[This issue has been updated to reflect events and developments that have transpired over the past year.]

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HIGHLIGHTS AND PITFALLS

The New Compensation Committee Responsibilities
A Roadmap For Meeting The New Standards And Avoiding Personal Liability

We have become increasingly concerned that directors—and those of us who counsel issuers—are not fully appreciating the potential exposure that many compensation committee members now face. Therefore, we are devoting this entire issue of *The Corporate Counsel* to (1) examining the new potential exposure for directors and senior management as well as those of us who counsel issuers, and (2) sharing a roadmap setting forth actions for compensation committees to consider implementing now.

We recognize that this roadmap can be a double-edged sword, as it could also serve to aid plaintiffs' lawyers, judges and regulators. But the elephant already is in the middle of the room, rearing up and blaring that the time has come for each of us to take meaningful action or face some unfortunate consequences.

Liability

It appears that many directors and their advisors, although aware of 2003's Disney decision (*In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003)), do not fully appreciate that the standard for determining director liability for permitting excessive CEO compensation has changed. As former Delaware Supreme Court Chief Justice Norman Veasey stated in a widely quoted Harvard Business Review article ("What's Wrong With Executive Compensation? A Roundtable," Jan. 2003), there is now "a new set of expectations for directors...that is changing how the courts look at these issues."

In Delaware, corporations are permitted to have a provision in their certificate of incorporation limiting directors' liability for breaches of their fiduciary duties. Key exceptions are for breaches of the duty of loyalty or acts or omissions "not in good faith" or "which involve intentional misconduct." Historically, courts were reluctant to find directors liable for breach of fiduciary duty in making executive compensation decisions.

But times truly have changed. In Disney, the Delaware Court of Chancery held that "[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its shareholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct.'"[The court denied Disney's motion to dismiss the complaint that alleged, among other things, that: (a) the Disney compensation committee and the full board had approved former President Michael Ovitz's compensation agreement without having seen even a draft of an agreement—only an incomplete summary; (b) there were no analyses to show the potential compensation over the term of the agreement; (c) there were no analyses of the potential cost of the severance package under various termination scenarios, including no-fault termination; (d) no outside consultant advised the board; (e) comparable peer compensation was not considered; (f) there was no review of the final employment or stock option agreements, which differed from the summaries previously provided; (g) the committee meeting lasted under an hour, during which more time was spent discussing a payment of a $250,000 fee to CEO Michael Eisner's personal attorney and director, than Ovitz's agreement. The court required the defendants to respond to the complaint on "all three of plaintiffs' claims for relief concerning fiduciary duty breaches and waste...." (We have posted the complaint, as well as the court's decision on the motion to dismiss the amended complaint, on our comprehensive executive compensation website, CompensationStandards.com, launched in connection with our upcoming Major Compensation Conference, discussed at the end of this issue).]

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Thus, because of the directors' actions—or really the lack thereof—the liability waiver provision in Disney's certificate of incorporation could not prevent the case from proceeding and, if the plaintiff prevails on the merits, it will not shield the directors from personal liability.

[After a three month bench trial ending in January 2005, Delaware Chancery Court Chancellor William Chandler III issued a 174 page opinion on August 9, 2005, holding that the Disney directors did not violate their duties by ratifying Eisner's decision to fire Ovitz in a way that entitled Ovitz to a huge severance package. Although he found in favor of the directors, Chandler expressed his disapproval of nearly every aspect of the Disney directors' actions. For more analysis on this important decision, go to the Disney Opinion and Analysis area on CompensationStandards.com.]

Picture proof of potential adverse consequences is reflected by the recent settlement of a lawsuit brought in Delaware against Cendant and each of its directors (who were individually named as defendants). After facing a complaint (posted on CompensationStandards.com) replete with quite detailed allegations—drawn from compensation committee minutes and more—that the committee had not met its fiduciary duty in blessing the CEO's pay package, the company settled the case in late April, with the CEO giving up a considerable portion of his pay package. It is not hard to imagine that this seemingly novel complaint could serve as a template for bringing actions against many other compensation committees.

[Indeed, in the wake of this case, a lawsuit was filed in November 2004 against the directors and officers of Fairchild Corp. The lawsuit alleges breach of fiduciary duty and waste of corporate assets relating to excessive compensation, advances on SERP payments and related-party transactions, among others. Interestingly, the Fairchild complaint appears to be cobbled together from disclosures in SEC filings, which is one step removed from the Cendant and Disney complaints that were replete with details taken from board minutes and other records that are not readily available. Obviously, putting together the *Fairchild* complaint was easy to do in comparison. Given that the *Wall Street Journal* reported last year that three-quarters of the S&P 500 companies disclosed at least one related-party transaction—the pool of potential defendants for this new breed of lawsuit appears to be quite large.]

As the Cendant case indicates, the plaintiffs' bar now appears to be emboldened to bring excessive compensation cases. (It is notable that the Disney case was brought by Mel Weiss, the well known class action lawyer.) Historically, judges were reluctant to intrude on the board's business judgment in setting compensation because these decisions arguably were so subjective. Accordingly, plaintiffs have been discouraged from bringing lawsuits that merely alleged excessive compensation. But Cendant is just that, a case that alleges that the directors breached their fiduciary duty in setting compensation. And, from former Chief Justice Veasey's statements, it appears that judges now might be willing—perhaps even eager—to wade in these waters.

[A case that will test the judges' willingness on this score is the Abercrombie & Fitch case, filed on February 8, 2005 in the Delaware Court of Chancery. This lawsuit alleges that the directors wasted corporate assets and breached their fiduciary duties for overpaying Abercrombie's CEO. The complaint appears to be solely based on the company's 2002 compensation committee report, the company's 2003 proxy statement (which discusses an amended and restated employment agreement with the CEO), and an August 4, 2004 article by Bud Crystal of Bloomberg.com, in which Crystal points out that the Abercrombie CEO pay was at the top of the peer group. Note that the plaintiff firm needed very little in this case—two proxy statements and a newspaper article—to be prompted to file a lawsuit.]

