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Compensation Committee Guide

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About this Compensation Committee Guide

This Compensation Committee Guide (this "Guide") provides an overview of the key rules applicable to compensation committees of New York Stock Exchange (the "NYSE") and NASDAQ-listed U.S. companies and 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 also is 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 current 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 Guide is not intended as legal advice, cannot take into account particular facts and circumstances and does not generally address individual state corporate laws.

About the Exhibits

The Exhibits to this Guide are sample compensation committee charters and a sample tally sheet. These Exhibits are to some extent useful in assisting a compensation committee in performing its functions. However, it would be a mistake to simply copy published models. The creation of charters and tally sheets 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 explicitly 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 for the particular company, 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 In The Spotlight

The world of executive compensation is in a state of constant change. A spurt of recent regulatory activity, publicity of executive compensation arrangements and outcry over perceived excesses continue to foist executive compensation matters into the spotlight. 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, continue to take 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:

- In October 2008, the President signed into law the Emergency Economic Stabilization Act of 2008 (the "EESA"), which includes a number of provisions relating to executive compensation that have important implications for financial institutions selling troubled assets under the EESA, some of which have been extended to institutions participating in the Treasury's Capital Purchase Program;

- Also in October 2008, John White, the Director of Corporate Finance at the U.S. Securities and Exchange Commission (the "SEC"), implied in a speech that all public companies should disclose the risks an executive might be incentivized to take to meet performance goals, if such goals are a material part of a company's compensation policies, and further stated that the SEC will review in 2009 the disclosure of all the largest financial institutions;

- In November 2008, Representative Henry Waxman (D-CA), Chairman of the U.S. House of Representatives Committee on Oversight and Government Reform, sent letters to certain financial institutions seeking detailed data about employee compensation at the institutions; and the attorneys general of several states have made similar requests;

- Also in November 2008, RiskMetrics issued an update of its Corporate Governance Policy which characterizes as "poor pay practices" such common provisions as newly implemented "golden parachute" excise tax gross-ups and post-change-in-control "window" walk-away provisions.

- The Internal Revenue Service (the "IRS") issued notices under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), apparently establishing December 31, 2008 as the final date by which all deferred

compensation plans must be amended to comply with Section 409A;

- Activist shareholders submitted "say on pay" proposals to dozens of companies, threatening to usurp the role of the compensation committee in setting executive compensation;

- Presidential candidates for both major U.S. political parties expressed support for "say on pay" legislation; and

- In its "Declaration of the Summit on Financial Markets and the World Economy," the G-20 nations pledged that by March 31, 2009, "[f]inancial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking."

- The IRS reversed its previous position regarding the effect of severance provisions on the eligibility of compensation arrangements for the performance-based exception to Section 162(m) of the Code, causing public companies to review all severance and performance-based compensation arrangements.

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 regulators, the media and shareholder activists, many advisors are providing directors of public companies with advice solely intended to avoid the possibility of criticism. While frequently well-intentioned, this advice can distract directors from their basic responsibilities with respect to executive compensation and may ultimately lead to underperformance at our nation's public companies. The tendency to curtail recommendations with respect to compensation that may be in the best interest of a company is ill-advised.[1] While some of the proposals may well have merit for certain companies, this "one-size-fits-all" approach to compensation policy undermines the very strength of the corporation: the delegation of decision-making power from shareholders who have limited information and often conflicting interests to well-informed directors acting with due care in the best interests of the company.

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This Guide eschews the "one-size-fits-all" approach to executive compensation and, instead, seeks to focus directors on issues that are

[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).

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. Competition for human capital requires 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 latest trends and so-called "best practices" advocated by corporate critics and shareholder activists. This Guide advises directors to engage in a thoughtful and informed process regarding the manner in which they determine to compensate their executives, to discuss and understand the relevant issues, to reflect such discussions appropriately in compensation committee minutes, to listen to experts (whether internal or external), if appropriate or necessary, and to review documentation and cost estimates.

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

I

Key Responsibilities of Compensation Committee Members

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

A. Responsibilities Imposed by the Securities Markets[2]

1. 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,[3] composed entirely of independent directors.[4] The NYSE further requires that the compensation committee carry out a number of minimum responsibilities. While the responsibilities of a compensation committee may be delegated to subcommittees, each subcommittee still must be composed entirely of independent directors and have a published charter.[5]

Under the NYSE rules, a compensation committee must (a) review and approve goals and objectives relevant to CEO compensation, (b) evaluate the CEO's performance in light of such goals and objectives and (c) either as a committee or together with the other independent directors, determine and approve the CEO's compensation based upon such evaluation. In determining the long-term incentive component of CEO compensation, the NYSE requires a 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

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[2] 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).

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

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

[5] 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.

awards given to the CEO in past years.[6] Compensation committee responsibilities regarding CEO compensation do not preclude discussion of CEO compensation with the board of directors generally.

In addition, under NYSE rules, a 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 (the "PFO"), 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. A compensation committee also is charged with recommending to the board of directors the approval of incentive and equity-based compensation plans that are subject to board of director approval.

If a compensation committee desires to have the aid of a compensation consultant, the compensation committee must be vested with the sole authority to (a) retain and terminate such consultant, and (b) approve the consultant's fees and other retention terms. Additionally, the NYSE reiterates and adopts the SEC requirement that a 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, a 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 also have established an advisory service in which they meet with compensation committee members to lead them through the evaluation process. A 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 a 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 company and its directors.[7]

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

[7] For a brief discussion of the factors a compensation committee 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).

2. 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 executive compensation disclosure rules adopted in 2006, 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.[8] In addition, a compensation committee or a company's independent directors must approve equity compensation arrangements that are exempted from the NASDAQ shareholder approval requirement as a prerequisite to taking advantage of such exemption.[9]

B. CEO and Executive Officer Compensation

While both the NYSE and the NASDAQ only require that a compensation committee recommend to the full board of directors 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. A detailed discussion of the

[8] 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.

[9] The shareholder approval requirements and the relevant exemptions for certain compensation committee approved plans are discussed in Chapter 2.

requirements of Section 162(m) of the Code and Rule 16b-3 of the Exchange Act is set forth in Chapter 2 of this Guide.

In evaluating and setting executive officer compensation, a compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, a compensation 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 a compensation committee to certify satisfaction of such performance criteria in order to comply with the tax deductibility requirements of Section 162(m) of the Code.

Further, in order to ensure that compensation and severance packages are justifiable, members of a 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 a compensation committee to utilize a "tally sheet," which provides a 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 only a model; companies should customize the model to address their particular needs and circumstances.

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

There is no single allocation of compensation responsibilities that is right for every company; however, companies at least should 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 of directors 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 of this Guide, a compensation committee also may 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 compensation committee's own charter, or by virtue of actually exercising such responsibilities. It is possible for a plan to state that the full board of directors or the compensation committee is responsible for administering ERISA plans or for managing the investment of their assets, either of which will implicate ERISA's fiduciary duty rules. It may or may not be

appropriate for a compensation committee to assume such responsibilities, but, in any event, a compensation 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).

D. Development of Compensation Philosophy

A 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 its disclosure rules that companies include a section entitled "Compensation Discussion and Analysis" (the "CD&A") in their annual proxy statement, which discusses such a policy.

E. Compensation-Related Disclosure Responsibilities

A compensation committee should ensure that all compensation-related disclosure requirements are met unambiguously. This presents a particularly pronounced challenge in light of the comprehensive SEC rules regarding disclosure of executive officer and director compensation that were adopted in the summer of 2006. Compensation committee members should request that management discuss with them the nature of the information required to be disclosed in upcoming public filings, including information relating to compensation committee members themselves. A summary of the most important features of the rules is set forth below.

