee shall review and discuss the Compensation Discussion and Analysis (the "CD&A") required to be included in the Company's proxy statement and annual report on Form 10-K by the rules and regulations of the Securities and Exchange Commission (the "SEC") with management and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.

6. The Compensation Committee shall produce the annual Compensation Committee Report for inclusion in the Company's proxy statement in compliance with the rules and regulations promulgated by the SEC.

7. The Committee shall oversee the Company's compliance with the requirement under NYSE rules that, with limited exceptions, shareholders approve equity compensation plans.

8. The Compensation Committee shall receive periodic reports on the Company's compensation programs as they affect all employees.

9. The Compensation Committee shall make regular reports to the Board.

10. The Compensation Committee shall annually review its own performance.

11. The Compensation Committee shall have the sole authority to retain and terminate any compensation consultant to be used to assist it in the evaluation of Executive Officer compensation and shall have sole

authority to approve the consultant's fees and the other terms and conditions of the consultant's retention.[71]

12. The Compensation Committee may form and delegate authority to subcommittees as it deems appropriate.

[71] Unlike the Audit Committee, neither the SEC nor the NYSE requires that the Committee be provided with the authority to obtain advice and assistance from internal or external legal, accounting or other advisors (aside from compensation consultants). However, the Board may determine that it is in the best interests of the Company to provide the Committee with such authority.

January 2007

COMPENSATION COMMITTEE CHARTER[72]
(NASDAQ-Listed Company)

Purpose

The Compensation Committee is appointed by the Board to discharge the Board's responsibilities relating to compensation of the Company's Chief Executive Officer (the "CEO") and the Company's other executive officers (collectively, and including the CEO, the "Executive Officers"). The Committee has overall responsibility for approving and evaluating all compensation plans, policies and programs of the Company as they affect the Executive Officers.

Committee Membership

The Compensation Committee shall consist of no fewer than three members. The members of the Compensation Committee shall meet the independence requirements of the NASDAQ Marketplace Rules.

At least two members of the Compensation Committee shall also qualify as "outside" directors within the meaning of Internal Revenue Code § 162(m) and as "non-employee" directors within the meaning of Rule 16b-3 of the Securities and Exchange Act of 1934.[73]

[72] Charter must be adopted by the Board.

[73] Only two members need conform to the membership requirements of § 162(m) and/or Rule 16b-3 because satisfaction of those membership requirements may be accomplished by the delegation of the relevant decisions to a conforming two-person subcommittee or by the recusal or abstention of the non-conforming members if at least two conforming members remain. *See* PLR 9811029 (December 9, 1997); American Society of Corporate Secretaries, 1996 SEC No-Act, LEXIS 910 (December 11, 1996).
In addition, compliance with the membership requirements of § 162(m) is only necessary to the extent that the Board determines that it is in the best interests of the Company to qualify for the performance-based exemption to the non-deductibility of individual compensation payments in excess of $1 million made to the CEO and the next four highest paid officers. In addition, compliance with the Rule 16b-3 compensation committee membership requirements is not the only means available to the Board to ensure that grants or awards to company officers fall within the Rule 16b-3 short-swing profit safe harbor from § 16(b) liability. The safe harbor is also available if the grants or awards are approved by the full Board, if the securities issued to the

(footnote continued)

The members of the Compensation Committee shall be appointed by the Board on the recommendation of the Nominating & Governance Committee. One member of the Compensation Committee shall be appointed as its Chairman by the Board. Compensation Committee members may be replaced by the Board.

Meetings

The Compensation Committee shall meet as often as necessary to carry out its responsibilities. The Chairman shall preside at each meeting. In the event the Chairman is not present at a meeting, the Compensation Committee members present at that meeting shall designate one of its members as the acting chair of such meeting.

Committee Responsibilities and Authority

1. The Compensation Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers. The CEO shall not be present during any Committee deliberations or voting respecting his or her compensation.

2. The Compensation Committee shall, periodically and as and when appropriate, review and approve the following as they affect the Executive Officers: (a) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities; (b) any employment agreements and severance arrangements; (c) any change-in-control agreements and change-in-control provisions affecting any elements of compensation and benefits; and (d) any special or supplemental compensation and benefits for the Executive Officers and persons who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

3. The Compensation Committee shall review and discuss the Compensation Discussion and Analysis (the "CD&A") required to be included in the Company's proxy statement and annual report on Form 10-K by the rules and regulations of the Securities and Exchange Commission (the "SEC")

(footnote continued)

officers are held by the officers for at least six months or if a majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

with management and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.