Personal $ Liability—There is No D&O Insurance or Indemnification Available

What apparently has not fully sunk in with many directors and executives—and even some of us who counsel boards—is that a finding of lack of "good faith" also means that a company's D&O insurance policy cannot cover any damages in a judgment. Section 145 of the Delaware corporation law prohibits companies from indemnifying an officer or director unless the person "acted in good faith."

In short, if a court were to find that directors permitted a CEO to receive millions of dollars in excessive compensation—not an unrealistic number these days—by failing to meet minimal standards of due care by not considering basic information, such as the aggregate costs of a pay package including severance costs, the court might find that the board abrogated its duties to the company—in short, failed to act in good faith. Bottom line: This could mean that each director would have to pay out of his or her own pocket—without being reimbursed by the company or D&O insurance carrier—several million dollars each!

[Last year, the thought of a director paying out of his or her own pocket was borderline scandalous. Since that time, two boards have settled lawsuits by paying out of their pockets. In February 2005, it was announced that Enron's outside directors agreed to pay $13 million personally. This amount is based on 10% of their net gain on sales of certain Enron stock including certain stock options. And in March 2005, a $55.25 million settlement with eleven former directors (including one estate) in the WorldCom class action lawsuit was announced. The settlement calls for settling directors to pay $20.25 million of their own money and insurers to pay $35 million. A prior proposed settlement with directors included a so-called "ability-to-pay" provision that would have limited the amount by which any verdict or judgment against a non-settling defendant would be reduced with respect to the responsibility of settling defendants had there been no settlement, by the financial capability of settling directors to pay. The Court rejected that provision as being inconsistent with the PSLRA and the March 2005 proposed settlement does not have such a provision. Additionally, the WorldCom settlement provides that the payment made by each settling director will equal or exceed the compensation received for service as a board member since January 1, 1999, unless the parties otherwise agree based upon unique circumstances.]

This should be an attention grabber. Yet, it appears that many boards, notwithstanding teachings from the Disney case, Sarbanes-Oxley and a bevy of recent Blue Ribbon Executive Compensation reports, have done little more than make changes to their procedures (as a response to the SRO listing standards regarding compensation committee processes). Colleagues have shared with us that even well-intentioned boards have not yet implemented real substantive changes. To quote from one respected colleague, "changes in the composition of the committee and adopting a new charter are not enough, particularly if there are problems with already established arrangements; the Committee may have a chance to "cure" those problems by re-examining the past decisions, making sure they can be justified, and if (as likely will occur in many cases) they cannot be justified, then they need to be changed." [Indeed, it is possible that process changes could even be turned around in litigation against directors, showing they recognized a problem that needed to be addressed, but instead simply adopted new principles and processes, but took no substantive corrective actions, leaving the excesses in place. Such an argument could bolster a finding of lack of good faith.]

And Even Us Chickens

Moreover, as daily media reports tell us, CEOs can control or shape the pay process. Of course, the prime example of this is Grasso-Gate, in which Dick Grasso is alleged to have influenced the compensation consultant's recommendations to the NYSE board, including the cherry picking of "peer companies." Unfortunately, this is not an uncommon practice, as many consultants will acknowledge. Experts who knowingly go along with such practices and schemes, even permitting their names to be used in compensation committee reports (and even lawyers who help craft proxy disclosures that obfuscate or hide the full picture) may be potential defendants in civil and criminal suits—as well as SEC enforcement actions.

Along these lines, we commend SEC General Counsel Giovanni Prezioso's recent speech at the ABA Spring Meeting addressing lawyer responsibility and potential liability. Prezioso assured the audience that the SEC retains the authority to bring enforcement actions against those who aid and abet violations of the Exchange Act—including lawyers—and that in the eyes of the enforcement staff, aiding and abetting liability is alive and well. This speech (posted on CompensationStandards.com) should also help compensation consultants who may be searching for backbone to cite to boards when standing up for what is right.

[In the past year, the Division of Enforcement has made it clear that they will go after "gatekeepers" where warranted. For example, when Tyson Foods announced in August 2004 that it was being investigated by the SEC, it stated that "the Staff may recommend administrative action against two Tyson employees, neither of which are executive officers, for allegedly causing the violations." Although, as described below, it now appears that the employees escaped SEC action, we would not be surprised to see an SEC action soon brought against lawyers and others that fulfill their gatekeeping responsibilities. We also recommend to our readers former SEC Enforcement Director Stephen Cutler's September 20, 2004 speech, where he discusses the Enforcement Division's "access theory" from the 1970s: if you ensure good behavior by those who control "access" to the capital markets (*i.e.*, lawyers and consultants), then you can achieve more than you would by going after every bad actor.]

[It should be noted that the court in Disney also denied Ovitz's petition for dismissal of the complaint against him, focusing on his fiduciary obligations as an officer of the company, raising the prospect that a fiduciary duty claim could be leveled against officers whose compensation is excessive (and presumably other officers in a company who participate in 'gaming' the numbers or ushering through compensation arrangements with incomplete information). This point might help consultants and in-house employees reason with strong CEOs.]
[For our latest thoughts, see our "Personal Liability" discussion in our September-October 2005 issue.]

What Now Is Expected of Compensation Committee Members

Investor activity against perceived compensation abuses continues this year at record levels. Over four hundred shareholder proposals on compensation topics were submitted to companies this proxy season. These proposals take a variety of forms, ranging from capping CEO pay to performance pay to stock option holding periods, and from golden parachutes to executive pensions. And these proposals get substantial support from shareholders, with a significant number of them receiving a majority vote.

