[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

PART II: Steps Eight Through Twelve

As promised, the following is a continuation of our May-June issue setting forth guidance for compensation committees. (Note that, for ease of reference, we have posted an electronic version of this issue on CompensationStandards.com that contains direct links to the practice pointers and materials referred to in this issue.) Before resuming at Step Eight, a few follow-ups are in order.

Feedback

First, we would like to thank our readers for all the positive feedback we have received. A few representative comments from respected colleagues: "Although you laid out some pretty strong medicine, you seem to have struck a chord." "Many clients have been sending us underlined portions of the issue seeking our guidance on implementation." "With all the blue ribbon reports out there, your issue appears to be the catalyst that is causing clients to act."

Personal Liability/D&O Insurance

Some readers pointed out to us that, even though Section 145 of the Delaware General Corporation Law prohibits companies from indemnifying an officer or director unless the person acted in "good faith," Section 145(g), on the face of it, permits companies to purchase D&O insurance, notwithstanding bad faith. It was pointed out, however, that in some cases the D&O coverage might not be sufficient to cover a director's entire exposure. It was also brought to our attention that the SEC recently adopted a policy requiring settling parties to forgo any rights they may have to indemnification or reimbursement by insurers. Query: Could courts take a similar position? [This and other important issues relating to directors' exposure to personal liability in the compensation context were addressed in an important session with Professor Charles Elson and past and current Delaware Supreme Court Chief Justices Norman Veasey and Myron Steele at our October 20, 2004 Major Compensation Conference.]

[In May 2005, Delaware Vice Chancellor Leo Strine rejected a settlement between Fairchild Corp. and investors alleging, among other things, that Fairchild improperly paid a criminal fine and associated legal fees for its CEO. In rejecting the settlement, Vice Chancellor Strine indicated that he was open to a settlement on the matter, but that the parties should better explain why Fairchild paid the criminal and legal fees or should get a reimbursement of those fees.]

SERPs, Severance and Change in Control – And Tallying It All Up

The largest number of comments were centered around our coverage of the "stealth" components of compensation. Many readers praised the practice pointers we have now posted on CompensationStandards.com which focus on the red flags and important considerations that directors need to be aware of when reviewing or approving non-qualified deferred compensation, SERPs, severance and change in control arrangements – and the importance of tallying it all up. [Many readers asked us for model tally sheets for compensation committees. At our request, task force members have already begun to submit tally sheets which we will continue to post on the website.]

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Step Eight: Surveys, Benchmarking and Peer Groups – Misleading the Compensation Committee (and Shareholders)

The common practice when reviewing a CEO's compensation is to refer to executive compensation surveys. Unfortunately, as compensation consultants now readily acknowledge, surveys are not just flawed and biased (see Fred Cook's excellent article on this topic, "Compensation Surveys are Biased," posted on CompensationStandards.com – also see Fred Cook's June 21, 2005 speech at Stanford Directors' College, discussing surveys and benchmarking), they can be massaged and cherry picked to come up with pre-ordained results that a CEO has either explicitly requested or that the consultant has derived to ingratiate him/herself with the client. The consultant might deliver a report to the compensation committee with an incongruent pair of "peer" companies: one set for purposes of executive compensation and another for corporate performance. [As a respected colleague has pointed out to us, "A real issue here is who is the client. It may be easy for the consultant to lose sight of the fact that his 'client' is the compensation committee, acting on behalf of **the company**, not the executives."]

In executive compensation surveys, it is easy to inflate numbers by including extraordinary or one-time payments and grants, or by relying on surveys conducted for other companies that included such items. This reliance might even be unintentional. On top of all this, as more companies adopted the practice of "benchmarking" – taking the position that their above-average CEO should be paid in the top 25th percentile of all CEOs – a slippery slope resulted. Compounded each year, benchmarking quickly became an out-of-control ratcheting-up phenomenon that resulted in exponential growth in compensation, as this year's top 25th percentile becomes next year's 50th, requiring another increase to get back into the top 25th, and so on.

Another problem is that these surveys often do not take into account that some companies may put greater emphasis on cash compensation than stock options, while other companies may place greater emphasis on long-term incentives. By cherry picking from each category, a CEO can have his cake and eat it too.

All of this can help largely explain how at some companies CEO salary and bonus and stock grants and other components of CEO compensation have gotten so far out of line – not just from the median workforce salaries generally, but also from other senior and mid-level executive compensation at the CEO's own company.