1. Compensation Discussion and Analysis

The SEC disclosure rules require the CD&A to be a narrative overview of a company's executive compensation policies and decisions. The purpose of the CD&A is to provide investors with material information necessary for an understanding of a company's compensation policies and decisions regarding the Named Executive Officers (the "NEOs"). In particular, the CD&A must explain all material elements of the compensation of the NEOs, including the overall objectives of the compensation programs and the rationale underlying and method of determining specific amounts for each element of compensation. Specifically, a company must discuss in the CD&A (a) the objectives of

the compensation arrangements, (b) what the compensation program is designed to reward, (c) each element of compensation, (d) why a particular element was chosen, (e) how the amount (and, where applicable, the formula) is determined for each element and (f) how the various components of the compensation arrangements satisfy the company's overall compensation objectives.[10]

Though warning against boilerplate disclosures, the rules also include a nonexclusive list of suggested additional 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 nonpublic information. The CD&A is not merely deemed furnished to the SEC, but is considered "filed" with the SEC.[11] This means that misleading statements in the CD&A could expose a 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 mandated CEO and CFO certifications of the Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley"). However, if forward-looking information is included in the CD&A, a company may rely on the safe harbors for such information.[12]

2. Compensation Committee Report

The Compensation Committee Report is a recitation of whether a compensation committee has reviewed the CD&A, discussed it with management and recommended it to the board of directors. The Compensation Committee Report must be included in the proxy and the

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

[11] 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.

[12] 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).

annual report on Form 10-K, although incorporation by reference into the Form 10-K from the proxy statement is permitted. The names of compensation committee members must appear below the report. Unlike the CD&A, the Compensation Committee Report is 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.

3. Covered Executives

The SEC rules require tabular disclosure regarding both executive and director compensation. The specific requirements for the tabular/narrative disclosures are more fully described in sections G through L below.

The tabular/narrative disclosures for executive compensation apply to the CEO, the CFO, the three most highly compensated executive officers (other than the CFO and CEO) and up to two additional 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. Disclosure is not required 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 ("SCT"), which is discussed in section D below, reduced by the amounts includible in the total compensation column showing the change in pension value and non-qualified deferred compensation earnings.

For most issuers, the 2009 proxy season represents the third year of required compliance with the SEC's new executive compensation disclosure rules. In preparing updated disclosure for each new year, companies should consider using last year's proxy statement as a starting point. However, companies should examine the disclosure with fresh eyes, taking into account developments in their compensation philosophy and practices, as well as the SEC's latest guidance regarding compensation disclosures, including its frequently asked questions and its October 2007 report on compensation disclosures. Companies should also comply with any commitments made to the SEC in response to SEC review processes.

4. Summary Compensation Table

A company must disclose in the SCT in its proxy statement and annual report on Form 10-K all compensation earned, whether or not actually paid, with footnote disclosure explaining amounts deferred. To that end, the SCT includes 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.

While companies are required to include compensation information for fiscal years since the revised SEC requirements became applicable (generally 2006, 2007 and 2008) in the 2009 proxy statement compensation tables, disclosure for all three years is generally required only for executives who were named executive officers for all three years. The SEC 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 still must 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 of the SCT 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 generally is 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 repricing/modification in a given year requires 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, employee 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 generally is available on a nondiscriminatory basis to all employees; and

  - 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.

- If a perk or other personal benefit has no aggregate incremental cost, it must still be separately identified by type.

- Any item for which an executive officer has fully reimbursed the company for its *total cost*—not aggregate incremental cost—should not be considered a perquisite or other personal benefit and therefore need not be separately identified by type.

- Identify and quantify in a footnote each component of the "All Other Compensation" column of the SCT 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 SEC 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.

5. 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 SCT) 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 SCT 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 compensation 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.

6. Director Compensation Table

The SEC rules also establish a requirement that director compensation be disclosed in tabular form. In particular, the 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 director compensation disclosed in the table also must 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.

7. 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 Stock Appreciation Rights ("SARs"). With respect to options, disclosure generally is 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 a company's stock at the end of the last completed fiscal year and the number of shares or units underlying the award.

8. 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.

9. Pension Benefits Table

The Pension Benefits table discloses details of each pension plan in which each 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.

10. 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.

11. Narrative Disclosure Regarding Termination and Change-in-Control Provisions

In addition to the tabular and related narrative disclosures described above, the SEC 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 (*e.g.*, each type of employment termination), 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.

12. Narrative Disclosure Regarding the Compensation Committee

The SEC rules also require narrative disclosure regarding the governance of a compensation committee.[13] In particular, the narrative disclosure must provide a description of a 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.

F. Internal Controls

A compensation committee must work to ensure it attains sufficient understanding of, and compliance with, current legal rules affecting compensation. Companies should supplement disclosure controls and internal controls with a system to track and gather the information required under the disclosure rules. Individuals to be included in the SCT must be determined by reference to total compensation (excluding the amounts included in the change in pension value and non-qualified deferred compensation columns). As such, 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 amounts paid/accrued in connection with a termination of employment or a change in control. This likely will require tracking categories of compensation and benefit values in a manner that may differ from current practice and for a larger group of executives.

The need for vigilance in disclosure controls and internal controls is evidenced by the widely publicized issues that arose from option misdating at some public companies. Some public companies have been unable to file periodic reports in a timely manner as a result of options backdating. The SEC has investigated over 100 companies to determine

[13] If a 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.

whether they improperly backdated stock options[14] and the SEC and the U.S. 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 failure to maintain adequate internal controls).[15] Recently, some public company executives have even been sentenced to prison terms for option backdating.[16] As a result, a compensation committee should adopt compensation-related internal controls to facilitate compliance with applicable law.

G. Equity Compensation Grant Policy

Companies should review the manner in which equity compensation awards are granted to employees and directors. While any given company's equity grant practices will be tailored to the company's particular business and administrative needs, set forth below are general guidelines for companies to consider when reviewing their equity compensation award practices.

1. Written Grant Policy

To ensure that there is a clear understanding of a 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.

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[14] *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.

[15] *See, e.g.*, Wall Street Journal, "KLA, SafeNet, Brooks Ex-Executives Face Backdating Charges," July 26, 2007, at A2 (describing SEC proceedings and federal prosecutions arising from backdating charges against several former executives); Wall Street Journal, "The Backdating Molehill," March 7, 2007, at A16 (describing SEC proceedings against several former executives accused of backdating, including Gregory Reyes of Brocade Communications); 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.

[16] *See, e.g.*, N.Y. Times, "Former Brocade Official Sentenced in Backdating Case," March 20, 2008, at C11; N.Y. Times, "Backdating Case Brings A Prison Term," January 29, 2008, at C10.

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2. Designate an Equity Compensation Compliance Person

A 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. A compensation committee may wish to designate the same person as the person who is responsible for ensuring compliance with Section 162(m) of the Code and/or Section 16 of the Exchange Act (*see* Chapter 2).

3. Regular Grants at Fixed Meeting Dates

A company should consider specifying in its equity compensation award policy that regular equity awards (*e.g.*, annual grants) only will be made at fixed meeting dates that are specified well in advance of the actual meeting. A company also should consider specifying that these meeting dates will occur during "window periods" in which officers and directors can trade, to the extent practicable. A compensation 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, should make grants at the meeting for all employees who are to receive awards. While this approach likely will require more advanced planning and coordination among management, business unit heads and the compensation committee, having the compensation committee approve all individual grants at a regular meeting will 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.

4. *Ad Hoc* and New Hire Grants

Because decisions with respect to grants made outside a company's regular grant cycles often need to be made quickly, equity grant policies which are essential for corporate governance purposes also may 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 its grant policy depends 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 preestablished 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. Even so, a compensation committee should consider including in its grant policy the flexibility to make an extraordinary grant which, for valid business reasons, does not otherwise comply with the remainder of the policy.

5. 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, a 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.

6. 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 only are effective when the last signature is affixed to the consent (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.

7. Delegation

Any delegation of authority to make grants should comply with state law, the compensation committee charter and the applicable equity compensation plans.[17] 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

[17] *See*, *e.g.*, Section 157(c) of the Delaware General Corporation Law.

units ("RSUs"), and the terms of such awards. A compensation committee's authority to make grants intended to comply with Section 162(m) of the Code and/or the safe harbor under Section 16 of the Exchange Act, as described below, cannot be delegated to a committee that does not satisfy the requirements of these rules (*see* Chapter 6).