But investor activity no longer is confined to submitting and voting on non-binding shareholder proposals. Quite a few investors have gotten more aggressive and are demanding much more. In addition to novel lawsuits like the Cendant case, investors now are taking other innovative approaches to force companies to change their compensation practices—including withholding votes for directors.

It is clear that regulatory and judicial expectations also have changed. Earlier this year, the IRS began conducting audits at dozens of companies targeting perk practices. [In 2004, the IRS began reviewing executive pay as part of its corporate audits. On February 22, 2005, the IRS cited officers at 42 companies for underreporting $700 million in pay. In addition, to help companies and their executives comply with the tax laws, the IRS took the unprecedented step of publishing the audit technique guides that agents use during the course of a corporate audit, which are available on irs.gov.] And news of the SEC's enforcement investigation into disclosure of perks (see our September-October 2003 issue) and Corp Fin's recent consideration of rulemaking in the Item 402 and 404 areas indicates that compensation practices will be a high priority for the SEC going forward.

In fact, the SEC has begun using its enforcement powers with vigor to force executives to disgorge prior compensation. For example, in mid May, Warnaco's former CEO, CFO and General Counsel gave back $1.3 million, $264,000 and $165,000, respectively, as part of a settlement of an action related to misleading disclosures. A similar bonus disgorgement as part of an enforcement settlement with an Enron executive followed a week later. [In June 2005, the SEC settled with three executives of Huntington Bancshares, who were charged with inflating earnings to meet street expectations. The three executives disgorged $1.1 million of past compensation, including interest (Lit. Rel. No. 19243, June 5, 2005).] And the SEC already has used its new powers under Section 1103 of Sarbanes-Oxley to freeze $37.6 million in termination pay and bonuses negotiated by two top officials of Gemstar while they were under suspicion of cooking the company's books. [In mid May 2004, the 9th Circuit overturned a district court decision that had supported the SEC's placement of these funds in an escrow account.] But, upon a re-hearing of the case *en banc*, the Ninth Circuit affirmed the lower court's decision, noting that the payments to the CEO and CFO were "anything but ordinary."

Although there have been admirable guidelines and principles laid out for compensation committees during the past year (e.g., special reports from The Conference Board and an NACD Blue Ribbon Commission), there has been sparse practical guidance telling directors—and for that matter, the lawyers and even the compensation consultants from whom directors are seeking guidance—what to actually look for, how to ferret it out, and then what to do about righting excesses and mistakes that are uncovered.

How We Got Here

This is understandable. Many of us got caught up in and blinded by the euphoria and greed of the past decade and didn't see all the excesses that were being built into executive compensation. Others felt constrained to "follow the market." This includes well-intentioned boards, their advisors, institutional investors and even regulators. Now that those excesses have become apparent, there has been plenty of sermonizing and analyzing. But the critical question remains: "What do we do now, coach?"

The Roadmap for Compensation Committees

Getting past the trappings of revamped committee charters, requisite number of meetings and ongoing education requirements, the following are twelve basic steps (our "Twelve Step Program") that compensation committee members should now be focusing on—and that courts and regulators and shareholders should now be expecting. Up front, we must confess that a lot of what follows took us quite a while to see clearly—because the knowledge and information necessary to see the complete picture is so compartmentalized that it is not easy to put it all together.

The following is the result of many candid discussions with compensation consultants, lawyers and others in the trenches. The power of the press must also be acknowledged here, both for some excellent investigative reporting and for keeping the heat on all of us to wake up and do the right thing.

[While reading the following, please keep in mind that one size does not fit all. What might make good sense for a large company may not be applicable to a smaller company. There may be widespread problems in the compensation area and in the compensation process, but we do not think it is rampant—there are many well run companies out there that never make the headlines. Instead of draconian solutions, what is needed is people stepping back and opening their eyes. To imply otherwise borders on hysteria that is unfair to the many companies that have been doing a good job; nevertheless, we must all do what is and should be expected of us in order to restore investor trust in the marketplace.]

Step One: True Independence—When a Director's Pocketbook and Reputation are "On The Line"

We all acknowledge that what Warren Buffett described last year in his annual Berkshire Hathaway letter to stockholders as the "boardroom atmosphere" still exists. But, when directors realize that they are now facing a survival situation—the CEO's compensation vs. my personal monetary exposure and personal reputation—we believe that most directors will heed Delaware Chief Justice Veasey's admonition: "Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently" and "Compensation Committees should have their own advisers and lawyers." Veasey's further statement that directors must "demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively…to guard against anything that might happen in court" should be a sufficient warning to directors on compensation committees that their CEO compensation actions (and inactions) may now be 'me or you' survival decisions.

The need for independence—perhaps beyond the "emblematic" independence standards now required under the SRO listing standards—is borne out by the recent trend in lawsuits for plaintiffs to show in graphic detail the interrelationships between and among directors as well as the forms and amounts of compensation (and benefits) received by directors. This was true in the Disney and Cendant complaints (as noted prominently in the Cendant complaint, when the comp committee sets directors compensation, any extra perks for directors can be used to allege excessive self-interest). And it is really brought home in the Martha Stewart Omnimedia decision from March, where the plaintiffs described which directors were invited to weddings by other directors. [Shareholder lawsuits have continued to assert a lack of board independence based on social contacts. For example, the complaint filed against Morgan Stanley on July 19, 2005 asserts that the CEO had significant influence over other board members for reasons that included that the CEO and two other board members were members of Augusta National Golf Club.] Although this information obviously is not disclosed in SEC filings, the plaintiffs' bar is easily able to obtain this information through more inventive uses of the books and records provisions of the law and through new director relationship databases, (like the one available from The Corporate Library) and we have even heard of situations where the divorce proceedings of directors are scrutinized to ferret out conflict information. [Testing independence of directors is not something that should be left for "self-assessment" or other casual processes. More useful information on this topic is available from the recent "The Many Faces of Director Independence" webcast, archived on TheCorporateCounsel.net. See also *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003), which is posted on CompensationStandards.com.]