It still is troubling that many compensation consultants, who acknowledge how surveys have brought CEO compensation into the stratosphere, still use those inflated survey numbers – that have years of compounded inflated numbers built into them – to help clients determine what is the appropriate level of salary, bonus and other compensation. This continues to perpetuate all the mistakes of the past. Going to a 50th percentile now – which may have been last year's 25th percentile and which would have been off the charts just a few years earlier – is not reform.

[Compensation committees cannot afford to ignore the admonitions about surveys in recent governance reports: "The committee should resist an over-reliance on surveys and other statistical analyses in determining compensation levels." (Business Roundtable) "So-called market-based compensation…is a root cause of the current problem." (NACD Blue Ribbon Commission) "Percentile benchmarking should not ever be practiced except to provide broad market reference points." (Breeden Report)]

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

Step Nine: Directors Must Take Charge and Reassess, Modify, and Even Roll Back, Years of Built-In Excesses

The reality remains that compensation consultants, lawyers and other advisors are still paid by the company and can ill afford to alienate the CEO. Even where an advisor is retained separately by the board or compensation committee, the reality is that boards and committees include CEOs of other companies that don't want to hear that their compensation also has to be rolled back. And even newly retained consultants often are reluctant to (or can't afford to) jeopardize their relationships right off the bat with, *e.g.,* company counsel and other esteemed advisors that have been present while all this has been going on.

But the buck must stop somewhere. And it is becoming increasingly clear that all eyes are now fixed on the directors who comprise the compensation committee. As a result, it will no longer be sufficient for directors to blindly accept survey numbers. Instead, each board has an obligation to analyze its CEO compensation going all the way back to when divergences with the rest of the workforce began – which for many companies will mean having to analyze the CEO's total compensation going back to the early 1980s. Several surveys have demonstrated the divergences. An excellent article that explains how we got to where we are now – which should be basic reading for every director and every advisor – is the Fortune magazine piece by Geoffrey Colvin entitled "The Great CEO Pay Heist". For more thought provoking suggestions for compensation committees assessing CEO pay, see the articles just posted on CompensationStandards.com entitled "Excessive Executive Compensation: A New Test For Director Liability" and "How Much Pay For How Much Performance?"

As one major consulting firm points out, one reason why boards may not have realized just how far CEO compensation has skyrocketed is that decisions on various compensation components are made at different meetings, thus making it more challenging to tie all the components together and comprehend them. The result has been loading up on all the available components of compensation, instead of being selective.

As directors start to conduct the hard analysis, it will come out at a number of companies that not only has the cash compensation and the stock compensation gotten way out of line internally from the company's starting point back in the 1980s, but that the heretofore inadequately understood and undisclosed components – when now added to the cash and stock compensation – take the true numbers farther out of line, leading to the inescapable conclusion that rollbacks may be the only corrective solution.

[One corrective approach that we like is what we call "the internal check" – following the Dupont model of checking for "internal pay equity" at various levels within a company to ensure that the CEO's compensation has not gotten out of line within the company. As stated above, compensation committees should direct their H.R. people to provide a comparison chart that goes back to the 1980s (when the gaps began to get out of line) comparing the gaps in compensation levels within the company between the CEO and NEOs and senior and mid-level executives, down to the rank and file (and including all components of compensation, *e.g.,* SERPs and perks and accumulated option and restricted stock gains, etc.) as a framework to bring the CEO's (and, in some cases, NEOs') total compensation back in line.] [Other companies that perform internal pay equity checks include Intel and Whole Foods Market.]

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

Step 10: And So Many Other Things To Address

This next step is the hard one – how to correct the past excesses of many yesteryears. In some cases, adjustments and rollbacks will be the only solution. After-the-fact rationalizing could lead to cover-ups and more personal exposure. While in the process of "auditing" and rectifying your current CEO (and NEO) compensation, the following should not be overlooked:

How Can We Take Back and Modify Existing Grants?

Fortunately, there should be ample opportunity for compensation committees to change and renegotiate a past practice. These opportunities exist each time any aspect or component of a CEO's compensation is considered. For example, to be awarded a new option or restricted stock grant, the CEO could agree to fixes to past and outstanding awards. This could be accomplished by rollbacks or new retention provisions that require the executive to hold the stock until retirement.

After tallying up the compensation components, if a compensation committee finds it has been paying a lot more than it realized, hopefully that fact alone will be enough to motivate a CEO to agree to changes – rather than face the embarrassment of public disclosure of the excesses in the compensation committee report in the next proxy statement and a disclosure that the CEO refused to agree to meaningful adjustments.