8. Section 16 of the Securities Exchange Act

Rule 16b-3 under the Exchange Act establishes a safe harbor from the short-swing profits recovery rules of Section 16(b) of the Exchange Act for grants of options and other stock-based compensation to directors and officers if a transaction is approved by, among other alternatives, the board of directors or a committee thereof that is comprised of two or more non-employee directors. A company's equity compensation award policy should, therefore, require that grants to directors and officers will be made by the full board of directors or a committee that satisfies the requirements of Rule 16b-3.

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

As more fully described in Chapter 2 of this Guide, 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 two or more outside directors. Consequently, a 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) of the Code will be made by a compensation committee comprised solely of outside directors. For reasons described in detail in Chapter 2 of this Guide, the group of executives who are categorized as potential "covered employees" for Section 162(m) of the Code should be at least as broad as Exchange Act Section 16 officers at the time of grant. Whichever executives a 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) of the Code.

10. Stock Option Exercise Price

Because the SEC disclosure rules require disclosure if (a) an option exercise price differs from the closing stock price on the grant date or (b) 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 2008 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 NASDAQ rules or the terms of the applicable plan and would not have other unintended consequences.

H. Management Succession

The events of 2008 have demonstrated that succession planning is critical for the long-term success and stability of any public corporation. 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. Careful succession planning is an excellent way to meet compensation challenges, as studies indicate that it is considerably more expensive to recruit senior talent from outside an organization than from inside, and pay packages for outside recruits are often more publicized and scrutinized than compensation arrangements for internal candidates. Moreover, the nature of the planning strategy may affect the manner in which executives are compensated. For example, if there is a clear designated successor, the difference between the compensation of the CEO and the designee may be less than if there is no clearly designated successor.

Compensation committees charged with responsibility for succession planning should review and discuss, with input from the other members of the board of directors and the company's senior executive officers ("SEOs"), plans for corporate development and corporate succession plans for the CEO and other senior officers. Succession planning should be a top priority of the board of directors and CEO, and the board should evaluate annually the status of future generations of company leadership.

There are no prescribed procedures for planning succession; therefore, a compensation committee should fashion the principles and procedures it deems appropriate. In fulfilling its succession function, a compensation 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 of directors to meet all of its duties. In large measure, the success of each of the board of directors and the CEO is dependent on the other.

I. Shareholder Proposals

Institutional investors, individual shareholder activists and academic gadflies continue to submit shareholder proposals with regard to

executive compensation practices. Proxy voting advisors publish guides setting forth blanket voting policies on these issues. Institutional shareholders typically subscribe to the services of such proxy voting advisors and many rely heavily on the proxy voting guidelines, regardless of an individual company's performance or governance fundamentals. As a result, many shareholder votes are foreordained by a voting policy that is applied to all companies without reference to the particulars of a given company's situation.

Shareholder voting dynamics are being further complicated by "empty voting" arrangements, pursuant to which investors, particularly hedge funds, hold more votes than economic ownership. As a result of this de-coupling of voting power and economic ownership, the interests of these investors may not be aligned with—and, in the case of negative economic ownership, may be adverse to—the interests of the corporation's other shareholders. These arrangements are often difficult to detect, and to the extent these special interest groups are able to manipulate corporate decisions, there is no guarantee that such manipulation will benefit the corporation's broader shareholder constituency in either the short or the long term.

Executive compensation is a core responsibility of the board of directors, and crafting appropriate compensation programs is an enormously difficult task that requires a nuanced understanding of, among other things, the short-term and long-term goals that the board is trying to achieve, the competitive market for executive talent, and the personal dynamics of the management team.[18] Shareholder constraints on compensation policy can usurp the ability of the compensation committee to exercise its business judgment in determining executive compensation and should generally be resisted. Boards that lay strong foundations for their compensation program and that communicate that approach effectively to shareholders will be best positioned to maintain sensible corporate governance strategies and avoid having shareholders attempt to substitute their judgment for the judgment of the board of directors.

One executive compensation proposal that has gained traction recently is the "say on pay" proposal that calls for non-binding shareholder ratification of executive compensation. RiskMetrics Group recently reported that these "say on pay" proposals received an average level of shareholder support of 41.7 percent at 41 meetings in the first half of 2007 and received a majority vote at seven companies. In 2008, Aflac and RiskMetrics Group permitted shareholders to cast the first advisory votes on executive pay, and Blockbuster, Par Pharmaceuticals, RiskMetrics Group, and Verizon each indicated that they would permit

[18] For more on this, *see* Lawrence S. Makow and Jeremy L. Goldstein, *U.S. Bancorp Shareholders Reject Shareholder Proposal for Advisory Vote on Compensation Committee Report*, Wall Street Lawyer (July 2006) and Securities Litigation Report (July/August 2006) and Jeremy L. Goldstein, David E. Kahan and Jonathan H. Gordon, *Golden Parachute Policies: Practical and Governance Considerations*, M&A Lawyer (February 2007).

shareholders to cast advisory votes on pay at future annual meetings. "Say on pay" and other initiatives designed to increase shareholder input on executive compensation matters will continue to be central corporate governance issues in 2009.[19]

Similarly, the Laborer's International Union and the International Brotherhood of Teamsters are submitting proposals to financial institutions participating in the programs under the EESA. These proposals are designed, among other things, to limit annual incentive compensation to an amount equal to or less than one times the senior executive's annual salary; limit senior executive severance payments to one times the executive's annual salary; freeze supplemental executive retirement plan accruals for senior executives; require that a majority of long-term compensation be awarded in the form of performance-vested equity instruments; and freeze new stock option awards to senior executives, unless the options are indexed to peer group performance.

[19] President-elect Obama sponsored a 2007 Senate bill which would mandate a "say on pay" shareholder vote, and further endorsed the concept during the 2008 Presidential campaign. Consequently, legislative action in 2009 remains a significant possibility.

II

Compensation Rules, Laws and Other Relevant Authorities

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

1. 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 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) of the Code, a publicly traded company generally is 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 "covered employees," 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 "covered employees." As discussed below, the EESA has lowered the deduction limitation from $1 million to $500,000 and has eliminated the exception for performance-based compensation for participating institutions.

2. "Covered Employees" Subject to the Limitation

"Covered employees" for purposes of Section 162(m) of the Code are a company's PEO and the three other most highly compensated executive officers required to be named in the company's executive compensation disclosure under the SEC disclosure rules (other than the PFO). As such, the term "covered employee" does not include a PFO, regardless of whether the PFO is among the other three highest compensated officers for the taxable year.

While the exclusion of the PFO from Section 162(m) of the Code may be beneficial (at least for 2008) to companies whose PFOs receive compensation in excess of $1 million that does not otherwise comply with the performance-based exception of Section 162(m), the limitations of Section 162(m) generally apply to a company in the taxable year in which the compensation would otherwise be deductible, and Congress may ultimately amend the statute to provide that PFOs are covered employees. Moreover, the EESA has amended Section 162(m) for participating

financial institutions to be more stringent and to apply to PFOs (see below) and Congress has recently considered other proposed amendments to Section 162(m) which would expand the persons who would be "covered employees," and these proposals may resurface. Accordingly, even though there are only four executive officers potentially covered by Section 162(m), companies should cast a broad net when determining the executive officers who could potentially be considered "covered employees" when designing their compensation programs.

3. 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 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.

4. Section 162(m) of the Internal Revenue Code Compliance Procedures

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) of the Code, where such compliance is intended. In addition, compensation committee members should familiarize themselves with the basics of Section 162(m) of the Code 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) of the Code is accurate and should implement the proper internal controls to ensure compliance in these areas. In particular, a compensation committee should consider designating a single individual at the company as the compliance person for Section 162(m) of the Code and should consider requesting periodic

updates on Section 162(m) of the Code so that its requirements are fully understood.

5. Recent Development: Section 162(m) and Severance Provisions

On February 21, 2008, the IRS provided guidance stating that a compensation arrangement that otherwise complies with Section 162(m) of the Code will nonetheless fail to comply if it provides for payment of compensation without regard to the attainment of performance goals upon termination of an executive's employment by the employer without "cause" or by the executive with "good reason." The guidance further provides that the IRS's position will not apply to:

- performance-based compensation for which the performance period begins on or before January 1, 2009; and
- compensation payable pursuant to contracts as in effect on February 21, 2008 (without regard to renewals or extensions, whether automatic or by agreement).