4. The Compensation Committee shall produce the annual Compensation Committee Report for inclusion in the Company's proxy statement in compliance with the rules and regulations promulgated by the SEC.

5. The Compensation Committee shall monitor the Company's compliance with the requirements under the Sarbanes-Oxley Act of 2002 relating to 401(k) plans and loans to directors and officers and with all other applicable laws affecting employee compensation and benefits.

6. The Committee shall oversee the Company's compliance with the requirement under the NASDAQ Marketplace Rules that, with limited exceptions, shareholders approve equity compensation plans.

7. The Compensation Committee shall receive periodic reports on the Company's compensation programs as they affect all employees.

8. The Compensation Committee shall make regular reports to the Board.

9. The Compensation Committee shall have the sole authority to retain and terminate any compensation consultant to be used to assist it in the evaluation of Executive Officer compensation and shall have sole authority to approve the consultant's fees and the other terms and conditions of the consultant's retention.[74]

10. The Compensation Committee may form and delegate authority to subcommittees as it deems appropriate.

[74] Unlike the NYSE, the NASDAQ does not mandate that the Compensation Committee be given the authority to retain and terminate compensation consultants. As such, the Board may determine that it is not in the best interests of the Company for the Compensation Committee to possess such authority. In addition, unlike the Audit Committee, neither the SEC nor the NASDAQ requires that the Committee be provided with the authority to obtain advice and assistance from internal or external legal, accounting or other advisors. However, the Board may determine that it is in the best interests of the Company to provide the Compensation Committee with such authority. In this regard, the Compensation Committee should consider that the new executive compensation rules require disclosure of the role any compensation consultants played in the determining or recommending the amount or form of executive compensation and, among other things, whether any such consultants were engaged directly by the Compensation Committee.

TALLY SHEET

Name

ANNUAL PAY

1.	Annual Base Salary	$______
2.	Annual Bonus	______
3.	Other Annual Compensation[(1)]	______
4.	Directors' Fees	______
5.	Dividends Paid Currently on Equity Compensation Awards	______
	Sub-total Annual Compensation	$______

LONG-TERM PAY

6.	Stock Option and Stock Appreciation Right Value	$______
7.	Full Value Award (Restricted Stock, RSU) Value	______
8.	Long-Term Incentive Plan Payments	______
	Sub-total Long-term Compensation	$______

OTHER COMPENSATION

9.	Annual Defined Contribution Plan Employer Contribution Value	______
10.	Increase in Defined Contribution Plan Balance (excluding changes attributable to additional employee and employer contributions)	______
11.	Annual Change in Defined Benefit Plan Value	______
12.	Other[(2)]	______
	Sub-total Other Annual Compensation	$______
	TOTAL	$______

Notes

(1) Include value of perquisites and fringe benefits, such as financial counseling, tax preparation, company-provided transportation, facilities for personal use at net operating cost, perk allowances, car allowances, tax gross-ups, security systems, etc.

(2) Include Company-Owned Life Insurance premiums.

Current Issues in Executive Compensation

Web Resources

- Compensation Benchmarking Data:
  - Equilar.com
  - ExecutiveDisclosure.com
- Other Resources:
  - CompensationStandards.com
  - BoardMember.com
  - nacdonline.org
  - acc.com

Executive Compensation Disclosure

Executive Compensation Disclosure

2006 Proxy Season Expectations

- Areas of Focus:
  - Compensation Discussion and Analysis
  - The Summary Compensation Table
  - Post-employment disclosure requirements

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success
October 29-31, Hyatt Regency Chicago

Compensation Discussion and Analysis

- Difficulties of starting from scratch
- Applying a principles-based rule
  - What should be covered?
  - What level of detail is required?
  - Disclose in CD&A or along with tables
- Withholding performance targets
- Linking pay and performance

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success
October 29-31, Hyatt Regency Chicago

Summary Compensation Table

- Is there a focus on "Total" compensation?
- Who is in the NEO group?
- How to disclose equity awards?
- What SCT columns for cash awards?
- What to do with perquisites?