[For our latest thoughts, see our "Director Independence" discussion in our September-October 2005 issue.]

Step Two: The Role of the Compensation Consultant—The Need to Tell It Like It Is—And Like It Should Be

Unfortunately, but perhaps understandably, most compensation consultants have not wanted to rock the boat and go head to head against the CEO or challenge the compensation committee, knowing that it could result in ultimately having to back down or lose the client. Even consultants who have recently been hired by compensation committees have shared with us that they feel constrained to go slowly (and not raise all the questions they would really like to raise so as to not jeopardize their relationship). As a result, the changes at most companies to date have only addressed process, instead of real substantive review of the CEO's entire compensation package.

Many boards have now gotten the message that the compensation consultant should be hired by the compensation committee, not management. And it hopefully is clear that committees should be using consultants to help them analyze pay packages—remember the Cendant and Disney complaints alleged that the compensation committee did not hire or seek advice from a consultant or legal advisor. It is the rare compensation committee that has the requisite expertise to make complicated analyses—which now should be more complicated as more performance-based compensation is used—on their own.

But it is not enough just for the compensation committee to hire a compensation consultant. That consultant needs to be expressly assured that he or she is expected to "tell it like it is." As an initial assignment, the consultant should be instructed not only to review and make recommendations about the process, but more importantly, to review each component of the CEO's compensation (totalling it all up) and not pull any punches, including making recommendations to re-examine, modify and, where called for, even roll back past grants, bonuses, severance arrangements, perks, SERPs and more. Most importantly, the committee—and the full board—has to be prepared to accept the cold hard truth of any past excessive compensation practices and act upon it.

The consultant also needs to help the compensation committee with understanding financial measures. With the growing use of performance-based compensation, committee members need to be more savvy about how the company's finances work. Even before the negotiations over pay take place, the compensation committee should understand how any year-end financial reporting adjustments might affect compensation paid to key executives. The committee should have checks and controls in place to ensure against the likelihood of managers "gaming" the system to achieve undeserved payouts.

[For our latest thoughts, see our "Compensation Consultant" discussion in our September-October 2005 issue.]

Step Three: Calculate—and Tally Up—Each Component of Executive Compensation

When considering any aspect of a CEO's (or other senior executive's) compensation, the compensation committee should start with a tally sheet that lists each component of the CEO's compensation and tallies it all up. The concept is so basic, yet the practice does not appear to be widespread. Once you get past salary and bonus and stock compensation, many boards are in the dark about the quite significant amounts that CEOs are—or will be—receiving through SERPs, deferred compensation, perks and severance payouts that, when added up, can easily exceed the combination of salary and bonus.

These numbers have been obscured for several reasons. First, each component is not well understood. Many compensation consultants have confided to us that these areas are beyond their area of expertise and are handled by other specialists, thus compartmentalizing things so no individual consultant (much less directors) fully appreciates the totality of the pay package. Second, the SEC's proxy disclosure requirements in this area go back to 1992, when these components (and their potential magnitude) were not well understood. As a result, the appropriate disclosures for these components that should be provided to shareholders (and, of course, the board) have been largely overlooked. Steps Four through Seven below provide the essential basics that every compensation committee needs to know about these potentially huge amounts.

[For our latest thoughts, see our "Tally Sheet" discussion in our September-October 2005 issue.]

Step Four: Deferred Compensation—Problems with Annual "Interest" and Total Accumulated Amounts

Many companies maintain deferred compensation plans that allow executives to set aside up to 100% of salary and bonus. These plans became more popular after the Section 162(m) million dollar cap was adopted by Congress. However, the SEC's disclosure requirements predated this popularity and Item 402 only calls for disclosing the incremental amount of interest between 120% of the current interest rate and the rate the company actually pays on the deferred sums. Nobody fully appreciated a decade ago what might end up not having to be disclosed.

There are several excellent articles about the extent of these undisclosed amounts. For example, the Wall Street Journal and NY Times have described how the Wyeth proxy statements reveal that the CEO earned $1.2 million in 2001 and $1.6 million in 2002 in above-market interest on deferred compensation. [Instead of adjusting the interest rate to its current cost of money, Wyeth paid a fixed rate of 10%.] What does not jump out of the proxy statements (not even the latest proxy statement, where the board had the benefit of reading the newspaper accounts of the situation!) was the fact that the CEO actually received additional compensation ($2.6 million in 2001 and $2.9 million in 2002) from the company in "interest"—more than his salary and bonus combined in 2002. And, without adjustment, that amount could continue to grow each year as the approximately $45 million—which has now accumulated in the pool, compounding at a 10% interest rate (i.e. doubling every 7 years)—mushrooms until ultimately the company has to pay out and make good on this compounding liability.

Compensation committees must realize that even paying interest at the current cost of money is not a "wash," as we illustrated with a numerical analysis in the September-October 1987 issue of *The Corporate Executive*, since this does not factor in the deduction that a company receives on interest when it borrows money. There is no deduction for the compensation that is deferred until the deferred compensation is actually paid out.

Because the topic of deferred compensation has received so much public attention recently (and to avoid being sued for "hiding the ball"), compensation committees may now want to insist that the company go beyond the SEC rules and disclose these amounts. And, of course, when the committee annually reviews the CEO's compensation, the "interest" the company is paying the executive each year needs to be added to the total tally (which in some cases can easily double the cash being paid to the CEO through salary and bonus). The calculation should also factor in the compounding pre-tax benefits to the executive, not just the difference between the company's real after-tax cost of borrowing versus the rate paid the executive.