This guidance provides companies with the opportunity to review the impact of the IRS's position on their compensation arrangements and contracts, and to revise them to the extent necessary for 2009, 2010 and future incentive compensation. Compensation committees should ensure that management is taking steps reasonably necessary to ensure compliance with this guidance, which will require the review of applicable compensation plans and agreements.

B. 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 a compensation committee should satisfy itself that the company is aware of and is complying with the legislation, the board of directors 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, 2008 (operational compliance already is required). Accordingly, companies must finalize any necessary amendments to their deferred compensation plans by that time.

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

1. General Rules

The NYSE and the NASDAQ rules relating to shareholder approval of equity compensation plans were approved by the SEC in 2003. The NYSE and the NASDAQ rules require listed companies to obtain shareholder approval of most equity compensation plans. A 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 the 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) of the Code (qualified pension, profit-sharing, and stock bonus plans) or Section 423 of the Code (employee stock purchase plans);
- "parallel excess plans," a narrowly defined category of excess benefit plans;
- equity grants made as a material inducement to an individual'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 acquiror at the time of acquisition, of shares remaining under a target 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 the NASDAQ in determining whether the transaction must receive shareholder approval as an issuance of 20% or more of the company's outstanding common stock).

2. Material Revisions

The NYSE and the 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 individuals 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
- a 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, a 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.

D. Compensation-Related Provisions of the EESA

In the fall of 2008, the U.S. Department of the Treasury ("Treasury") issued interim rules and guidance for the executive compensation provisions of the Capital Purchase Program ("CPP") under the EESA. The following discussion summarizes the limitations on executive compensation applicable to institutions participating in the CPP, sets forth some thoughts about executive compensation provisions the Treasury has included in the required CPP documentation, and outlines certain of the executive compensation action items for companies considering participation in the CPP.

General Overview. The five senior executive officers (" SEOs") of institutions participating in the CPP are subject to the following limits on compensation under Section 111(b) of EESA for as long as the Treasury holds securities issued under the CPP:

- a prohibition on incentive compensation arrangements that involve unnecessary and excessive risks that threaten the value of the financial institution;

- a recovery or "clawback" of any bonus incentive compensation paid during the period the Treasury holds securities based on financial statements or other criteria that prove to be materially inaccurate; and

- a prohibition on making "golden parachute payments" (as defined under new Section 280G(e) of the Code) upon certain terminations of employment.

Additionally, the interim rules condition participation in the CPP on the participating institution agreeing that SEO compensation (without exception for performance-based compensation) will not be deductible under the new Section 162(m)(5) of the Code included in the EESA.

The CPP form of securities purchase agreement contains closing conditions that are intended to ensure compliance with the applicable compensation provisions under the EESA, including a requirement that SEOs sign a waiver of claims against the Treasury and the company with respect to the compensation restrictions imposed under the CPP. Prior to submitting an application for participation in the CPP, a company and its SEOs should understand who their SEOs are and how participation in the CPP will impact the SEOs' compensation arrangements, in particular the limitations on termination payments. An assessment of the potential consequences of participation will require a review of the company's incentive compensation arrangements and the plans and agreements that provide for payments or other enhanced benefits (including vesting rights) upon an "applicable severance of employment" within the meaning of the CPP regulations (as described below). As a practical matter, however, the true impact of the golden parachute prohibition under the EESA and the CPP will require an annual calculation of the amounts payable on account of an involuntary severance from employment, since only the payments that exceed that parachute safe harbor are prohibited.

Identification of the Senior Executive Officers. For purposes of the EESA, including the CPP, a SEO is a person who:

- is employed by a participating company during the period of the Treasury's investment; and

- is (1) either the principal executive officer or the principal financial officer of such financial institution or (2) one of the three most highly compensation executive officers of such financial institution other than the principal executive officer or principal financial officer.

The three highest compensated officers are determined in accordance with the SEC's proxy disclosure rules, although there is some ambiguity under the interim rules as to whether they are determined based on compensation for the then-current year or the prior year. It is clear, however, that an executive officer cannot be an SEO if he or she has terminated employment prior to the date that the Treasury makes its investment.

Excessive Risk Taking. The interim rules require a participating institution's compensation committee to take three steps with respect to the EESA's prohibition on providing incentive compensation that involves excessive risk taking.

- First, promptly after a purchase by the Treasury under EESA, and in no case more than 90 days after such a purchase, the institution's compensation committee must review SEO incentive compensation arrangements with the institution's senior risk officers to ensure that the arrangements do not encourage SEOs to take unnecessary or excessive risks that threaten the value of the financial institutions.

- Second, after the initial review, the compensation committee must meet annually with senior risk officers to discuss and review the relationship between the financial institution's risk management policies and practices and SEO compensation arrangements. With respect to both the initial and annual reviews required by EESA, however, the interim rules expressly recognize that each financial institution "faces different material risks given the unique nature of its business," and hence requires only that committees identify, and limit, the features in the institution's SEO incentive compensation arrangements that could lead a SEO to take risks that are unnecessary or excessive.

- Finally, the compensation committee must certify that it has completed these reviews and that the committee has made reasonable efforts to ensure that SEO incentive compensation arrangements are appropriately designed to avoid unnecessary and excessive risk taking. The interim rules direct financial institutions that are public companies to include this certification in the CD&A included in the company's annual proxy statement. As a result, the certification will likely be subject to the liability provisions of the Exchange Act and the CEO/CFO certification requirements under Sarbanes Oxley. The interim rules instruct a private company participating in the CPP to provide the certification to its primary regulator.

Although the regulations set forth relatively detailed procedural requirements for compensation committees seeking to comply with EESA, they offer important flexibility with respect to how committees may discharge those obligations based on the particular institution's risk profile. Compensation committees at participating institutions should therefore consider the appropriate approach to EESA compliance in view of the institution's business needs. For example, if SEOs are precluded from participating in an incentive compensation arrangement based on the compensation committee's evaluation of the compensation arrangement's risk profile and the exclusion from participation results in a meaningful

lost compensation opportunity, companies may wish to consider redesigning such compensation plan or providing an alternative compensation arrangement that is determined not to involve excessive risk.

Incentive Compensation Clawbacks. EESA requires that participating financial institutions provide for the recovery of bonus or incentive compensation paid to an SEO based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate. The interim rules clarify that a financial institution participating in the CPP must require that SEO bonus and incentive compensation *paid* during the period of the Treasury's investment be subject to recovery (or "clawback") by the financial institution if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria. While the interim rules do not provide detail on the meaning of "inaccurate performance metric criteria," the rule appears intended to encompass compensation paid as a result of achievement of a performance metric that is later determined to have been based on materially inaccurate information.

Unlike the clawback under Sarbanes Oxley, the EESA clawback provisions do not require that "misconduct" cause the inaccurate results. In addition, the interim rules under the CPP specifically note that the clawback requirements are not triggered solely by an accounting restatement, are not limited to a specific recovery period and are not limited to material inaccuracies related to financial reporting.

Prohibitions on Golden Parachute Payments. Financial institutions participating in the CPP may not make "golden parachute payments" to an SEO during the period of the Treasury's investment in the institution, and the EESA prohibits any new employment contract with an SEO that provides a "golden parachute payment" if a financial institution sells any troubled assets to the Treasury through auction and the aggregate amount of auction and direct purchases by the Treasury exceeds $300 million. For purposes of the CPP, a "golden parachute payment" is defined under new Section 280G(e) of the Code added by the EESA, and means a compensatory payment in connection with an SEO's "applicable severance from employment" to the extent such payment exceeds three times the SEO's average taxable compensation for the five years preceding the year of termination.