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success

October 29-31, Hyatt Regency Chicago

Post-Employment Disclosure

- Completing the new tables
  - Pension Benefits Table
  - Nonqualified Deferred Compensation Table
- Approaching the termination and change in control disclosure requirements
  - Use a table or narrative discussion?
  - What needs to be disclosed and how is it valued?

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success

October 29-31, Hyatt Regency Chicago

December 2006 Revisions

- Equity award disclosure now has little to do with compensation decisions
- Sent many back to the drawing board
  - Impact on NEOs
  - Explanations for CD&A
  - Adding supplemental tables
  - Impact on "Total" compensation

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success
October 29-31, Hyatt Regency Chicago

2007 Proxy Season Results

- Overall length and "readability" of disclosures
- Length and scope of CD&A
- Performance Target Measures
- Reporting equity awards
- Perquisites issues
- Retirement benefits calculations
- Variations in termination disclosures

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success
October 29-31, Hyatt Regency Chicago

SEC Staff Targeted Review Project

- Corporation Finance Task Force reviewed around 300 proxy statements for executive compensation disclosures
- Selected mostly larger issuers for review
- For the most part futures comments with requests for supplemental information, particularly on the topic of withheld performance targets

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success — October 29-31, Hyatt Regency Chicago

Staff Comments - CD&A

- More analysis in CD&A
- Relationship between the CEO's compensation and the actual compensation of the other NEOs and others
- Benchmarking and peer group descriptions
- The role of executive officers in compensation decisions
- How payment and benefit levels are determined for termination and change in control situations and how they fit into the issuer's overall compensation program
- Location of the CD&A in the compensation disclosure

ACC's 2007 Annual Meeting:
Enjoying the Ride on the Track to Success — October 29-31, Hyatt Regency Chicago

Staff Comments - Performance Targets

- Basis for determining if particular factors or criteria involve confidential trade secrets or confidential commercial or financial information and why disclosure would result in competitive harm
- The adequacy of the alternative “degree of difficulty” disclosure that is provided when performance target measures are withheld
- Specifics about incentive plans and use of discretion

Staff Comments - Termination and Change in Control Disclosure

- Preference for a tabular presentation of this information
- Staff is seeking a more comprehensive discussion of the payment and benefit levels and how they have been determined.
- In some instances, the Staff requests that the amounts reported be totaled to provide investors with a “bottom line” figure for each NEO under each different scenario.

SEC Staff Guidance

Compliance and Disclosure Interpretations

- More frequently updated to reflect latest guidance
- Notable interpretations:
  - Reimbursement for Perquisites
  - Valuation of accelerated stock options
  - Negative numbers in the SCT

SEC Staff Guidance

- Staff Observations in the Review of Executive Compensation Disclosure
  - Manner of Presentation
  - CD&A
  - Executive and Director Compensation Tables
  - Compensation Committee Report
  - Related Person Transaction Disclosure
  - Corporate Governance

SEC Staff Guidance

John White's "Where's the Analysis Speech?"

- Analysis
- Presentation
- On one page:
  - the key analytic tools used by the compensation committee;
  - the findings that emerged from the analysis; and
  - the resulting actions taken impacting executive compensation in the last year.

Section 409A Update: More Time, Many Pitfalls

Overview

- 409A Effective Date Relief
- Related Guidance
- Coming Attractions
- Pitfalls
- Faux-Pitfalls

409A Effective Date Relief

- The Dialectics of Delay
  - Dialectic – A zigzag progression to a resolution
    - The Final Regulations: Effective January 1, 2008
    - First law firm letter
    - Notice 2007-78: Partial document delay
      - No "good faith compliance" and no payment elections
    - Second law firm letter
    - Notice 2007-86: Meaningful delay
      - Nearly complete relief until 12/31/08

- Notice 2007-86
  - Good faith compliance permitted in 2008
    - But on slightly modified terms (next slide)
    - Impermissible discretion – employee/employer
      - Amending early could reduce the potential risk from exercising employer discretion.