Also, bear in mind that those companies whose plans are tied to the company's stock price are not currently required to make any proxy disclosure at all. In fact, we heard from one reader who got a call from a CEO, after the Grasso deferred amounts came to light, concerned with how his board would react when they finally focused on his accumulated deferred compensation and woke up to the millions that he was due to be paid for deferred amounts tied to his company's stock price.

Compensation committees can no longer plead ignorance here. These are not isolated examples. According to Equilar, 61% of the S&P 500 companies have deferred compensation plans. We understand that many companies are still paying fixed interest way above current market rates, even though they are not contractually bound, and without disclosing the rate or justifying the practice. The annual interest paid, the rate of interest and the accumulations to date, which are material to the executive and essential to providing a true picture to the board and shareholders, should be addressed and disclosed.

[For our latest thoughts, see our "Deferred Compensation" discussion in our September-October 2005 issue.]

Step Five: SERPs—A Four Letter Acronym?

Another area where there has been a woeful lack of understanding—and inadequate proxy disclosure—relates to SERPs (i.e. supplemental executive retirement plans). SERPs came into being to supplement the pension payouts of some higher paid executives beyond the IRS limits for qualified pension plans. Item 402 allows companies merely to include generic tables showing possible payouts based on years of service in their proxy statements. From proxy disclosures, even sophisticated compensation consultants have been unable to figure out how much the Named Executive Officers will actually receive under a company's SERP.

A typical example of how SERPs can be manipulated to provide much higher payouts than the generic chart implies is the recently highlighted Delta Air Lines SERP. At Delta, the CEO was credited with an additional 22 years of service to inflate his pension payments so that he would receive $1million a year for the rest of his life, starting at age 65. Even after the CEO took a cut in his pay package in the face of the company's downturn, his SERP was left intact and put in a trust to protect the payments in the event of bankruptcy. At the same time, the company was reducing the pensions of its workers to conserve cash, without adequately disclosing the conflicting actions, calling into question the adequacy and accuracy of the company's disclosures. At last month's annual meeting, a precatory shareholder proposal seeking shareholder approval of SERPs received a majority vote and the new Delta CEO has agreed to implement this proposal and put future SERPs up for a vote.

As widely reported, former Tyco CEO Dennis Kozlowski is trying to collect on a $4.5 million per year SERP, worth an estimated $50 million in current value. [As of August 2005, the parties were still litigating this dispute.] In addition to playing with years of service, SERP payout amounts at some companies have been inflated by including bonuses and other payments in the calculation.

One respected compensation consultant says that compensation committees should view SERPs as the equivalent of restricted stock that is simply paid out in cash. As a result, they should be treated as a form of long-term compensation, and that those companies that have both SERPs and restricted stock (or other long-term compensation) are, in essence, double dipping. Whether or not one agrees with that characterization, what is clear is that a lack of understanding of SERPs has enabled many executives to receive additional compensation that has not been factored into the final tally.

[For our latest thoughts, see our "SERPs" discussion in our September-October 2005 issue.]

Step Six: Perks—Trouble Is Brewing on Multiple Fronts

Although the dollar amounts of perks reported in proxy statements may seem small compared to the CEO's total compensation, this may be the first area where compensation committees (and those of us responsible for drafting the disclosures) may find themselves in the hot seat. Both the IRS and the SEC are right now investigating the practices of some companies in this area (see our September-October 2003 issue).

[In addition to the IRS's citations for underreporting executive compensation described above, the SEC has brought actions relating to the non-disclosure of perks against General Electric and Tyson Foods. These actions are described below.]

Just as Nixon, Clinton, Martha Stewart, Frank Quattrone and the entire Arthur Andersen firm found, the cover-up can be more costly than the crime. We suspect that boards and CEOs, and those that may be helping cover up the full picture about perks, may find themselves defending lawsuits.

S-K Item 402(b)(2)(iii)(C)(1) requires issuers to disclose in the summary compensation table the "dollar value" of perquisites made available to NEOs if the amount exceeds $50,000 or 10% of total salary and bonus, and footnote disclosure must be included regarding any individual perk that exceeds 25% of the value of all reported perks. As we noted right after adoption of the 1992 disclosure requirements, the proposed requirement for footnote disclosure of "all" items reported under the "Other Annual Compensation" column was unfortunately dropped from the adopted version (see our September-October 1992 issue). As a result, the nature of many personal benefits provided to NEOs (e.g., country club memberships, home security systems, even personal chefs) is not made known to shareholders (or even directors).

A more serious problem is that companies appear to have found ways to underdisclose the value of perks. A consulting firm recently told us that it had taken an informal poll of a handful of its clients and found that practices and methods for valuing—and hence disclosing or not disclosing—perks are all over the lot. The lack of consistency in classifying, quantifying and disclosing perks may be attributable to the lack of Staff guidance or intervention on perks disclosure, as we have noted before. (See the January-February 1993 issue of *The Corporate Executive* and our March-April 1993 and January-February 2004 issues.) The Staff did clarify at its meeting with the ABA JCEB last year that the value of a perk is the "incremental cost" to the company of providing it. But what this translates to in actual practice is not clear.

[At our Executive Compensation Conference last year, SEC Corp Fin Director Alan Beller reiterated this point by saying: "The valuation of perks also should be carefully examined. We have seen disclosure of large tax gross ups for perks that are themselves not disclosed, and this obviously raises questions. I also remind you that the appropriate measure of value is the aggregate incremental cost to the company, not the tax value of the benefit."]