A "golden parachute payment" for this purpose is a payment that would not have been made absent the applicable severance from employment, including amounts that would have been forfeited if the termination had not occurred and amounts that are accelerated due to the termination of employment. Fully vested retirement benefits and deferred compensation that would be payable upon a voluntary termination of employment are not considered golden parachute payments. The rules applicable under pre-EESA Section 280G of the Code (the change-in-control parachute rules with which most financial institutions are familiar) generally are used to determine the value of "golden parachute payments" for purposes of new Section 280G(e) of the Code. although the interim

regulations on new Section 280G of the Code eliminate many of the exclusions under pre-EESA Section 280G of the Code typically relied upon to reduce the amounts that are considered parachute payments.

The CPP interim rules define an "applicable severance from employment" as a termination from employment by reason of involuntary termination or in connection with any bankruptcy filing, insolvency or receivership of the financial institution. The rules provide that an "involuntary termination" is a termination due to the independent exercise of the employer's unilateral authority to terminate the SEO's services, other than due to the SEO's request, where the executive was willing and able to continue performing services. The guidance specifically provides that an involuntary termination may include the following:

- an executive's resignation under circumstances in which the executive knew that the employer would have terminated his or her employment absent resignation;

- a failure by the employer to renew an expiring contract, despite an executive's willingness to continue to provide services on substantially similar terms; and

- an executive's termination for good reason due to a material negative change in the employment relationship.

Application of Amended Section 162(m) of the Code. The EESA amends Section 162(m) of the Code to limit the deductibility of compensation earned by "covered executives" (*i.e.*, the CEO, CFO and the three other most highly compensated executive officers of public and private financial institutions that sell any troubled assets to the Treasury through an auction if the aggregate amount of auction and direct purchases by the Treasury exceeds $300 million) to $500,000 per year per executive, without exception for performance-based compensation. For purposes of the amendments, "applicable taxable year" means any taxable year during which (1) the Secretary has authority under the EESA (generally through December 31, 2009, but subject to extension until as late as October 3, 2010) *and* (2) the aggregate amount of troubled assets acquired at any time from such financial institution exceeds $300 million.

The interim rules under the CPP require institutions participating in the CPP to agree to the application of the $500,000 deduction limit, even though under the EESA this provision only applies to participants in the auction purchase program. The applicable tax guidance clarifies that compensation subject to the new $500,000 deduction limit must be attributable to services rendered during an "applicable taxable year." Thus, compensation vested in a year before the financial institution's participation in the CPP but payable during a year that the financial institution participates in the CPP will not be subject to the new limit on deductibility.

Executive Compensation Provisions of the CPP Securities Purchase Agreement. In connection with investments under the CPP, the

Treasury has required participating financial institutions to execute a securities purchase agreement that includes additional restrictions on executive compensation. The standard CPP securities purchase agreement contains closing conditions relating to compensation matters, including the delivery of: (1) a waiver by each SEO of claims the executive may have against the government or the company due to the application of compensation restrictions under the CPP, and (2) an officer's certificate certifying that the amendments to compensation and benefit plans and agreements applicable to SEOs necessary to comply with the applicable provisions of the EESA have been made. The standard securities purchase agreement also includes a post-closing covenant that obligates a participating company to operate its plans and agreements with respect to its SEOs in a manner that complies with EESA and the interim rules, and prohibits the company from adopting plans or agreements that do not comply with these measures.

In order to satisfy the plan amendment closing condition imposed by the securities purchase agreement under the CPP, boards of directors or compensation committees of participating institutions should adopt omnibus resolutions amending all implicated plans solely to the extent necessary to comply with the executive compensation provisions applicable to SEOs under EESA and the CPP interim rules. Resolutions may include enabling language authorizing the company's officers to implement the omnibus resolutions, so that a company can adopt more targeted amendments once it has had an opportunity to review all of its arrangements in light of all the applicable Treasury regulations.

In connection with submitting an application for participation in the CPP, a company should confirm that its SEOs understand that they will be required to execute waivers of claims the officers may have due to the application of compensation restrictions under the EESA and CPP. In addition, since the amendments to compensatory plans and agreements needed to comply with the EESA may require the consent of SEOs in order to be legally enforceable, institutions will likely need their SEOs to execute a consent agreeing to such amendments. While these consents should broadly cover implicated arrangements applicable to SEOs, the restrictions imposed should be limited to those necessary to comply with the requirements of the CPP.

Application to M&A Transactions. The interim rules under the CPP provide that the acquisition by an unrelated entity (the acquirer) of a financial institution (target) that has participated in the CPP does not result in the acquirer becoming subject to the executive compensation restrictions of the EESA merely as a result of the acquisition. With respect to the target, any employees of the target who are SEOs prior to the acquisition will be subject to the limitation on golden parachute payments until after the first anniversary following the acquisition.

The guidance Treasury provided in the fall of 2008 answers many of the questions raised by the executive compensation provisions of the EESA. While open issues remain, the guidance is generally informative enough for a financial institution and its SEOs to evaluate the implications

of participation in the CPP. The limitations on executive compensation in the EESA and CPP should not deter financial institutions that could benefit from additional capital from participating in the CPP. Participating institutions that respond swiftly to these new developments and adapt their existing compensation arrangements accordingly can enhance their ability to operate effectively in the changing environment in 2009.

III

Fiduciary Duties of Compensation Committee Members

A. Fiduciary Duties Generally

Decisions by members of compensation committees with respect to executive compensation generally are 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.

1. 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 of directors has not met its duty of care or loyalty.[22]

a. Duty of Care

To show that a board of directors 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

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[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 company may in its certificate of incorporation either eliminate or limit the personal liability of a director to the company or its shareholders 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 company and its shareholders or (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Many Delaware corporation either have 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.

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.

b. Duty of Loyalty

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

2. 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 of directors' process and its action. That said, a compensation arrangement will not be subjected to enhanced scrutiny merely because a board of directors adopts a compensation arrangement in the face of a takeover threat; in order for enhanced scrutiny to apply, a board of directors must have entered into the compensation arrangement

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[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 of directors after a consent solicitation had begun, designed to thwart the dissident shareholder's goal of obtaining majority representation on the board of directors, violated the board of directors' fiduciary duty).

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

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]

- a board of directors 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

- a board of directors 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 a board of directors 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 a board of directors' process and actions.[31] Therefore, we recommend that a company adopt change-in-control employment arrangements in advance of an actual or threatened takeover.[32]

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[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).

[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 company'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).

3. 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 shareholders.[33] Such conflicts may arise in situations where 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 company and its shareholders.[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:

> 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 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 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

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[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*).

[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 of directors 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] *See, e.g.*, *Tate & Lyle PLC*, *supra*, at *20-22 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

compensation be delegated to a company's corporate governance and nominating committee, subject to the approval of the entire board of directors.

B. Duty of "Good Faith"

In the landmark *Disney* case,[39] shareholders filed suit alleging that the board of directors 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 Delaware Chancery court ultimately exonerated the board of directors, 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 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 an appropriate measure for determining that a director has acted in good faith is whether there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities." 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 company," (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* decision 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 of directors 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

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[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.

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

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]

C. The Employee Retirement Income Security Act 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 imposed from the beginning a comprehensive set of requirements for many 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 that 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 company 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

[41] *Id*. at *2.

come into conflict with the individual's duty under the Federal securities laws 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 directors and executives in recent years. Major corporate transactions also can 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 of directors, serve as ERISA fiduciaries. In such cases, however, the responsibility to appoint those fiduciaries often remains with the full board of directors 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).

IV

Methods of Compensation

A. 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 company—not to guarantee a certain level of performance.

In this volatile economic and financial environment, many companies will find that they have not achieved pre-established performance goals. Some compensation committees will struggle with whether to pay bonuses in excess of the amount yielded by pre-existing goals in order to retain key executives. Paying annual bonuses to senior executives when pre-established performance goals have not been met falls within a committee's business judgment and may in some circumstances be advisable in order to retain senior talent. Directors should, however, be aware that payment of discretionary bonuses may result in adverse consequences under Section 162(m) of the Code and may need to be disclosed on a Form 8-K. In addition, companies will need to describe the rationale for paying discretionary bonuses in the proxy statement's CD&A and will need to reconcile this disclosure with any prior disclosure regarding payment of non-deductible compensation.