One challenge with roll-backs is that many CEO contracts provide for a severance payment for termination without cause or if the CEO walks for "good reason." Good reason typically is defined to include any diminution of salary or other benefits. As a result, a CEO could easily say, "I won't agree to a rollback and you can't make me or I walk and receive a big payout."

Here is one respected colleague's response: "But the court in the 2003 Disney opinion made it pointedly clear [at pgs 29-32 of the opinion] that the executive has a fiduciary duty here as well. Query whether a committee could bootstrap that into some leverage: 'We think you, Mr. Executive, have a fiduciary duty to the company and its shareholders to be sure that the package was fair and appropriately authorized and if you don't cooperate with our re-examination under a review that applies the proper process and asks the right questions, we think you are breaching your fiduciary duty, and therefore providing a basis for us to terminate you, Mr. Executive.' In other words, the executive may have a self-interest in having the committee re-evaluate the existing compensation arrangements and defending the pay by being able to show that the committee had thoroughly considered it."

[The 2005 *Disney* opinion reaffirmed the fiduciary duties of an executive, but ultimately found that Ovitz did not breach his fiduciary duties because he did not play a role in terminating himself or determining that the termination would not be for cause under his employment agreement.]

[See the excellent Task Force piece posted on CompensationStandards.com that provides practical guidance regarding how to deal with excessive CEO compensation, *"Taking From The King: The Mutual Need and Practical Tips for Rolling Back or Modifying Excessive CEO Compensation."*]

Converting Options to Restricted Stock or RSUs: The Obligation to Reassess Underlying Grants – And Other Concerns

Compensation committees that have been converting outstanding options to restricted stock or RSUs may be overlooking an important obligation. A grant of restricted stock or RSUs is a new grant. This means the compensation committee has a more fundamental obligation than just deciding on the proper percentage to apply to the conversion. The committee can't just rubber stamp what was already granted. If it turns out – by today's more conscientious standards – those past option grants (particularly mega-grants) would now be considered excessive, then this new grant should be reduced, particularly now that the grant should be viewed in the context of the CEO's total compensation and not as an isolated component. We are concerned that quite a few companies have not focused on this and may be vulnerable unless they make adjustments to those new grants.

Another troubling aspect of the rush to restricted stock at some companies is the failure to attach any meaningful performance conditions. Query: Would directors be so quick to grant restricted stock if they viewed it as essentially handing cash to an executive to buy company stock (which can be kept – no matter how the executive performs – simply by hanging on with the company for a few years). And worse, the vesting period often is accelerated under various scenarios, as several of our Task Force submissions point out. In addition, restricted stock generally does not qualify under the 162(m) one million dollar cap.

[It would be interesting to see whether compensation committee minutes covering the approval of simple time-vested restricted stock grants address the absence of performance risk, or reflect any discussion of the cost to the company of the lost tax deductions for amounts granted to top executives exceeding the $1 million cap – and whether the proxy statements of those companies that recently have made large restricted stock grants to replace outstanding options have included any discussion or rationalization in their 162(m) proxy statement disclosure (or compensation committee report) or have just included the same old boilerplate – leaving directors vulnerable.]

Stock Grants to CEOs and NEOs: The Need to Calculate Total Accumulated Gains – And Hold Until Retirement

Although stock options, restricted stock and other similar types of equity are classified as long-term incentive compensation, most recipients treat the cash from selling these shares more in the nature of bonuses or windfalls to be capitalized on when the stock price is up. At least for CEOs and NEOs – particularly where total accumulated stock option and restricted stock gains are substantial – it is time to view stock compensation as solely a long-term vehicle. [Indeed, some consultants have shared with us their concern that accumulated option and restricted stock gains are not being factored into current compensation decisions at many companies.]

This means that, at a minimum, the compensation committee should seriously consider whether top executives should be required to hold the after-tax portion of these shares until retirement so that the executive truly has a long-term incentive. To avoid unintended effects (*e.g.,* encourage early retirement), retention provisions can provide for something like "the shares must be held after exercise or vesting for the *longer of* __ years (the difference between the person's then age and age 65) or retirement." Compensation committees can take a major positive step by implementing a hold-til-retirement policy for CEOs and NEOs, particularly with respect to large outstanding awards. [Remember our colleague's suggestion, above, on the CEO's fiduciary self interest in agreeing to modifying existing grants. CEOs (and boards) may find that, in some instances, adding a retirement retention requirement could be a sufficient and more palatable fix than a rollback. Note also the possible application of such an approach to addressing the problems with recent conversions from options to restricted stock, raised above.]

