Necessary Corrective Action. Please note (at pgs 2-6) that many compensation committees will want to consider adoption/implementation of "the four tools."

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HIGHLIGHTS AND PITFALLS

The New Standards for Compensation Committees—Our Updated Guidance

One year has now transpired since we published our "Twelve-Step" Guidance for Compensation Committees. A lot has happened since then. In response to many recent requests from readers, and in anticipation of the upcoming 2nd Annual Executive Compensation Conference, we are providing the following updated guidance. [Please note that we have posted an electronic version of this issue, with hyperlinks to underlying sources, reference materials and models, on CompensationStandards.com.]

Is the Guidance in Our May-June and September-October 2004 Issues Still Current?

We have recently re-read the two issues in which we set forth our guidance. And, what we said last year is, if anything, more important and more helpful now than it was a year ago. Where appropriate, we have revised those two issues, updating sections to take into account subsequent events, and to include (and provide links to) important new examples and models. The updated electronic versions of the May-June 2004 and September-October 2004 issues that we now have posted on CompensationStandards.com incorporate all these changes.

What follows is our current take on the lay of the land (including landmines).

Personal Liability

Although more directors clearly are aware that they may face personal liability for their compensation decisions, we are still finding that a number of directors (and their advisors) assume that the company's D&O insurance will cover them. What may not be fully appreciated is that: (a) there is an important "good faith" requirement that must be satisfied, both to be able to claim indemnification and to be able to rely on the advice of compensation consultants and other experts, (b) indemnification and D&O insurance cannot restore a director's good name and reputation, relieve a director from the uncertainty that will loom during any litigation on whether his or her conduct will be protected, or avoid the months of depositions, interrogatories and other legal work that the director will have to go through in order to try to vindicate his or her conduct, (c) often the amount of D&O coverage may not be sufficient to cover the judgment (with interest) as well as the legal fees—as we understand has been the situation at Disney, (d) the SEC now has adopted a policy requiring settling parties to forgo any rights they may have to indemnification, reimbursement by insurers, or favorable tax treatment of penalties—and now court settlements are applying the same no-indemnification approach, and (e) courts are scrutinizing and rejecting settlements where the size of directors' personal obligations and the scope of the remedies do not appear to be sufficient (in May 2005, Delaware Vice Chancellor Leo Strine rejected a settlement between Fairchild Corp. and investors over allegations that the CEO and other senior managers received excessive and improper pay, stating that if the allegations in the lawsuit are true, the proposed settlement amounted to a "cosmetic whimper"). See also the Enron and Worldcom settlements, where the directors agreed to pay millions personally.

Lastly, it will not surprise us to see the SEC and plaintiffs' lawyers bringing actions that also name compensation consultants (who permit their names to be used in proxy statements to support unreasonable, excessive practices) and lawyers who craft disclosures that obfuscate or hide the full picture. [Although the lawyers who drafted the disclosures at issue in the SEC's recent Tyson settlement were targets, but ultimately were not prosecuted, we believe it is just a matter of time before the SEC sends a chilling message to those counsel/consultants who still view their client as management and not the company (and its shareholders).]

[The blue highlights throughout represent hyperlinks on the electronic version of this issue posted at www.CompensationStandards.com.]

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Director Independence

As we said in Step One of our May-June 2004 issue (at pg 4), when directors fully appreciate that their personal wealth and reputation are on the line, we expect to see many more examples of truly independent actions that heretofore have been too uncomfortable for many directors to address squarely. We recognize the reality, however, that many boards are still functioning under the same "boardroom atmosphere" that Warren Buffet described in his 2003 letter to shareholders. Indeed, it is difficult to be independent, for example, when many of your fellow board members belong to the same clubs and play golf together. (This was, in fact, cited in the recently filed action against Morgan Stanley's directors.) However, as more directors see cases brought against fellow directors at Disney, Fairchild, Martha Stewart Omnimedia, Nortel, Huntington Bancshares, Abercrombie & Fitch and Morgan Stanley, we expect to see more directors taking those tough positions and asking those previously unspoken questions. [Brief thoughts about the recent *Disney* decision are made at the end of this issue. Just the fact alone that *Disney* went to trial signals that the Delaware judiciary is very interested in the executive compensation decision-making process.]