Similarly, in the current environment, some companies will find that their employees hold a substantial number of underwater options and equity awards with significantly lower value than was targeted at grant. In light of the difficulties involved in repricing and restructuring existing awards, including the need for shareholder approval of repricings, many compensation committees have focused on the current grant season as an opportunity to re-align incentives. The appropriate mix of incentives to achieve this re-alignment will be different for every company.

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, a 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. A 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 shareholder activists.

B. Equity Compensation

The manner in which most companies will provide executives with future equity compensation remains unsettled. Mega-grants of stock options came under fire earlier in the decade, as institutional investors and the media perceived large stock 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, the executive compensation disclosure rules and issues that arose out of highly publicized instances of option misdating may have a chilling effect on the use of stock 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 stock options need to be weighed against the limitations imposed on the flexibility of such awards under Section 409A of the Code and the satisfaction of the performance based award requirements of Section 162(m) of the Code when using full value awards. These developments, along with the SEC disclosure 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, set

forth below are the material economic characteristics of various types of equity compensation awards.

1. Stock Options

Stock 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 stock options typically is 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 stock options).

The benefits and drawbacks to granting stock options are as follows:

Benefits	***Drawbacks***
• Generally deductible under Section 162(m) of the Code without the need to establish additional performance goals if strike price is equal to or greater than fair market value on grant date. • Generally not subject to Section 409A of the Code if strike price is equal to or greater than fair market value on grant date, it is based on "service recipient" stock and there is not otherwise any deferral feature. • Because stock options are not considered outstanding shares until exercised, they are not counted in the denominator for calculating earnings per share.	• An accounting 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 stock 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 stock options results in an increase of so-called "over-hang," which ultimately can result in dilution

- 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 stock options may increase management's incentive to take on risks, which may be considered advantageous for diversified investors.[43]

of existing shareholders if the stock options are exercised. We note that institutional shareholders often measure dilution based on outstanding stock options or even reserved option shares.

- The accelerated Form 4 reporting requirements under Sarbanes Oxley have resulted in the implementation of more stringent preclearance procedures for exercises and sales by executive officers.
- In a falling stock market, underwater stock options may lose 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.

2. Stock Appreciation Rights

SARs provide employees 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.

[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.

The benefits and drawbacks of granting SARs generally are the same as granting stock options, except:

Benefits	***Drawbacks***
• SARs that may be settled only in cash are not equity compensation under the NYSE and the NASDAQ rules. Accordingly, no shareholder approval under such rules is required with respect to plans under which only these awards may be granted. • Like stock options, SARs generally are subject to Section 409A of the Code if the strike price is equal to or greater than 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 broker-assisted cashless exercise, potentially in violation of Section 402 of Sarbanes Oxley. • 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.

3. 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 stock options. • Restricted shareholders can receive dividends. • The ability of employees to make a Section 83(b) election may enable an employee to achieve a favorable tax result if the value of the restricted stock appreciates during the vesting period. • Restricted stock generally is not subject to Section 409A of the Code. • Restricted shareholders 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 stock options in a down market.	• Employees still will 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) of the Code unless its grant or vesting is performance-based.

4. Restricted Stock Units

RSUs consist of awards in the form of phantom shares or units, which generally are 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 of the Code and merely represent a general unsecured promise to pay a future amount, an 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. • No administrative burden with respect to stock certificates until shares are paid. • RSUs that can be settled only in cash are not equity compensation under the NYSE and the NASDAQ rules. Accordingly, no shareholder approval is required with respect to RSUs under such rules. • RSUs settled in cash instead of stock will not result in shareholder dilution. • RSUs are reportable on the proxy statement beneficial ownership table if they must be settled in stock or may be settled in stock at the holder's election, so that if the holder were currently terminated he or she would get the underlying stock without the need to satisfy any additional vesting requirements. • Because RSUs are not property (making Section 83(b) election unavailable), companies do not have	• 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. • Because RSUs are not property, grantees cannot make a Section 83(b) election. • RSUs settled in cash instead of stock result in a cash outlay. • RSUs are included in the denominator for computing diluted earnings per share. • 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) of the Code unless its grant or vesting is performance-based or the receipt of income from the award is deferred until the executive is no longer subject to Section 162(m) of the Code. • 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). • RSUs may be subject to Section 409A, depending on their terms.

the difficulty of administering Section 83(b) elections for broad employee populations.

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

6. Perquisites

No perquisites should be provided to executive officers without full disclosure to the compensation committee. Any compensation or other benefit received by any officer from any affiliated entities (using a low threshold for the definition of an affiliated entity) should be 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

[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).

affiliated should be carefully scrutinized to make sure that they do not create any potential appearance of impropriety.

General Electric Co's ("GE") 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. Recently, some companies have modified perquisite programs by increasing annual base salaries and eliminating perks, by limiting the aggregate value of perquisites to less than the disclosure threshold and/or by entering into arrangements whereby the company is reimbursed by the executives for perks that the company provides.

V

Change-in-Control Compensation Arrangements

A. 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-in-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-in-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, RiskMetrics states that "parachutes tend to result in higher takeover bids, which lead to greater returns for shareholders."

Appropriately structured change-in-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.

B. Legality

Ideally the implementation of or adoption of amendments to change-of-control protections should be done in advance of an actual or threatened transaction. The case law relating to the adoption of change-of-control agreements and other benefit protections and the timing of their adoption is not extensive. Those courts that have addressed the issue have almost universally found such arrangements to be enforceable and consistent with directors' fiduciary duties so long as such directors do not have a conflict of interest.[45] A board of directors' decision to adopt

[45] *See, e.g., Campbell* v. *Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 800 (6th Cir. 2001) (holding such agreements "well within the confines [of] the business judgment rule"); *International Ins. Co.* v. *Johns*, 874 F.2d 1447, 1461 (11th Cir. 1989) (business judgment deference applies to evaluation of change-in-control agreements where agreements were approved by a disinterested board). *See also Hanrahan* v. *Kruidenier*, 473 N.W. 2d 184, 188-89 (Iowa 1991) (employing closer scrutiny and concluding, "emphatically," that the challenged "program was fair and reasonable").

change-in-control provisions usually is 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.

C. Arrangements

1. Change-in-Control Employment Agreements

Companies should consider adoption of reasonable change-in-control protections for senior management. Typically, these will include a change-in-control severance or employment agreement. A change-in-control employment agreement will often become effective only upon a change in control or in the event of a termination of employment in anticipation of a change in control. A standard form of agreement usually provides for a three-year term after the change in 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 and the executive resigns 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-in-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 company. 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 years preceding the year in which the change in control occurs). In such a case, the excess parachute payments are equal to the excess of (1) such aggregate change-in-control payments over (2) the greater of the employee's base amount or the amount of such change-in-control payments that 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;

[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.*

- payments that are contingent on a change in 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 in 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 a "gross-up" provision for reasons of equity. In light 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, agreements often provide that no gross-up will be paid unless total payments exceed 110% of the executive's safe harbor.

2. Options and Stock-Based Compensation Plans

In addition to employment agreements, companies should review the status of their stock-based compensation plans for change-in-control provisions. Plans often contain provisions for acceleration of stock options, lapse of restrictions on restricted stock and deemed achievement of performance goals on performance stock awards upon a change in control. Stock plans also often provide an extended post-termination exercise period for stock options and SARs upon terminations of employment following a change in control (*e.g.*, the lesser of three years or the remainder of the original term). Since these provisions may result in parachute payments, plan amendments should be considered and implemented in the context of an overall review of change-in-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 of directors is delivering to the acquiror an intact management team.

3. Separation Plans

In addition to change-in-control employment agreements with senior executives, many public companies have adopted change-in-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 layoff occurring within one or two years after a change in control. These plans generally provide for severance benefits determined on the basis of seniority/position, pay and years of service or some combination of these factors, and may provide continuation of benefits with the company paying all or a portion of the expense and outplacement services.

Severance usually is 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 of the Code 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.

4. Deferred Compensation Plans

Despite Congressional and public debate about the abuses associated with deferred compensation arrangements and the enactment of 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 Section 409A of the Code provides 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 often is the case that plans provide for, or participants elect, an immediate lump-sum payment of the entire account balance upon a change in control without regard to prior elections as to timing and method of distribution. Any such election should be reviewed to ensure that it complies with Section 409A of the Code.