[For our latest thoughts, see our "Stock Options—The Accumulated Gains & Carried Interest Table" discussion in our September-October 2005 issue and the Hold-Til-Retirement Practice Area on CompensationStandards.com.]

The List Goes On: Contracts, Double-Triggers, Three Times Salary and Bonus, 162(m) Violations and Inadequate/Misleading Disclosures

Contracts. As covered in the NASPP's March 2004 webcast, "What the Compensation Consultants are NOW Telling Compensation Committees" (archived at Naspp.com), the NACD Blue Ribbon Report (at pg 48), and our Task Force pointers, long-term and automatically renewing employment contracts are becoming increasingly disfavored and should be seriously reconsidered, generally avoided and, where possible, eliminated. The very nature of a long-term or evergreen contract ties a company to an executive – for better or worse – and may require the company to choose between letting the executive go (*i.e.,* non-renewal of the contract), with the incurrence of a hefty severance payment, or continuing with a less-than-average executive.

It is clear that a company that does have a long-term employment contract with its CEO has an affirmative obligation to consider its automatic renewal. The recent case of *Pereira v. Cogan,* 294 B.R. 449 (S.D.N.Y. 2003), decided by a district judge applying Delaware law, found directors of a privately-held company to have abdicated their fiduciary responsibility when they failed even to consider the automatic renewal of a CEO's long-term employment agreement, without a review of the CEO's performance and the continuing appropriateness of the terms of agreement. The bottom line here is to avoid evergreens where possible, but if you have one, you still must fulfill your fiduciary obligations.

[On June 30, 2005, the Second Circuit Court of Appeals vacated the district court's ruling in *Pereira v. Cogan*, finding that the lower court erred in denying the defendant directors and officers their request for a jury trial and that the bankruptcy trustee did not have standing to bring due care claims. There will not be a new trial, however, as the parties settled prior to the appellate decision.]

Note also that companies should carefully review the definition of "cause" in employment contracts, possibly adding such elements as cooperation with governmental investigations (this has never been more important than in today's environment, given the recent $25 million Lucent penalty for its lack of cooperation and the just updated Federal Sentencing Guidelines, which take into consideration corporate cooperation; not to mention a growing SEC Enforcement Staff and the birth of the PCAOB) or fraudulent CEO/CFO certifications under Section 302 or 906 of Sarbanes-Oxley. It would be inequitable if the company is required to pay the executive severance or a lucrative lifetime pension when the executive is fired because of fraud or other securities violations.

[In January 2005, the Supreme Court declared the Federal Sentencing Guidelines, as then-applied, unconstitutional. See *United States v. Booker*. Effectively, the Court determined that the Guidelines can be constitutionally applied as written if they are "advisory," but not mandatory. It is expected that the Sentencing Commission and Congress will either revise the current federal sentencing system or pass new legislation to preserve the original intent of the Sentencing Reform Act and ensure uniformity in sentences nationwide.]

Hand in hand with refining the definition of "cause" is the need to add to all outstanding agreements (including options and restricted stock agreements) for CEOs and NEOs a clawback in the event of restatements or other harmful actions by the CEO/NEO to the employer – even where there has been no fraud or certification claim. For example, in February 2005, International Paper amended its Long-Term Incentive Compensation Plan to give the company the right to recover compensation paid to a participant in cases of a restatement of the company's financial statements due to "errors, omissions or fraud." (See our Task Force pointers regarding "cause" provisions and clawbacks.)

Note that in those instances where contracts cannot be avoided, the negotiation process is paramount. Consultants and independent counsel can help ensure that the compensation committee engages in real negotiation with the executive over the pay package contained in an employment contract. Without a real analysis and negotiation (and without fresh reviews of outstanding contracts – including running projections annually of payouts under various scenarios), the plaintiffs' bar will have a field day.

Double–Triggers, Severance Formulas. In addition, severance and golden parachute provisions that only have a single trigger (*i.e.,* awards become vested upon a change in control) need to be re-examined to assess whether there should be a double trigger (*e.g.,* awards become vested only after a change in control *and* termination in connection with the change in control). The practice of providing single-trigger acceleration was driven by accounting considerations that are now largely obsolete. In light of today's market, there is no compelling reason to provide the "windfall" of accelerated vesting. Where a double-trigger acceleration is used, severance is paid out only in the event of termination of employment. The plan will need to provide detail about what constitutes a qualifying termination for accelerated vesting, such as being fired without "cause" or resigning for "good reason."