The Need to Drill Down

Another concern is that many directors who sit on compensation committees still have not taken the time to do their own independent learning, and specifically drill down and focus on how these issues are applicable to affairs at the companies where they serve, notwithstanding all the admonitions about the need for ongoing director education by the NYSE and blue ribbon commissions. For example, in a recent conversation we had with a well-respected director, we discussed whether any of the boards he sits on had ever tasked their consultants or the company's HR staff to provide the board with a comprehensive "tally sheet" showing all the components of the CEO's compensation in one place, so that, when reviewing or approving any single aspect of the CEO's compensation, the directors would understand the sum total of all aspects of the CEO's compensation. His response was: "every board that I sit on has brought in [a well-known corporate lawyer] to talk to us."

What is troublesome about this response is that so many directors are still in the old school mode of assuming that if a board can show that it brought in an "expert" for a Sarbanes-Oxley presentation, that fulfills the directors' ongoing responsibility "to inform themselves of all material information reasonably available to them before making a decision" (see the *Disney* opinion at pg 127). As courts are now saying (see, *e.g.*, then Delaware Chief Justice Veasey's statements in the widely quoted *Harvard Business Review* article, "What's Wrong With Executive Compensation? A Roundtable," January 2003, in which he said that there is now "a new set of expectations for directors…that is changing how the courts look at these issues"), today the knowledge level is higher and the expectations and standards for compensations committees are higher, particularly now that there are specific resources that have been provided and are readily available to directors (such as the guidance on the CompensationStandards.com website).

It is also still troublesome that directors are not yet posing hard questions to their "experts," but instead, for example, still accept survey numbers from their experts without asking tough questions. (Now that surveys are being discredited, could plaintiffs' lawyers assert lack of "good faith" here?) And, it is troublesome that directors, when presented with "comparisons" of "peer companies," often still do not insist that they be shown true apples-to-apples comparisons. And, we are concerned that many compensation committees are not yet employing basic tools that are now available (and that we will address below). All of these raise the question of whether directors who know the rules, but fail to apply the lessons to their work as directors will be able to make a showing that satisfies the "good faith" standard under Delaware law.

These are the kinds of basic actions that we expect courts will be increasingly scrutinizing in assessing whether a director has truly fulfilled his or her responsibility as an independent fiduciary. We hope that the following will prove helpful to our readers who sit on (or advise) compensation committees.

TOOLS—Directors Need to Apply the Tools Available to Them

Many directors (and their advisors) have shared with us their discomfort about how far out of line CEO total compensation has come. But they have also questioned whether there is anything that they can do about it at this point. In fact, what follows are important ways in which directors—and responsible CEOs—can specifically examine compensation practices at their companies and make the necessary fixes.

Tool #1: Tally Sheets—Calculating Each Component of Compensation and Tallying it All Up

We are pleased to report that "tally sheets" are beginning to become a "household word" for both compensation consulting firms and boards. This is an example of how—in the span of one year since this basic concept was first highlighted in our May-June 2004 issue—boards and consultants have recognized that they lacked an important tool and are now taking corrective steps. We fully expect to see the SEC propose rules requiring disclosure of "total compensation" (see Chairman Cox's recent statements), and tally sheets are an indispensable tool to provide that information.

As our readers know, and as more fully explained in our May-June 2004 issue (at pg 5), the purpose of the tally sheet is to gather together in one place all the components of the CEO's compensation and then tally it all up. Too often in the past, compensation committees have made decisions about individual pay components (*e.g.*, stock option grants, or retirement benefits) without, at the same time, viewing the total compensation package in its entirety or understanding how a change to one element of compensation can ripple through and impact other elements of compensation.

As consultants have shared with us, often when a compensation committee is presented with the total picture (including how much the CEO has amassed in realized and unrealized option gains and what the real retirement or severance benefits will be, and what the real values of some perks actually amount to), the reaction is a true *"Holy cow … we had no idea that what we authorized would add up to all this"* moment. The purpose of tally sheets is to ferret out and address these surprises before they become an embarrassment and a source of potential liability.