Here are some examples of how companies have tried to get under the disclosure radar. Cars and limousines purchased for executives costing $55-$75,000 each (not to mention the annual cost of a personal driver, garaging and maintenance) are technically placed into a "pool" that makes them available to drive visiting VIPs, etc. This allows the company to treat the purchase price of the car as a business expense, and to treat as a perk only the cost of the NEO's personal use (i.e., the cost of gas and the driver's salary while the car is being used for personal travel). In reality, the car may be the CEO's (and may be referred to as such), but for proxy reporting purposes, it is a company car and only the cost of actual "incremental" use by the CEO for personal travel is counted.

The same goes for the company jet on which the free ride by the NEO's spouse may not count as having any perk reporting value "since the jet was already flying to that destination." Some companies have gone a step further, claiming that, where the use of a company jet for personal travel is mandatory for "security purposes," all use of the jet is "business" rather than "personal." The Staff made it clear last year that this rationale won't fly to avoid the requirement to report personal usage as a perk. (See our January-February 2004 issue).

[At our 2004 Executive Compensation Conference, Alan Beller stated that "there are specific items that I fear companies are routinely omitting from their disclosure that should be included. These include the personal use of company planes and similar perks. Simply stating that company executives must always fly in company planes (or drive in company cars, or accept any other benefit) for security reasons does not relieve a company from considering whether these benefits are perks. We also fear that some companies are being overly creative when categorizing other items. I'd suggest that a perk, by any other name, is still a perk, and therefore must be considered for disclosure. When companies review their disclosure, they should give serious consideration to items that have previously been called business expenses (*e.g.*, housing, security systems, cars etc.) but actually are perks. I don't think it is very difficult to determine whether or not something is a perk. One question to ask that is not dispositive but may be useful is whether it is an expense that is available to employees generally on a non-discretionary basis, like reimbursement for the taxi across town for a meeting, or whether it is a benefit for which only a chosen few are eligible (or selected on a discretionary basis)."] Investors likely have taken note of a recent study by Professor David Yermack of New York University's Stern School of Business (posted on CompensationStandards.com) finding that companies that allow corporate jet use for personal travel underperform the rest of the market.

If a company were to report the real values and costs of perks, including actual purchase or rental price and maintenance costs of the executives' limousines, jets and apartments, etc., these numbers could be embarrassing, to say the least. As we have seen with Koslowski's $18 million New York apartment or GE's $11.3 million apartment for Jeffrey Immelt (or the countless other New York apartments maintained for CEOs), it is misleading not to report these numbers by taking the position that the incremental cost of non-business use doesn't meet the $50,000 reporting threshold.

Directors should not leave themselves open to embarrassment (or worse) by not knowing the real costs and benefits their CEOs are receiving. A question we received from in-house counsel during the Q&A following the March webcast on "What the Top Compensation Consultants are NOW Telling Compensation Committees" says it all. Essentially the question boiled down to: "What perks do we actually have to disclose to our compensation committee?" The answer is that directors should be demanding a full, detailed description of each and every benefit provided to the CEO (and each NEO)—one colleague calls it a "perk audit". It is irksome that management (and counsel) are still screening this essential information so that directors are not being provided the fullest disclosure—and that directors do not appear to be asking the tough questions to ferret out the full cost to the company of providing personal benefits to executives.

[In April 2005, the SEC brought an action against Tyson Foods for inadequately disclosing perks and other benefits to its former CEO (Lit. Rel. No. 19208, April 28, 2005). In addition, Tyson was charged with failing to maintain adequate internal controls for providing $1.5 million in personal benefits to its CEO that, in the SEC's view, were not appropriately authorized by either the compensation committee or the board of directors. Although the compensation committee knew (i) that the CEO received "travel and entertainment" benefits in the form of personal use of corporate aircraft and homes, and (ii) the dollar amount of the annual perquisites, the internal controls violation apparently was based on the compensation committee's failure to determine the details of the benefits being provided to the CEO. For example, the compensation committee did not know the corporate aircraft was often used by family members and friends of the CEO, without the CEO on board. The SEC is clearly signaling a growing impatience with "stealth" compensation and failure to disclose perquisites, especially to the compensation committee. Issuers may want to revisit the nature and amount of information available to their compensation committee members regarding NEO perquisites, both to assure compliance with the disclosure requirements and to avoid internal controls violations.]

[In September 2004, the SEC brought an action against General Electric for failure to adequately disclose the retirement perks of former CEO Jack Welch (SEC Rel. No. 34-50426, September 23, 2004). Although the severance agreement was filed with the SEC and GE's proxy statements disclosed that Welch would receive "lifetime access to Company facilities and services comparable to those which" were made available to him as CEO, the SEC alleged the disclosure should have better described the benefits that Welch would receive because "investors could not learn from GE's previously filed proxy statements many of the most significant 'facilities and services' Welch had been provided prior to his retirement, including personal use of GE-owned aircraft, personal use of chauffeured limousines and home security systems." As a result, companies should review their disclosure of perks and other benefits to ensure that they adequately describe the benefits.]

If executives receive perks, the cost of those perks should be fully disclosed. Of course, disclosing lavish perks is a sure way to alienate employees and outrage shareholders. A better approach, which more counsel and advisors should be advocating to their clients, is not to provide executive perks at all. The following quotation from this year's proxy statement filed by Intel should become the norm, not the exception:

> Personal Benefits
> Intel seeks to maintain an egalitarian culture in its facilities and operations. Officers are not entitled to operate under different standards from other Intel employees. We do not provide officers with reserved parking spaces or separate dining or other facilities, nor do we have programs for

providing personal benefit perquisites to officers, such as permanent lodging or defraying the cost of personal entertainment or family travel. Our health care and other insurance programs are the same for all eligible employees, including officers. Our loan programs, although modest in nature, are not available to executive officers. There are no outstanding loans of any kind to any executive officer, and since 2002, federal law has prohibited any new company loans to executive officers. We expect our officers to be role models under our Corporate Business Principles, which are applicable to all employees, and officers are not entitled to operate under lesser standards.