Notice 2007-86: Gauging Good Faith

- Pre-2008
  - Need not follow Regs. (Final or Proposed)
  - May follow Notice 2005-1, Prop. Regs, or Final Regs.
- 2008
  - Same
  - Same, except not Prop. Regs.
    - Final Regs. generally more liberal, but not always, *e.g.*, short-term deferral exception

- Notice 2007-86
  - Payment elections in 2008
    - Avoids 1-year/5-year rules
    - 2008 in/out restrictions apply
    - When is something “payable” in a year?
      - Constructive receipt principles appear to apply
    - 409A options: Can use to fix payment terms
      - But not for insiders if a backdating accounting charge
    - 2007 election may avoid a 2008 in/out issue

- Notice 2007-86
  - Payment linked to qualified plans
    - Applies through 2008, for plans that linked on October 3, 2004
    - Scope expanded
      - Now includes links to: Qualified plans, 403(b), 457(b) and certain foreign broad-based plans.

- Notice 2007-86
  - Substituting non-discount stock options/SARs
    - Generally applies through 2008
    - With similar restrictions as before
      - No make-up cash or vested property may be paid in the same year as substitution
      - Not for insiders if a backdating accounting charge

- Notice 2007-86
  - What's not extended
    - Relief for grace period assets from the offshore trust/financial health rules
      - But can still use good faith to determine if arrangement violates 409A(b)
    - Initial election relief for performance-based comp
      - But payment election relief may work (applies to short-term deferrals)

Related Guidance

- Notice 2007-78: Substantive Guidance
  - Employment agreements – “good reason”
    - Rehabilitating a too liberal provision
      - To avoid 6-month delay or coverage by 409A
    - Can’t impose or extend a risk of forfeiture
      - But good faith still applies
      - Good reason after CIC: Forfeiture risk generally applies
    - Payment election – Pay only on involuntary termination

- Notice 2007-78: Substantive Guidance
  - Employment agreements – “substitution”
    - Avoiding 409A “cradle to grave” syndrome
    - Applies to –
      - Severance for involuntary termination
      - If no payment for non-renewal of agreement
    - Severance under new agreement not a substitute until further notice
      - Shows how tough the basic rules are

- Notice 2007-78: Substantive Guidance
  - Pre-determined cashouts
    - Cashout of low-value remaining payments allowed
      - Under the Regs, must cashout whenever value reached
      - Until further notice, may value only at the time payments begin
      - This temporarily permits a very common design
      - Again, shows how tough the basic rules are

Coming Attractions

- Corrections Program
  - For certain unintentional operational failures
  - Correct in same taxable year
  - Congressional skids are greased
- Notice on reporting and withholding
  - Expected to look much like Notice 2006-100

Pitfalls

- Cancelling Elections Upon Ineligibility
  - Stop taking deferrals upon an overseas transfer
    - IRS concerned this will be abused
  - IRS regards as an impermissible revocation
    - Real practical problem for most employers
  - But watch out for documentary noncompliance, which can affect the entire plan
    - Probably safer not to include cancellation in plans for now
    - Hopeful, conditional drafting?
    - OK to bar from making new elections

- Defining "Retirement"
  - Allowed to pay differently at separation after an age, or an age and service (e.g., 55 and 10 years)
  - Qualified plans – earlier of 55/10 or 65/5 common
    - Natural to carry that over to a linked non-qualified plan
  - IRS was saying this was OK
    - Because only one toggle would apply to each participant
    - But they recently reversed course
    - Options – Hope for change, use projected service from hire, vest at retirement

- 280G Tax Gross-Up: 6-Month Delay
  - Final regs allow payment by end of year after when taxes are remitted – a nice, simple rule
  - But the 6-month delay can make this a pitfall
    - IRS says 280G gross-ups are triggered either by the CIC or by a related separation
    - To the extent triggered by the separation, 6-month delay applies
    - If have both types of gross-ups, care needs to be taken not to pay too much too soon (consider delaying all 6 months)

- Shifts Between Non-Qualified Plans
  - Issue arises where more than one linked SERP, and there are payment differences
    - Basic SERP – Annuity
    - Officers' supplemental SERP – Lump sum
  - Need to make sure deferrals are not shifting
    - There is relief for shifts between qualified and non-qualified plans
    - Ruling out shifting can require careful work with your actuaries
    - Expedient approach – Uniform payment terms

Equity Vesting at Retirement

- Full-value award vests after completing a service period or upon retirement
- Retirement-eligibles: Typically vested at grant
  - Restricted stock – 409A exempt, but premature taxation
  - RSUs – Taxes are deferred, but 409A applies (not a short-term deferral)
    - » 6-month delay, need to use 409A separation definition
    - » Some companies shifting RSUs to "pay as you vest" for retirement eligibles