A Caution

We are pleased to see that several of the major consulting and law firms (and many companies' HR executives) are now recommending that boards implement tally sheet procedures. We have recently posted some very good tally sheets that readers may wish to refer to and borrow from to improve upon their own tally sheets.

Of late, however, we are becoming concerned about potential misuse of tally sheets. The problem seems to be arising at consulting firms that are so used to the "survey" way of life that they just view this as another opportunity to provide survey comparisons showing what others have done. The problem with this is that tally sheets are supposed to help uncover and fix (if necessary) past mistakes and unintended amounts, not to memorialize them. As Fred Cook so ably pointed out in his speech this past June at the Stanford Directors College, surveys have been a major factor in causing excessive compensation. And now, if we are not careful, some consultants will latch onto providing tally sheet "surveys" as another source of business that will undermine the purpose of the tally sheet and further escalate compensation.

Learning From Others' Mistakes

Two recent examples that have been in the headlines demonstrate how tally sheets can backfire if the resulting findings are used mainly for comparison. These two companies had excellent disclosures in their proxy statements setting forth and tallying up all the components of the CEO's compensation. Indeed, there were many similarities to the model form of disclosure that we have posted for companies to use as a template. The suggested disclosure in our model, however, calls for the compensation committee to state, in conclusion, that they found the CEO's total compensation to be "reasonable and not excessive" (see, as an excellent example, Libbey Inc.'s disclosure—which has received positive reviews). Instead, it appeared that the two compensation committees used references to other companies' compensation as justification. Shareholders and the press, upon seeing the numbers, sharply criticized the boards for not addressing the apparent disparity between the compensation and the CEO's actual performance. (They could also be criticized for not fulfilling the requirement that the compensation committee report specifically address the relationship between pay and performance.)

We expect that in next season's proxy statements, boards will recognize that if they do not squarely address the reasonableness of the total compensation once it is all pulled together and tallied up, they may be digging themselves into a deeper hole.

We also expect that this coming year, when a compensation consultant or the company's HR staff is tasked with putting together a tally sheet, they will learn from the past year's embarrassments and realize that it is short sighted and not in the directors' or the company's (or their own) best interests to attempt to rationalize the numbers, instead of focusing on and addressing head-on the appropriateness of the total compensation. We are concerned that many directors may still be falsely lulled into thinking they will be insulated if they can show that a consultant provided or "blessed the numbers." Shareholders and courts have gotten too sophisticated to accept this approach, which, given the right situation, can provide ample fodder for plaintiffs' lawyers.

Implementing Tally Sheets

Because many compensation committees are, or will be, implementing tally sheet procedures this year, it is important that directors know what items need to be included. For example, we have noted some early efforts that have overlooked (or misunderstood) how to address and factor in: (a) annual pre-tax interest on previously deferred compensation (including returns on hypothetical investments), (b) dividends on growing restricted stock accumulations, (c) accumulated gains from past stock options and restricted stock grants, (d) the true value of perks, and (e) SERPs and other potential retirement and severance payouts (including the true value of projected post-retirement perks and ongoing benefits). In addition, directors need to be able to assess why (and when) each component of the CEO's total compensation became part of the package and whether—now that all the components are presented in one place—some aspects may now be redundant or no longer appropriate.

To get directors up to speed here and to avoid some of the early mistakes and embarrassments, we have added a half hour "nuts and bolts" session on what every director will need to know about tally sheets to this year's upcoming 2nd Annual Executive Compensation Conference. [In fact, one reason we were persuaded to do the Conference this year was the importance of getting past the platitudes and generalities so that directors could actually have and understand how to use the tools that are now available to them.]

Tool #2: Internal Pay Equity: The Basic Benchmark

Just as tally sheets are gaining hold as an essential tool (Tool #1) for compensation committees, we expect to see many more companies implement internal pay equity (Tool #2) policies and procedures. Internal pay equity is fundamental. As Fred Cook and other respected consultants have now advocated, compensation committees should now task their HR people to provide them with internal pay equity "audits."