VI

Compensation Committee Membership

In enlisting qualified directors to sit as members on a 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.

A. 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 on the board of directors.

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

[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).

- 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 personally works on the company's audit;

- 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;

- 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 that, in any of the last three fiscal

[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.

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 12-month period within the last three years more than $120,000 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* that such compensation is not contingent in any way on continued service) and 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 $120,000 during any 12-month period within the last three years (other than director or committee fees, benefits under qualified retirement plans, or nondiscretionary compensation and payments

[51] The NASDAQ rules exclude from the calculation payments arising solely from investments in the company's securities and payments under nondiscretionary charitable contribution matching programs.

[52] The NYSE rules focus on direct compensation. Consequently, investment income from the company (such as dividend or interest income) would not count toward the $120,000 threshold. In addition, the NYSE's focus on "direct" compensation means that *bona fide* and documented reimbursement of expenses also may be excluded. Note, however, that the NYSE considers payments to a director's solely owned business entity to be direct compensation.

[53] The NYSE rules also permit companies to exclude from the $120,000 threshold compensation received by a director for former service as an interim executive officer of the company.

[54] Unlike the NYSE rules, the NASDAQ rules are not limited to direct compensation. Accordingly, even indirect compensation must be included in the calculation of the $120,000 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 $120,000 threshold.

received by an immediate family member for service as a non-executive employee).[55]

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, a board of directors still is 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 also must be publicly disclosed in the company's annual report or proxy statement. The NYSE rules also provide that the board of directors 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 of directors adopts. Any determination of independence for a director who does not meet such standards must be specifically explained. In addition, under the 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 a board of directors 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 ordinarily could be entrusted to it had it been fully independent. Specifically, if a 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 of directors, under exceptional and limited circumstances, determines that such individual's membership on the compensation committee is required by the best interests of the company and its shareholders. If the board of directors 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 the NASDAQ need only one independent member of the compensation committee at the time of the company's initial public offering, a majority of independent

[55] The NASDAQ rules also permit 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.

members within 90 days of listing[56] and a fully independent committee within one year of listing.

B. Internal Revenue Code Section 162(m) Membership Requirements

As more fully discussed in Chapter 2 of this Guide, compensation paid to a company's CEO and the three other highest paid executive officers (other than the CFO) 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; or

- 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.

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

[56] 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 of directors.

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 company, 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 company, 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 company that previously was an affiliated company of the company.

C. Membership Requirements for the Short-Swing Profit Exemption of Rule 16b-3 Under 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 company for any profits resulting from his or her purchase and sale of the company's equity securities within any period of less than six months. 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 be considered a "non-exempt" purchase for this purpose and subject the officer to liability for short-swing profits. In an effort to address this issue, the SEC adopted Rule 16b-3 of the Exchange Act, 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."

1. Non-Employee Director

Under Rule 16b-3 of the Exchange Act, 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.

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 (1) the company is a participant, (2) the amount involved exceeds $120,000 and (3) any "related person" had or will have a direct or indirect material interest. Under the disclosure 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 SEC disclosure 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 of the Exchange Act if the transaction was terminated prior to the director's proposed service as a non-employee director.

2. 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) of the Code and Rule 16b-3 of the Exchange Act. 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) of the Code and/or Rule 16b-3 of the Exchange Act is still possible. As long as a 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) of the Code and/or Rule 16b-3 of the Exchange Act to such subcommittee. Compliance with Section 162(m) of the Code also might 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) of the Code.

3. Ensuring Independence under State Law

Transactions between a company 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 a company 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 in certain relatively recent decisions 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 generally is understood as requiring only economic independence based on a facts-and-circumstances analysis. In one opinion, the Delaware Supreme Court, addressing the independence of certain directors of Martha Stewart Living Omnimedia, Inc.,[57] specifically addressed the persuasiveness of arguments that social connections and personal friendships can result in disqualification from a finding of independence. In deciding *Martha Stewart*, 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 of directors impede independent decision-making.

No doubt, each case of alleged directorial conflict of interest is different. Nonetheless, the *Martha Stewart* 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 or her child's wedding) unless there is real evidence to the contrary. The concept of the board of directors 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 a company, 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.

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

VII

Compensation Committee Meetings

A. Meetings and Agenda

A 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. A compensation committee should schedule at least one of its meetings before the company's annual report and proxy statement are filed to discuss the proposed compensation-related disclosures. The number of meetings a compensation committee should hold per year 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 of director meetings, should be sufficiently long to allot adequate time to carry out the duties of the compensation committee. Compensation committees should consider scheduling their meetings for the day before full board of director meetings, to permit adequate time to consider and discuss agenda items.

A 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, a compensation committee should have access to management as it deems appropriate.

A compensation committee should be active in setting its agendas for the year as well as for each compensation committee meeting. While management rather than the board of directors 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 compensation committee meetings and annual agendas should reflect an appropriate division of labor and should be distributed to the compensation committee members in advance.

B. Quorum Requirements

For a compensation committee to conduct official business at a compensation committee meeting, a quorum of its members must be legally present. Unless otherwise restricted in a company's charter, most states consider a director who participates via telephone or video conference to be legally present (as long as all those present at the compensation meeting can hear and speak to each other). A company's bylaws or a board of director 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 a compensation committee is a majority of its members.[58] 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 of directors and the committees on which such director served.

Actions undertaken by a compensation 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) compensation committee meeting notices should be sent sufficiently in advance of a compensation committee meeting and responses promptly reviewed and (2) the chairman of the compensation committee should consult with the corporate secretary in advance of the compensation committee meeting. In the event a compensation committee meeting takes place without a quorum, it should be noted in the minutes.

C. Minutes

Compensation committees typically prepare minutes of compensation committee meetings, but not of their executive sessions. It is common and prudent practice for such minutes to identify the topics discussed at compensation committee 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 also should indicate which directors attended, whether they attended in person or via telephone or video conference, and whether individuals other than the compensation committee members were present.

A compensation committee should approve the minutes at the compensation committee meeting following the compensation committee meeting regarding which the minutes were prepared. The minutes should be attached to the agenda for the next compensation committee meeting and circulated in advance so that the compensation committee members have time to review them before they are approved. If the minutes have not been attached and adequately reviewed before the next compensation committee meeting, it may be advisable for the corporate secretary to read

[58] 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 generally is a majority of its members, the same holds true for a board committee, such as the compensation committee.

the minutes to compensation committee members before approval to ensure that the members are aware of the actions that were taken at the last compensation committee meeting and approve of their characterization in the minutes. Unless otherwise required by state statute or a 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.

A compensation committee should consider providing a report or a copy of the minutes of each compensation committee 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 meetings.

D. 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 of director 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.[59] A 2005 Delaware Supreme Court order[60] in remanding a lower court decision allowing a company to demand confidential treatment before divulging sensitive information to dissident shareholders, 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 a shareholder's

[59] 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 Global Opportunities Master Fund) demanded access to West Corporation's books and records after West Corporation announced its intention to undertake a going-private transaction. In denying Polygon Global Opportunities Master Fund'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 obtain that discovery in advance of the appraisal action itself" and Polygon Global Opportunities Master Fund's desire to investigate alleged board of director misconduct cannot be a proper purpose because Polygon Global Opportunities Master Fund would not have standing to pursue any claims (given that it purchased shares in West only after the announcement of the transaction).

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

communication interest and establish that the confidentiality interest "outweighed" the shareholder's interest.[61]

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 minutes are carefully and thoughtfully drafted so that an ambiguous litigation record is not created.

E. Access to Outside Advisors

In order to enable a compensation committee to deal with any special problems that may arise in the course of performing its duties, a compensation committee should be granted the authority to engage compensation consultants where appropriate. The NYSE rules provide that the charter of a compensation committee should give the compensation 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 compensation committee and management when considering issues of executive compensation may raise issues. Such an approach can give rise to inefficiencies in compensation discussions, put a board of directors in the awkward position of receiving conflicting advice, create a bad record if litigation subsequently arises, and, perhaps most importantly, create an adversarial relationship between management and the board. While 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, the use of such consultants is not legally required, and a consultant's judgment should not be viewed as a substitute for a board of directors' exercise of judgment after careful and informed deliberation. As a matter of good corporate governance, compensation committees should understand the nature and scope of services that consulting firms and their affiliates provide to the company in order to evaluate any actual or perceived conflicts of interests.