As Soon As Practicable

- To avoid creating rigid expectations (and because of Murphy's law), plans traditionally paid "ASAP"
- But this can be too loose under 409A
  - *E.g.*, ASAP after separation
  - Appears to be a plan document violation
- Alternatives
  - Eliminate
  - 90-day rule
  - Administrative convenience rule

Faux-Pitfalls

- Multiple Deferrals that Pay at Separation
  - Standard deferral plan – Payments triggered by separation from service
  - 2007 deferral pays at separation; 2008 at separation plus 2 years
  - Not clear under Final Regs. that this works
    - Language states that all payments tied to an event must be paid the same
    - But OK, because can have distinct payments for different deferrals

- Dividends on Phantom Stock
  - Final Regs. bar employer control over the deferral amount
    - Violates 409A: Payment not sufficiently fixed
    - Language strict enough that the company's ability to decide what dividends to pay appears to be a problem
    - But this appears to be OK if the dividends just define the earnings on the deferral, and not the deferral

Disclosure Preparation Process
Lessons Learned from 2006

Disclosure Process

Consider Written Procedures

- Define Roles and Responsibilities
  - Parties – Legal, Finance, HR, Comp. Committee, Consultants
  - Data Ownership and Collection
    - Disparate systems
    - Third parties may be involved – pension, 280G experts
- Establish communication plan and calendar
    - Coordinate timing with Disclosure Committee

Disclosure Process

Written Procedures (continued)

- Levels of Review
  - Legal
  - Finance/Internal Audit
  - Compensation Committee and Board
- Establish record retention guidelines for back-up materials
  - Create centralized record including data and guidance from external advisors
- SOX control mapping
  - Comprehensive listing of data sources, computations, formulas and related controls

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Role of the Board and Compensation Committee in Setting and Reviewing Executive Compensation and Related Disclosure

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Compensation Committee

New Hot Seat on the Board

- Regulatory and Activist Attention
  - Plaintiff's bar next?
- In S&P 1500, average Board tenure of Compensation Committee members is 7.3 years, 1.2 years higher than average tenure for Audit Committee members

Compensation Committee

Compensation Committee Composition

- All independent directors
  - Limited exception for Nasdaq companies
- Differing standards of independence
  - NYSE/Nasdaq*
  - 162(m)
  - Rule 16b-3

Compensation Committee

NYSE Mandated Duties

- Review and approve goals and objectives relevant to CEO performance
- Evaluate CEO's performance against goals
- Determine and approve CEO's compensation
  - When setting long-term incentives, consider:
    - Company performance and shareholder return
    - Past awards to CEO and awards to CEOs at comparable companies

Compensation Committee

NYSE Mandated Duties (continued)

- Recommend to full Board for approval:
  - Non-CEO executive compensation
  - Incentive and equity based plans
- Sole authority to hire, fire and pay consultants
- Produce a report for the 10-K
- Conduct annual self-evaluation

Compensation Committee

Other Mandates

- Nasdaq Mandates
  - No express requirement for a formal, independent compensation committee
  - Compensation of CEO and executive officers must be determined by a majority of independent directors or a compensation committee composed entirely of independent directors, with a limited exception
- Disclosure Mandates
  - Significant planning, analysis and review required

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Compensation Committee Process

Compensation Committee Charter

- Address regulatory requirements and company practice
- Should not be "aspirational"
- Careful monitoring of compliance with charter requirements

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Compensation Committee Process

Meetings and Agendas

- Set annual agenda based on charter and regulatory requirements
  - Work with CEO and committee chair
- Time Intensive Process
  - S&P 1500 held a median of 5 meetings per year
  - Significant analysis required for setting strategy, performance goals and reviewing comparable companies
  - Meet the analytical requirements of the CD&A
  - Executive sessions – best practice and required by Nasdaq

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Compensation Committee Process

Meetings and Agendas

- Who attends the meetings
  - All meetings - CEO, GC
  - Some meetings – CFO, HR, consultants, analysts
- Minutes
  - Meetings (yes) and executive sessions (no)
  - Strike a balance: evidencing appropriate deliberation while avoiding a plaintiff's or activist's treasure trove
- Materials
  - Content heavy, members need time to analyze
  - Highly sensitive – confidentiality protections

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Compensation Committee Process