This should give many compensation committee members the ammunition they have been looking for to supplant external survey numbers with an essential internal benchmark. When compensation committee members have before them a chart that shows graphically how, over time, the CEO's total compensation has gotten out of line within the company—with ever widening gaps between the CEO and other levels of executives within the company—it becomes clearer and easier for a board to say "we have reached a point where enough is enough, and instead of blindly chasing survey numbers, we must return to our own company's values and roots."

Companies like Dupont and Intel have been using an internal pay equity approach for years. At DuPont, the ratio between the CEO and the next highest executive stayed at 1.5x for years (since 1990, when former CEO Ed Woolard instituted the approach) and is now closer to 2x. We suspect that many companies, as they conduct their own internal pay equity audits going back several years, will find that they, too, were operating with similar ratios that have only gotten out of line over the last 10 years or so.

The internal pay equity audit can help a compensation committee see, for example, how it may have unwittingly added components of compensation to the mix without fully appreciating the need to reduce other components and without appreciating how large the total numbers (and the internal gaps) had become.

Implementing Internal Pay Equity—How To Do It

An internal pay equity audit is primarily an in-house project. The compensation committee tasks HR to provide a historical chart showing the compensation of the CEO and other levels of executives. The study at some companies may need to go back to the 1980s to see where the divergences within the company began; at other companies it may be over the last 10 or 15 years. Key to the study will be the need to include all the components (showing the impact of stock option and other equity grants and the addition of retirement and severance arrangements and perks, etc). Many companies will find that it is those components, particularly the stock option and restricted stock grants, that have widened the gaps even farther—especially from middle and lower level executives. (At DuPont, the size of the CEO's option grants and other benefits has remained within the same ratio as the cash compensation, perhaps because grants and other benefits were based on multiples of the cash compensation.)

For more specific guidance on implementing internal pay equity audits, we commend to our readers the guidance posted on the Internal Pay Equity Practice Area of CompensationStandards.com. In addition, there will be a "nuts and bolts" session on "Why and How to Implement Internal Pay Equity" at the upcoming 2nd Annual Executive Compensation Conference.

Two Cautions

No Place For Surveys Here. Beware that internal pay equity is an internal exercise and there is no reason to use external surveys or comparisons as part of the process. Each company will have its own unique circumstances and culture.

Surveys of others' practices will both distort the true numbers and take the focus away from *within* the company. Indeed, if a survey were to be done today showing companies that now have huge gaps between their CEOs and other levels within their companies, this could be used to attempt to justify those inappropriate ratios. Instead, those very companies—after conducting their own historical internal pay equity audit going back several years within their own company—might conclude that their ratios need to be brought back in line within the company. [To keep the focus clear, we urge compensation committees to emphasize to whomever is preparing the internal pay equity chart that you do not want to see surveys or comparisons of other companies' ratios—and to let consultants know that they may not use or share your company's ratios, even on a no-name basis, with others.]

Don't Game the Numbers. It has been pointed out to us that some companies could claim to have a 2x ratio between the CEO and the CFO simply by elevating the CFO's total compensation. (That's why it is essential to test the ratios against different levels of executives and employees down the line.) Also, cherry picking to leave out components (like the CEO's perks and stealth components like above market interest on deferred compensation and SERPs and severance amounts—and leaving out dividends on restricted stock grants) can distort the CEO's real total compensation, and hence the ratios.

Tool #3: Stock Options—The "Accumulated Gains & Carried Interest Table"

The third essential tool for every compensation committee is the "Accumulated Gains & Carried Interest Table." As Fred Cook so ably recounted in his speech, stock options were not originally intended to be part of current compensation, but rather an ownership incentive. Over time, executives would accumulate a "carried interest" that would motivate them to increase the value of the company over the long term. Unfortunately, because so many consulting firms included one-time mega grants in their surveys and smoothed them out to look like annual grants, over time the numbers became so inflated that today's average annual grant is higher than what used to be a huge one-time mega grant. (See the chart prepared by one of our Task Force members that dramatically shows that the median *annual* CEO grant is now 2.2 times larger than a *one-time* mega grant in 1988.) To quote from Fred's talk, "it is my belief that currently high stock option grant values for executives have gone beyond any rational motivational value and are sustained only by compensation surveys."