Further, as many responsible critics have pointed out, the practice of using 3x salary as a severance formula needs to be re-examined and cut back to reasonable levels. In an August 2004 letter to CalPERS from the California State Treasurer, it was noted that "[f]ederal law places a steep excise tax on 'excessive' golden parachutes, those that provide more than three years of compensation. But what federal law set as a ceiling has become a floor for golden parachutes." The Treasurer went on to request that CalPERS put in place a "model severance policy that more closely ties payouts to shareholders' interests."

Providing more than one year's base salary to a departed executive (and adding bonuses – which are supposed to be incentives that are earned – to the formula) is out of step in today's world, especially when taking into account the CEO's other payments, including SERPs, vesting accelerators and the size of accumulated equity gains. (See the helpful Task Force submissions addressing potential severance pitfalls and the need to run all the numbers resulting from payments from different overlapping components that can be triggered by termination of employment.)

[In November 2004, CalPERS announced its new Executive Compensation Strategic Plan, focused on reigning in abusive compensation practices in corporate America. The plan calls for CalPERS to advocate for executive compensation reforms on a national level by addressing issues of transparency and design with the SEC, the SRO and the compensation consulting industry.]

162(m) Violations. The IRS is wrapping up an executive compensation audit pilot program in which it found Section 162(m) violations surprisingly common among the two dozen large-cap companies that it audited. As a result, we understand that the IRS has targeted 162(m) non-compliance as a focus area for future audits. As our readers know, Section 162(m) disallows a public company's deductions for compensation in excess of $1 million per year for its CEO and its next four highest-paid officers unless the compensation meets the requirements for "performance-based compensation" paid under shareholder-approved plans.

Common 162(m) compliance problems include: options granted under a non-shareholder approved plan; restricted stock (or restricted stock units), where neither the award nor the vesting is tied to objective, pre-established performance criteria; failure by the compensation committee to certify in writing prior to payment that the performance goals have been satisfied; or failure to timely set the performance goals – *e.g.,* not set within the first 90 days of a one-year performance period.

To avoid these 162(m) violations, it is imperative that the members of the compensation committee understand 162(m) and its technical requirements. Further, a company's human resources staff should consult and coordinate with both the chairman of the compensation committee and the company's compensation consultant, if any, so that the staff acts as a backstop for compliance – and compensation decisions are not made in a vacuum.

Moreover, as is true for much of the compensation committee report, it appears that quite a few companies simply regurgitate boilerplate language about 162(m) compliance in their proxy statements each year, putting directors as well as those responsible for internal controls at risk for regulatory actions – and providing additional fodder for plaintiffs' lawyers. The boilerplate disclosure can be particularly problematic if a company is sitting on a Section 162(m) violation. Compensation committees should make sure that, in addition to setting forth the company's policy on Section 162(m), companies are, in fact, disclosing what they are actually doing in practice, including the actual costs the company is incurring where there is non-compliance. [See the excellent Task Force submissions providing 162(m) pointers and red flags for compensation committees, including a 162(m) checklist for compensation committees.]

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

Step 11: The Art of Minute-Taking – The Plaintiffs' Bar is Watching

Recent complaints in executive compensation lawsuits remind us of the importance of proper minute-taking. Under recent innovative uses of the books and records provisions of Delaware law, it is now easier for plaintiffs (as well as those pursuing "just vote no" campaigns against incumbent directors) to access board and committee minutes. Complaints filed in executive compensation lawsuits quote heavily from minutes and, just as importantly, note what is not in the minutes (see the April 20, 2004 *Stanziale v. Nachtomi* decision from the U.S. District Court in Delaware).

[Note that in August 2005, the Third Circuit Court of Appeals reversed the district court's dismissal of *Stanziale v. Nachtomi*, concluding that while the district court correctly applied the business judgment rule to *Stanziale,* the lower court erred by applying Delaware's stricter "fact pleading" standard rather than the more lenient federal "notice pleading" standard. Thus, when analyzed under the more lenient federal standard, many of *Stanziale*'s claims would overcome the presumption that the officers and directors made their decisions based on valid business judgments.]

Although many companies have traditionally followed the school of thought that board minutes should be "bare-boned," the tide appears to have changed in the past few years and now many practitioners believe that boards should take care to provide sufficient detail in their minutes to reflect more clearly what transpired. It is not that the minutes need to be so detailed as to reflect what each particular director said – but they should state that discussions took place (as opposed to merely noting that a specific action was approved). This might be important if a government investigation or lawsuit ensues – but also will assist independent auditors, underwriters and any others that need to conduct due diligence.