Establish a Firm and Defensible Process

- Reasonable decisions by a well-informed committee
- How much participation by CEO and management?
  - Nasdaq restriction on CEO participation
  - CEO can be a guide for the Committee
- Data Analysis
  - Robust reporting to committee
  - Consultants
  - On-line data aggregators
    - Provide robust reporting capabilities
    - Allow targeted and efficient use of consultants

Compensation Committee Process

Outside Advisors

- Committee retains sole authority to hire/fire/pay
- Choose consultant and their role carefully
  - Consultants don't necessarily quiet outside criticism
- Absent special circumstances, appropriate to hire one consultant
  - Dueling consultants for Board and management can create a bad record if there is conflict
- Is there a need to hire a consultant every year?

Compensation Committee Process

Consider an Equity Grant Policy

- Issues to consider addressing:
  - Designate equity compensation compliance officer
  - Grants at fixed meeting dates
  - Policies for ad hoc and new hire grants
  - No grants by written consent
  - Delegation of power to grant, if any
  - Policy for granting and tracking grants at a price other than the closing price on the date of grant

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Compensation Committee Process

Involvement of the Full Board

- Compensation Committee handles heavy lifting, but…
- Board plays a vital role
  - Regulatory requirements
  - Shareholder/activist issues
  - Prevent NYSE/Disney episodes
- Absolute clarity for all elements of compensation
  - The beloved tally sheet

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Compensation Committee – Hot Topics

Compensation Committee Pay

- 82% of S&P 1500 pay chair retainer
  - Median retainer is $8,000
- <17% pay retainer to non-chair members
  - Median retainer is $5,000
- Median per meeting fee is $1,500

Compensation Committee – Hot Topics

Activist Hot Buttons 2007/2008

- Gross-ups in change of control agreements
- Options v. restricted stock v. performance-based restricted stock
- Planes, trains and automobiles – Perquisites disclosure
  - Relatively minimal uproar in 2007
  - Some move to cash payment in lieu of perqs

June 28, 2007 09:10 AM Eastern Daylight Time

Pfizer Board of Directors to Initiate Face-to-Face Meetings with Company’s Institutional Investors on Corporate Governance Policies and Practices

Commitment Enhances Long-Standing Focus on Highest Governance Standards

NEW YORK--(BUSINESS WIRE)--Pfizer said today that members of its Board of Directors will invite its largest institutional shareholders to a meeting where they will have an opportunity to provide comments and perspective on the company’s governance policies and practices including executive compensation.

Pfizer is the first company to initiate a regular meeting between its Board and institutional investors on governance. The Board will invite representatives who evaluate governance practices and who vote the proxies of the company’s largest institutional investors. These representatives own in aggregate approximately 35 percent of Pfizer’s shares. The initial meeting is planned for the fall.

“We believe this meeting with our shareholders on our governance and compensation policies will give us valuable insights and help us maintain the highest standards in corporate governance,” said Constance Horner, Lead Director of the Pfizer Board. “I am personally committed as the Chair of the Governance Committee, as are the Chairs of the Compensation and Audit Committees, to attend these meetings and listen to shareholder viewpoints on governance and executive compensation."

The Pfizer Board has in place several other mechanisms to foster communications with all shareholders. These include e-mail addresses for the Lead Director and committee chairs and a Board policy of regularly reviewing communications that it receives from shareholders. In addition, members of the Board regularly participate in investor conferences focused on governance practices.

Said Dana Mead, Chairman of the Compensation Committee, “The opinions of our shareholders have always been important to the Board. Today’s announcement builds on our broad-based outreach to shareholders and formalizes what we have informally practiced for many years.”

Pfizer has been in the forefront of corporate governance for over two decades. It has taken the lead in the elimination of its poison pill; the declassification of the Board, so that all directors are elected at each annual meeting; the adoption of majority voting policy; and expanded disclosures on executive compensation well ahead of new SEC regulations. The company was also among the first to use SEC “Plain English” rules to make disclosures more understandable to investors.

“Open and candid dialogue with our shareholders -- and, in fact, all of our stakeholders – is very valuable and will help us become a better company,” said Pfizer’s Chairman and Chief Executive Officer, Jeff Kindler. “These meetings reflect the view of both Pfizer’s management and its Board that we must listen to shareholder viewpoints on governance so that we can continue to improve our practices.”

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