Because so many CEOs now have accumulated so much equity, the motivational value of additional, incremental grants has been lost for those CEOs. Indeed, there is the temptation to cash out and take the money and run (a perverse, reverse incentive). Again to quote from Fred Cook, "What can be the possible purpose served in granting a CEO who already has an equity carried interest of 150-200 times salary, another option whose 'face value' is 20 times salary? The CEO is likely to be already so motivated by stock price performance that new grants add no incremental motivational value. They only add cost. It is only done because the surveys say that, without the new grant, the CEO's total compensation will not be competitive. No survey, to my knowledge, considers what executives have already received in options."

An Accumulated Gains & Carried Interest Table enables a compensation committee to see in one place the total value of all the options and other equity delivered to the executive to date. Too often, directors do not have that information in front of them when they consider making new grants (or when reviewing other aspects of the CEO's compensation). As Fred Cook has pointed out, setting as a target a net future gain from equity grants of 6 to 15 times current salary "should be sufficient to optimize a leader's alignment with shareholders and motivation for a share price appreciation." We have posted an example of a table that illustrates how to set forth both the cumulative realized and unrealized gains for top executives at a company, as well as a chart to demonstrate what the values of equity holdings will be as the stock price rises.

What Can a Responsible Compensation Committee Do Here?

After a compensation committee has an accumulated gains table in front of it and sees how much wealth has already been delivered, there are two obvious courses that responsible boards and CEOs should take.

Turn Off the Hose (It Has Flooded the Field and is Damaging Roots). First is to recognize that the purpose of the equity grants has been met. This means that boards must bite the bullet and put on the table that the CEO has received so much already that there is no reason for more. (For this to happen, some responsible

CEOs are going to need to speak out—as some CEOs already have—by, *e.g.,* asking their compensation committees to put their grants back in the pool for other employees. See these and other important examples set forth in the new "CEOs That Have Set an Example" section on CompensationStandards.com.)

This also carries over to retirement and severance arrangements. Boards must recognize that the purpose of their option grants was to provide (a) incentive for the long term and (b) a healthy nest egg should all things work out. At those companies where the amounts from accumulated equity grants have now exceeded what were beyond the wildest dreams just a decade ago, boards must consider what is now already out there for the executive's retirement years and cut back on (and, in some cases, eliminate) the retirement and severance provisions that were intended to provide for the future. Now that some executives have amassed several lifetimes' worth of wealth as a result of past grants, it is time for responsible boards and CEOs to act here to restore (both internally and externally) trust and loyalty in the company's leadership.

Add Hold-Til-Retirement Provisions (Tool #4). An important step (indeed, we view it as basic Tool #4) that has already taken hold at a number of the savviest financial institutions—and other companies that have gotten concerned that they had delivered so much wealth through previous equity grants that their key executives and top producers could now cash out and leave (or even go to a competitor)—is the hold-til-retirement provision.

We have posted a growing list of the companies that have added provisions requiring their CEO and their top executives to hold 75% or more of the stock received from their equity grants until they reach retirement age. These provisions generally also apply retroactively to all outstanding past grants. (Companies have had little difficulty in persuading top executives to do so, for example, as a precondition to the receipt of another grant or a bonus.)

Make Necessary Fixes to Restricted Stock. For those companies that are now making restricted stock grants, where the amounts from prior stock options and other equity grants are already large, in some instances (as with stock options), the board must say "enough is enough." In other instances, where the board sees that it has already granted too much, it may well be appropriate to come to an agreement with the CEO to change the vesting schedule so that those prior restricted stock grants will not vest until reaching retirement age.