F. Compensation Committee Chairman

While each member of a compensation committee contributes to its effectiveness, the compensation committee chairman has a special role. The compensation committee chairman is responsible for ensuring that compensation committee meetings run efficiently and that each agenda

[61] 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 shareholder'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, still will be available.

item receives the appropriate level of attention. The compensation committee chairman is also often the key contact between the compensation committee and other directors and senior management.

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

VIII

Compensation Committee Charters

Under the SEC executive compensation disclosure rules, a public company must disclose whether or not it has adopted a compensation committee charter, and any such compensation committee charter must be made publicly available on the company's website or 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 that must include specified provisions. In light of this, the compensation committee of a publicly held company should have a compensation committee charter that complies with applicable regulations and securities market requirements and addresses key responsibilities vested in it by the board of directors. That being said, any such compensation committee charter should not over-engineer the operation of the compensation committee. If a compensation committee charter requires review or other action and the board of directors or compensation committee has not taken that action, the failure can be considered evidence of lack of due care. The creation of compensation committee charters is an art that requires experience and careful thought; it is a mistake to copy blindly the published models.

Each company therefore should tailor its own compensation committee charter to address the company's particular needs and circumstances, limiting the charter 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 a company have everything other companies have. A compensation committee 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.

A. NYSE-Listed Companies Charter Requirements

The compensation committee of a company listed on the NYSE must have a written compensation committee charter that, at a minimum, contains the required provisions specified by the NYSE listing standards.[62] The compensation committee charter must be approved and adopted by the board of directors and should provide:

- A description of the compensation committee's purpose. In this regard, the compensation committee charter should indicate that the compensation committee is appointed by the board of directors in order to discharge the responsibilities of the board of directors relating to compensation of the company's CEO as well as the other executive officers. In addition, as applicable, it should

[62] 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.

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, 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 also should 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 of directors the CD&A's inclusion in the company's proxy statement and annual report on Form 10-K.

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

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

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

- How compensation committee members are appointed.

- How compensation committee members may be removed.

- The qualifications for compensation committee membership.

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

- The procedures for compensation committee reporting to the board of directors.

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

It also may 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 compensation committee will receive periodic reports on the company's compensation programs as they affect all employees.

- That the compensation committee will review and approve any special or supplemental compensation and benefits for the CEO and other senior executives and individuals 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 compensation committee will review and reassess the adequacy of the compensation committee charter annually and recommend any proposed changes to the board of directors for approval.

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

Exhibit A to this Guide is a model compensation committee charter for NYSE-listed companies. This compensation committee 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 address their particular needs and circumstances.

B. 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 compensation committee charter. Nonetheless, in accordance with best practice and for practical application of a compensation committee's functions, a compensation committee of a NASDAQ-listed company should have a written compensation committee 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, a board of directors, 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.

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

IX

Director Compensation, Indemnification and D&O Insurance

A. Director Compensation

Director compensation is one of the more difficult issues on the corporate governance agenda and is 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 of this Guide, the SEC's executive compensation rules now require formatted tabular disclosure of all director compensation. The required disclosure is comparable to the extensive disclosure that is required for executive officer compensation in the SCT, except that only information concerning the last fiscal year needs to be disclosed. In addition, as described in Chapter 1 of this Guide, narrative disclosure of a company's processes and procedures for the consideration and determination of director compensation must be provided. These 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 of directors, such as the compensation committee or the governance and nominating committee, or the full board of directors. As discussed in Chapter 3 of this Guide, when directors who would directly benefit from 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.[63] In light of this, we generally recommend that the responsibility for adopting director compensation be delegated to a company's corporate governance and nominating committee, subject to the approval of the entire board of directors. 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

[63] *See, e.g.*, *Tate & Lyle PLC*, *supra*, at *20-22 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

also should 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.[64]

A compensation committee (or other responsible board of director 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 is a trend 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 stock option grants, because restricted stock grants will align director and shareholder interests more directly and avoid the perception that directors are supporting more aggressive risk taking on the part of management in order to maximize director option values.

Perquisite programs and company charitable donations to any organizations with which a director is affiliated also should 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 considered carefully and disclosed fully. Note that, under Section 301 of Sarbanes Oxley, the receipt of any consulting, advisory or other compensatory fee from a company other than in the capacity of a director or committee member will disqualify a director for service on the audit committee.

B. 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 also can 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 General Corporation Law and similar statutes in other states.

Directors and Officers ("D&O") insurance 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

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

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 also should 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.

EXHIBIT A

COMPENSATION COMMITTEE CHARTER[65]
(NYSE-Listed Company)

Purpose

The Compensation Committee (the "Committee") is appointed by the Board of Directors (the "Board") to discharge the Board's responsibilities relating to compensation of **[Name of Company]** (the "Company") Chief Executive Officer (the "CEO") and the Company's other executive officers (collectively, 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.[66]

Compensation Committee Membership

The Committee shall consist of no fewer than three members. The members of the Committee shall meet the independence requirements of the New York Stock Exchange (the "NYSE"). At least two members of the Committee also shall 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 Exchange Act of 1934, as amended.[67]

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[65] A compensation committee charter must be adopted by the board of directors.

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

[67] Only two members need conform to the membership requirements of Internal Revenue Code § 162(m) and/or Rule 16b-3 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") 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 Internal Revenue Code § 162(m) is only necessary to the extent that the board of directors 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 membership requirements of Rule 16b-3 of the "Exchange Act is not the only means available to the board of directors to ensure that grants or awards to company officers fall

(footnote continued)

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

Meetings

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the 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 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 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 Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers.

3. The 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 individuals who formerly served as

(footnote continued)

within the Rule 16b-3 short-swing profit safe harbor from Exchange Act § 16(b) liability. The safe harbor also is 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.

Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

4. The 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.

5. The 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.

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

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

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

9. The Committee shall annually review its own performance.

10. 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.[68]

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

[68] Unlike the Audit Committee, neither the SEC nor the NYSE requires that the compensation 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 of directors may determine that it is in the best interests of the Company to provide the compensation committee with such authority.

EXHIBIT B

COMPENSATION COMMITTEE CHARTER[69]
(NASDAQ-Listed Company)

Purpose

The Compensation Committee (the "Committee") is appointed by the Board of Directors (the "Board") to discharge the Board's responsibilities relating to compensation of **[Name of Company]** (the "Company") Chief Executive Officer (the "CEO") and the Company's other executive officers (collectively, 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 Committee shall consist of no fewer than three members. The members of the Committee shall meet the independence requirements of the NASDAQ Stock Market.

At least two members of the Committee also shall 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 Exchange Act of 1934, as amended.[70]

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[69] A compensation committee charter must be adopted by the board of directors.

[70] Only two members need conform to the membership requirements of Internal Revenue Code § 162(m) and/or Rule 16b-3 of the Securities Exchange Act of 1934 (the "Exchange Act"), as amended 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 Internal Revenue Code § 162(m) is only necessary to the extent that the board of directors 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 membership requirements of Exchange Act Rule 16b-3 is not the only means available to the board of directors to ensure that grants or awards to company officers fall within the Rule 16b-3 short-swing profit safe harbor from Exchange Act § 16(b) liability. The safe harbor also is 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

(footnote continued)

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

Meetings

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the 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 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 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 individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

3. The 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.

(footnote continued)

majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

4. The 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 Committee shall monitor the Company's compliance with the requirements under the Sarbanes-Oxley Act of 2002 relating to 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 rules that, with limited exceptions, shareholders approve equity compensation plans.

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

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

9. The 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]

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

[71] 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 of directors 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 compensation committee be provided with the authority to obtain advice and assistance from internal or external legal, accounting or other advisors. However, the board of directors 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.

EXHIBIT C

TALLY SHEET

Name

ANNUAL COMPENSATION

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 COMPENSATION

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.