[Note that Intel's 2004 "no-perks" disclosure included the following additional language about airplane usage: Company-provided air travel for Intel's officers is for business purposes only: Intel's company-owned aircraft each holds approximately 40 passengers and are used in regularly scheduled shuttle routes between Intel's major U.S. facility locations, and Intel's use of non-commercial aircraft on a time-share or rental basis is limited to appropriate business-only travel.]

[See also the disclosure of Potlatch Corporation in its 2004 proxy statement:

> Potlatch seeks to maintain an egalitarian culture in its facilities and offices. Officers and senior employees are not entitled to operate under different standards than other Potlatch employees. Potlatch does not provide officers and senior employees with reserved parking spaces, country club memberships or separate dining facilities. Nor does Potlatch provide personal benefit perquisites to officers and senior employees such as the use of aircraft (Potlatch does not own or routinely lease aircraft) or defraying the cost of personal entertainment or family travel. Although Potlatch maintains a Supplemental Benefit Plan due to Internal Revenue Service limitations, we do not have a supplemental executive retirement program. Our health care and other medical insurance programs are the same for all salaried employees, including officers, with the exception that highly compensated employees pay a larger percentage of their insurance premiums than other employees. The loan program, provided as a feature of participation in Potlatch's 401(k) savings plans, is not available to executive officers. There are no outstanding loans of any kind to any executive officer, and since 2002, federal law has prohibited any new company loans to executive officers for any reason. We expect our officers and senior employees to be role models under Potlatch's Corporate Conduct and Ethics Code, which is applicable equally to the members of the Board of Directors and all employees, including officers.]

[For our latest thoughts, see our "Perks" discussion in our September-October 2005 issue.]

Step Seven: Overlooked Severance and Termination Payouts

Another component of CEO compensation that often gets overlooked and, as a result, is not factored into the full compensation equation is severance payouts under varying scenarios. These are payments beyond the SERP payments that executives will receive as part of their retirement benefits. From a litigation perspective, it is noteworthy that the Disney and Cendant complaints both alleged that the compensation committee did not discuss the size of potential payments in the event of the exiting executive's termination. [Additionally, the 2005 Morgan Stanley complaint alleges corporate waste for the $109 million severance payments to two departing executives that was not required by their employment agreements.]

This is an appropriate place to bring an excellent missive to our readers' attention by highly respected consultant Fred Cook. We thank Fred for permitting us to provide the following excerpt from his memo. You will note that Fred not only flags five termination scenarios that should be addressed and quantified by every compensation committee, but his first paragraph makes the important point that we made above—that most compensation committees and consultants have until now focused only on salary and bonuses and long term incentives, and have not tallied up the CEO's aggregate compensation.

> Tallying Top Executives' Total Compensation
>
> We in the executive compensation community are used to tallying a top executive's total compensation as the sum of base salary, annual incentive bonuses and the present value of long-term incentives, including stock options, granted or earned for a particular year. Even this sometimes weighty number, however, overlooks the value or cost of employee benefits, perquisites and retirement benefits accrued for the year. These are important numbers because they represent what the Board's Compensation Committee can manage and influence going forward. But they overlook another important number that the Compensation Committee and the Board should be

aware of—the sum total that the company would owe the executive upon a termination of employment.

Critics of American business and executive compensation practices seemed shocked that the Board of the New York Stock Exchange did not realize that it owed Mr. Richard Grasso $139.5 million when he renewed his contract, and might owe him an additional $48 million when he terminated employment. It was not surprising to me, however, and I suspect to others in the compensation community, that these numbers were not known to the board or its compensation committee. They are not disclosed anywhere and are often not even tabulated until the event occurs that triggers their payment.

The lesson is obvious. The Chair of the Compensation Committee should ask the company to prepare a special report every year or every other year enumerating the amount of termination benefits that would be owed to the CEO and other senior executives upon a termination of employment. These numbers should be tabulated under five termination scenarios: [The memo in its entirety is posted on CompensationStandards.com in both the Severance and Tallying Total Compensation sections.]

[For our latest thoughts, see our "Severance" discussion in our September-October 2005 issue.]

More To Come

Because there is a lot to digest here, and because we are still fine tuning parts of the remaining five steps, we have decided to publish the balance of this piece in the September issue of *The Corporate Counsel*. The following outlines what is covered in the balance of the piece as of now. (For those interested in seeing what we have written at this point and following our progress, we have posted on CompensationStandards.com the working draft of the rest of this issue.)

The Remaining Five Steps

- Step Eight: Surveys, Benchmarking and Peer Groups—Misleading the Compensation Committee (and Shareholders)
- Step Nine: Directors Must Take Charge and Reassess, Modify, And Even Roll Back Years of Built-In Excesses
- Step Ten: And So Many Other Things To Address
  - Converting Options to Restricted Stock or RSUs: The Obligation to Reassess Underlying Grants
  - Stock Grants to CEOs and NEOs: The Need to Calculate Total Accumulated Gains—And to Hold Until Retirement
  - The List Goes On: Employment Contracts, Double-Triggers, Three Times Salary and Bonus, 162(m) Violations and Inadequate/Misleading Disclosures
- Step Eleven: The Art of Minute-Taking—The Plaintiffs' Bar is Watching
- Step Twelve: The Importance of Your Proxy Disclosures—and the Need to Go Beyond S-K
  - Overhauling the Compensation Committee Report

The Plaintiffs' Lawyers, Institutional Investors and Regulators

As we said at the outset, this issue of *The Corporate Counsel* will be a double-edged sword. Directors (and their advisors) are now on notice. Necessary steps and actions to help meet the "good faith" standard have been laid out. Plaintiffs' lawyers (including Section 16 lawyers looking for greener pastures), institutional investors and regulators now also will better understand what to look for and go after—and what to point to as minimum "good faith" actions. No doubt, they will start with the companies that have been singled out by the press. But there may be many companies that are vulnerable.