In fact, for compensation decisions that are considered major corporate actions, it might even make sense to have a litigation-savvy lawyer draft the minutes. Remember that boards and board committees have the authority to hire their own counsel – and this may be an appropriate role for such counsel.

Recent cases that have challenged board or committee actions have faulted the corporate record left behind, preventing directors from establishing that they have met a duty of care or good faith (*e.g.,* the specific reference in the 2003 Disney opinion that only one and one-half pages of the minutes covered the approval of Mr. Ovitz's contract).

In short, minutes should include a description of each major item acted on, including a summary of the item, the major issues presented, the major factors taken into account – or relied upon – by the board, the board's decision and, in appropriate cases, the alternatives considered.

Based on the complaint filed against Cendant, those drafting compensation committee minutes may also want to address:

- The use of outside advisors and the extent of their involvement
- Complete explanations about how any pay formulas, caps or other thresholds were derived
- The reliance on spreadsheets and analyses regarding the pay package
- Any material changes to the pay package as originally presented, including the rationale for those changes
- The calculation of what the entire executive pay package could amount to – and the financial impact that payout would have on the company
- The calculation of what termination pay could amount to – and the financial impact that payout would have on the company
- The minutes should reflect that questions were asked throughout the meeting (if true – and it should be true!)
- If members of the committee were involved in negotiations with executives over pay packages (as they should be), their participation should be noted in the minutes by having them report to the committee

Step 12: The Importance of Your Proxy Disclosures – and the Need to Go Beyond S-K

As covered above and as many compensation committees – and counsel – will find upon conducting a review of all the components of their CEO's compensation, the compensation disclosures in many proxy statements, although perhaps literally complying with the SEC rules, have not provided a complete picture, perhaps to the point that they are misleading. Even though existing Items 402 and 404 do not explicitly require companies to ferret out and tally up all the components of CEO and NEO compensation, the Staff has made clear in the past that compensation disclosure cannot omit information that, although not specifically called for, would make the disclosures misleading.

[One respected colleague (and former SEC Staff member) who reviewed this issue responded to the above as follows: "You can cite Rule 12b-20 for the requirement to disclose other material information necessary to make the disclosures not misleading. If the committee follows all of your recommendations above, they should have a lot to talk about regarding how they set compensation and what they looked at."

[Also, as pointed out at our Executive Compensation Conference last year by SEC Corp Fin Director Alan Beller, Item 402(a)(2) of Regulation S-K requires "clear, concise and understandable disclosure of *all* plan and non-plan compensation awarded to, earned by, or paid to the named executive officers … for *all* services rendered in *all* capacities, unless otherwise specified.]

As part of each compensation committee's fresh review of compensation disclosure, many companies will need to take a hard look at their compensation committee reports. In 1993, the SEC issued interpretive guidance after an exhaustive analysis of the first batch of these reports (which were first filed in the 1993 proxy season – see Securities Act Release No. 7009, Aug. 6, 1993). This interpretive release identified a variety of deficiencies in the compensation committee reports, including "[t]he lack of specificity…with respect to CEO compensation for which more individualized disclosure is required by the rule." After an initial improvement in quality in response to this release, compensation committee reports appear to have deteriorated further.

[An excellent article analyzing the inadequate state of compensation committee report disclosure today, which parses a number of recent committee reports – that should be must reading for anyone responsible for drafting or reviewing the committee's report in this year's upcoming proxy statements – has been written by Martin Mobley and is posted on CompensationStandards.com.]

An obvious immediate fix is to list each component of the CEO's compensation – complete with dollar amounts – and then tally it all up and conclude with a statement that each member of the committee found that the total amount was not excessive or unreasonable. Since every compensation committee should routinely be conducting such analysis in connection with its annual CEO (and NEO) compensation review, this should be the standard in every compensation committee report. [We have posted a model disclosure for this section of the compensation committee report on CompensationStandards.com.]

Note that specifically naming a compensation consulting firm and disclosing that the firm is now retained by the board (rather than management) does not in any way reduce the obligation of compensation committee members to ensure that the compensation committee report is providing a true and complete picture. (We also refer readers to suggestions about the compensation committee report made in the May-June 2004 issue of *The Corporate Executive*.)

Because each member of the compensation committee literally goes on the line by having his or her name printed beneath the report, committee members should not blindly accept the verbiage of the past drafted by their well-intentioned advisors. Compensation committee reports that follow the old mode and remain boilerplate could well become fodder for the plaintiffs' bar – and the SEC.