We believe that compensation committees that take the bull by the horns and actually fix their past mistakes (which, in some instances may require modifying and rolling back excessive grants and pay packages) will have a powerful good faith defense, pointing out that it was not until now that someone pulled it all together in one place and made clear what needs to be looked for and addressed by every diligent compensation committee.

Those compensation committees, on the other hand, that try to rationalize past actions, and simply pay cosmetic homage to the new standards, including those that make changes only going forward (thus ratifying their past actions), run the risk of greater exposure.

Advancing The Ball

We recognize that this topic is too important to let hang, so we have decided to take the following additional steps to provide additional guidance and to keep us all abreast of the latest responsible practices:

October 20, 2004: A Major Compensation Conference That Will Long Be Remembered. We are taking on the major undertaking of holding a one-day practical conference that will pull no punches, "Executive Compensation—Meeting the New Standards: What Every Compensation Committee Needs to Know—and Do—Now". To demonstrate our deep commitment, the conference is co-sponsored by *The Corporate Counsel, The Corporate Executive* and the NASPP.

The purpose of this major compensation conference—with key participants from the compensation consulting community, the institutional and other critics and the regulators—is to pick up where this article leaves off, expanding upon several items touched on above and providing up-to-the-moment practical, "what to do now" guidance for directors and counsel. For more information and to hold a place, see the enclosed brief description and registration form or go to Naspp.com or TheCorporateCounsel.net.

The Conference will be held live in San Francisco the day before the NASPP's Annual Conference (at which we expect to have a large contingent of lawyers and advisors, since that conference will address—head on—the changes to plans, features and practices we will all need to be considering and implementing in connection with the impending accounting changes and more).

Perhaps more importantly, to enable all those that may be too busy to travel to San Francisco, we will webcast and videocast the entire conference to boardrooms, conference rooms and desktops across the country. And, we will archive the valuable content covered in each section to facilitate subsequent access (which can be useful for boards that want to access content on specific topics at a convenient time, including board or compensation committee meetings).

A "One Stop" Reference Tool. In the process of writing this issue and gathering related materials, we came to realize that, especially in the days ahead as we are all going to be called upon to "right" the CEO compensation excesses, as well as to make decisions (and counsel companies) about new plans, features and practices as a result of the upcoming accounting changes, there is a crying need for a single source where lawyers and other advisors (and compensation committee members themselves—who are ultimately accountable and should be entitled to see it all on their own, not just what is distilled for them) can go to find all the resources in one place:

- all the relevant articles and client memos (including memos and guidance from the compensation consulting firms)
- examples of good proxy disclosures and model compensation committee reports
- actual new plans and features and practices
- ongoing articles and guidance on new developments and practices
- Q&A/Discussion Forum in which the top consultants and the top compensation lawyers are actively participating, sharing ideas and practice tips

To address this need, and in anticipation of the October 20, 2004 compensation conference, we have now put together a Task Force made up of over 80 leaders in the field—the top compensation lawyers, compensation consultants and critics.

With our help, this Task Force is in the midst of putting together practice pointers, documents and materials for CompensationStandards.com, a special website available to those that intend to attend the compensation conference, either live or via webcast. Because we have already gathered and posted some extremely useful materials, rather than wait until the conference, we have decided to make these materials (including an *Electronic Version of this issue of The Corporate Counsel,* complete with links to important supporting materials and resources addressing each of the points and suggestions covered in the issue) available right now to provide an ongoing resource for those that sign up for the conference. (Note, we have also posted the working draft of the remaining five steps, containing important guidance and suggestions.)

New Developments

Due to the length of this issue, we are deferring our New Developments section to next issue. In the interim, however, we should mention that, as a result of higher stock prices, we are seeing more transactions by insiders these days—and more inadvertent Rule 144 and Section 16 violations. In that connection, we encourage our readers to refer to the various pointers we have provided in past issues (just word-search our Electronic Back Issues available on TheCorporateCounsel.net) or in the "Rule 144 Q&A Forum with Jesse Brill and Bob Barron" and Alan Dye's Section 16 Q&A forum on Section16.net. We also note that Alan Dye has started his own blog on Section16.net, where he muses about the latest Section 16 developments and analysis.

We have also decided to add a brief bonus/thank you session at the end of the October 20, 2004 Major Compensation Conference during which Jesse Brill and Alan Dye will provide "Ten Nuggets For Directors and Officers To Prevent Inadvertent Violations." Also, those who may have missed our recent webcast on "The Latest Rule 10b5-1 Selling Plan Practices" should review the transcript or listen to the archived audio on TheCorporateCounsel.net.

Come Join Us to Celebrate 30 Years of The Corporate Counsel

It is hard to believe that we are approaching our 30-year mark. We launched *The Corporate Counsel* in San Francisco in October 1975. It occurred to us that, with so many of our readers expected at the October 20, 2004 Major Compensation Conference as well as the ensuing NASPP Conference, we should invite all our readers to join us to celebrate this milestone. We will recognize the many loyal readers in attendance who have been with us since the '70s, as well as our newer readers. We are looking forward to seeing many of our old friends and esteemed colleagues. The Gala Reception—which some of our friends have dubbed "Networking with the Stars"—will be held on the evening of October 20th, immediately following our Major Compensation Conference. Please join us.

—J.M.B.

Readers have our permission to furnish copies of this issue (in its entirety, please) to anyone who might benefit from it.

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