[Readers should be aware that the Director of the SEC's Division of Corporation Finance, Alan Beller, recently admonished those responsible for compensation disclosures, stating forcefully, that the Staff of the SEC is fed up with inadequate executive compensation disclosure that, in fact, fails to comply with the requirements, as well as disclosure that obfuscates. It is clear that the SEC expects to see much more specificity and transparency in this year's upcoming disclosures, not the least of which includes straight talk in compensation committee reports. – While on the subject, those of our colleagues who may have missed its significance should be aware that the SEC Staff is considering recommending that the Commission bring administrative actions against those responsible for drafting misleading, incomplete proxy statement disclosures of perks at Tyson Foods. Readers should not dismiss this as simply applying to an isolated, egregious fact pattern. Our take is that the Staff has reached its boiling point with those of us responsible for compensation disclosures.]

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). Although it now appears that the two employees escaped SEC action, the Division of Enforcement is on record as focusing on "gatekeepers." See former SEC Enforcement Director Stephen Cutler's speech at UCLA on September 20, 2004 and the discussion of the Flowserve proceeding in our March-April 2005 issue at pg 7. Given the Staff's current frustrations with lawyers who are still "hiding the ball" in the misbelief that their clients are the executives and not the shareholders, we would not be surprised to see an SEC action soon brought against lawyers and others responsible for drafting incomplete or misleading perquisites disclosures.]

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

The Plaintiffs' Lawyers, Institutional Investors and Regulators

As we said in our May-June 2004 issue, 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 out 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 rolling back excessive grants and pay packages) will have a powerful good faith defense, pointing out that clear guidance that pulled it all together in one place was lacking until now.

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.

NEW DEVELOPMENTS

Space does not permit our inclusion of our regular *New Developments* section, but there have been a few compensation related developments that we wanted to share with our readers.

A Heads Up – "Internal Controls" and Compensation

As referred to above, on August 16, Tyson Foods filed an 8-K disclosing that the SEC Staff intends to recommend an enforcement action against the company, the company's CEO and two company employees who were responsible for drafting the company's proxy statement disclosures, alleging that they "failed to fully comply with SEC regulations with respect to the description and disclosure of perquisites totaling approximately $1.7 million provided to Don Tyson, former Senior Chairman of the Company, and the Company failed to maintain an adequate system of internal controls regarding the personal use of Company assets and the disclosure of perquisites and personal benefits."

What our readers should not miss here is the allegation that the company "failed to maintain an adequate system of internal controls…" Whether the Staff is speaking of internal controls in the Sarbanes-Oxley Section 404 sense or in a broader sense, it is clear that the Staff expects companies to have compensation related controls in place.

[In fact, the April 2005 action against Tyson did include a charge for 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. 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.]

As covered above, the IRS recently found many companies with 162(m) violations involving potentially significant dollar amounts. Apparently none of those companies had any proper 162(m) compliance controls in place. Our concern is that the SEC (or PCAOB) could well look at these and many other companies to ascertain whether there are any controls in place with respect to not only 162(m), but also other compensation related areas, including the company's potential payout obligations under SERPs, deferred compensation plans, severance and change in control arrangements, not to mention the real costs of perks.

It should not be overlooked that CEOs and CFOs may face potential personal exposure here for their certifications about internal controls if, and when, all the potential payout obligations are tallied up, the amounts in the aggregate are material and the lack of controls is deemed a material weakness.

In short, companies (and auditors) would be well advised to implement procedures to ferret out and add up all the compensation related payment obligations, including projected payouts under SERPs, severance and change in control scenarios. Note that this is one more reason why compensation committees should insist on being provided with tally sheets.

[Because of this very real concern, we put together an important panel with John Huber of Latham & Watkins and Michael Kesner of Deloitte & Touche at the October 20, 2004 Conference that addressed compensation related internal controls exposure and steps companies should be implementing now. The video archive of this panel and an accompanying outline of talking points are posted on CompensationStandards.com.]

SEC Speaks on Compensation

Because there has been so much confusion over perks and other compensation disclosure – and what the SEC's expectations are – Alan Beller, Director of the SEC's Corp Fin Division, joined us at the October 20, 2004 Conference and shared with us what the Staff is now looking for with respect to perks and other compensation disclosures – and what the SEC expects to see in place in the way of internal controls. [We should also point out that we have obtained permission to post the excellent chapter addressing airplane perk disclosure from David Cay Johnston's book, *Perfectly Legal*.]

The "One Stop" Reference Tool – A Thank You

As can be seen from all the references above to practice pointers, model language, etc., even we have come to rely heavily on CompensationStandards.com as an essential source. It has already exceeded our expectations. We would like to acknowledge and thank our Task Force members for making this happen and continuing to provide us with invaluable practice pointers.

We are gratified that so many companies and law firms are now relying upon the website – and that so many directors have found that they now have a resource. (Anyone who has not yet taken advantage of it should go to CompensationStandards.com and enter a no-risk trial.)

[Website vs. Conference – Confusion. As our readers may recall, CompensationStandards.com was launched initially as the repository for the course materials and practice pointers to accompany the October 20, 2004 Conference. Because we were receiving so many excellent, timely submissions, we decided to launch the site in advance of the Conference. But, the website has now taken on a life of its own. So, essentially people now are getting two for one. Those signing up for the Conference (in San Francisco, or by live simultaneous webcast) get all the resources on CompensationStandards.com at no additional charge. And those wanting just the website, get the Conference "thrown in."]

The Upcoming October 20, 2004 Major Compensation Conference

The second prong of our commitment to responsible, practical guidance is the October 20, 2004 Conference. We are humbled that so many distinguished colleagues have agreed to join us. The list of prominent speakers is too long to include here, but see the enclosed conference brochure and the complete list of speakers set forth on CompensationStandards.com.

And, we are gratified with the overwhelming response, especially from all the companies and law firms that are having people "attend" the conference via the simultaneous, live video and audio webcast. [Don't forget, immediately after the conference we will post the audio and video of the entire conference on CompensationStandards.com so those with schedule conflicts will still be able to hear it all. And, we will maintain it on the site until the end of the year so that each session can be accessed to facilitate subsequent reference and usage (which can be useful for boards that want to focus on specific topics at a convenient time, including board or compensation committee meetings).]

Some Confusion over the "Sold Out" Hotel

Due to heavy demand for the October 20, 2004 Conference (and the two NASPP Pre-Conference sessions), we have just learned that the conference hotel – the San Francisco Marriott – may be sold out for the night of October 19th. To accommodate attendees, we have secured rooms for the 19th at several nearby hotels at favorable rates.

Unfortunately, the Marriott Reservations center sometimes incorrectly advises people that the Marriott is fully booked for the other days of that week during which the NASPP Annual Conference is taking place. In fact, there still are rooms available at the Marriott from October 20, 2004 and thereafter. (Those who have not yet registered for the NASPP Conference are encouraged to register now as it is expected to sell out –

particularly with all the changes upon us impacting every company's equity compensation plans.) Don't forget to mention to the hotel the NASPP Annual Conference to get our special rate for the remaining blocked rooms. If you have trouble securing reservations, please contact the Marriott directly in San Francisco at 415-896-1600 or contact us at info@TheCorporateCounsel.net or 925-685-5111.

A Heads Up About Stock SARs

We should also mention that the NASPP has just added an important plenary session (to follow Fred Cook's keynote) that will focus on everything companies and counsel will need to know in order to implement stock SARs, "the new cashless exercise." Some of our readers have already recognized that once the new accounting charges become effective, issuing stock settled SARs will be a much more efficient way to exercise stock options. [Essentially, stock SARs would replace all current cashless exercise programs, saving companies on share usage and dilution, eliminating the Sarbanes-Oxley "loan" problem in connection with executives' cashless exercises – and even facilitating a move to adding retirement retention requirements for top executives' options, as we recommended above. The NASPP has anticipated all this. Their plenary session, alone, should be reason to attend that conference, on October 21, 2004. If you can't make it, be sure to order the tapes. Also, see the piece in the September NASPP newsletter on stock SARs (as well as the heads-up on the possible SAR monkey wrench contained in the pending deferred compensation legislation – and what companies can be doing now).]

Please Join Us to Celebrate 30 Years of *The Corporate Counsel*

Lastly, we should remind our readers that, with so many of our colleagues attending the October 20 Conference as well as the ensuing NASPP Conference, we are planning to celebrate our 30 Year milestone during the gala reception immediately following the October 20, 2004 Conference.

Please join us.

– J.M.B.

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

The Publisher of *The Corporate Counsel,* **Jesse M. Brill,** is a member of the New York and California Bars and received his J.D. from Yale Law School. Mr. Brill, formerly an attorney with the Securities and Exchange Commission, is securities counsel for one of the largest brokerage firms in the nation, and Chair of the NASPP. Mr. Brill has participated on a number of panels and seminars covering securities regulations sponsored by the SEC, NASD, Practising Law Institute, ALI-ABA, American Society of Corporate Secretaries, NASPP and others.
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