Space does not permit our delving into the problems and pitfalls that compensation committees (and some advisors) have unwittingly gotten themselves into in connection with switching to restricted stock from stock options (and the potential problems that many are now sitting on). In this connection, please reread what we said in our September-October 2004 issue (at pg 3) and what Fred Cook said in his talk "A Warning About Restricted Stock." We should also mention one very important aspect of restricted stock that often gets buried and overlooked by boards tallying up current compensation or considering retirement and severance payments: the annual dividends from previous restricted stock grants. We recently saw one company where the CEO's dividend income from restricted stock is already over $1.5 million a year and growing. (Again, this unintended outcome can be avoided, if grants do not vest, and dividends do not accrue, until retirement.)

MISUNDERSTOOD COMPONENTS

Rather than rehash what we said in last year's issues about each of the components that compensation committees need to better understand (and which HR staff, consultants and counsel need to do a better job of explaining and quantifying for their directors), we urge our readers to reread the updated sections of Steps Four through Seven, which we have posted on CompensationStandsards.com. The following are our current observations on continuing problem areas.

Deferred Compensation—Still a Disclosure Problem for Directors

As we set forth in our May-June 2004 issue (at pg 5), there is still a lack of disclosure—both to directors and to shareholders—of the additional compensation that is being delivered to executives through the interest being paid on accumulating deferred salary and bonus. And, there are still companies that are paying above-market interest rates and more than the company's actual after-tax cost of money, without any disclosure or justification in their proxy statements of this practice. (See the excellent discussion of the hidden, substantial costs to the company, and the under appreciated benefits to the executive that we have posted in the Deferred Compensation Practice Area on CompensationStandards.com, including a useful piece from one of our respected Task Force members focusing on the real costs to the company.) As many of our readers know, S-K Item 402 requires disclosure of only the "above-market interest," defined as the incremental amount of interest between 120% of the current interest rates and the rate the company actually pays on deferred sums. In some companies, as was the case at Wyeth in 2001 and 2002, the annual interest disclosed as paid to the CEO can exceed the CEO's actual salary and bonus combined. And, despite the public outcry, in addition to Wyeth, some companies still have arrangements whereby the CEO earns more than $1 million per year in above market interest earnings (or returns on "investments") on their deferred compensation, while other companies are paying interest rates as high as 9.5 to 14%.

As SEC Corp Fin Director Alan Beller made clear in his speech at our Executive Compensation Conference last year, the SEC will not tolerate lawyers who draft (and compensation committees that go along with) proxy statement disclosures that may literally appear to meet the requirements, but that do not present the full picture. Deferred compensation disclosures are one area, in particular, where this problem persists and where we can see the SEC (and plaintiffs' lawyers) honing in. Our word of advice here is to disclose the full amount of interest being paid (not just the above-market portion) and to make clear what rate of interest is being applied. [If the return is above the company's *after-tax* cost of money, our advice is to disclose that fact in the board compensation committee report, with a statement that, going forward, the rate of interest will no longer exceed the company's after-tax cost of money.]

[This year is a very good time for compensation committees to address these deferred compensation issues, since virtually every deferred compensation plan in America will need to be reviewed and amended this year to comply with new Internal Revenue Code Section 409A.]

SERPs—Still A Four Letter Word

As we set forth in our May-June 2004 issue (at pg 6), and as was underscored by all the consultants and counsel at last year's Executive Compensation Conference, companies should not be providing a retirement benefit to their executives that does not precisely mirror the amounts that would be payable under the company's retirement plan for all other employees. In other words, companies should not game the numbers by, *e.g.*, using more favorable definitions of final average earnings, crediting additional years of service, applying a more lucrative pension formula, or adding in forms of compensation in the calculation that are not counted under the company's regular retirement plan for employees. (See the excellent materials by leading consultants and lawyers posted in the SERPs and Other Retirement Benefits Practice Area on CompensationStandards.com that explain abusive supplemental executive retirement plans, and why they cannot be justified.)

A more fundamental question that boards should be addressing when reviewing their top executives' retirement plans is the actual purpose of a retirement plan. The purpose of a retirement plan is to provide a safety net for one's retirement years. It should be recognized that many of the most respected companies still operate on much simpler compensation models, where there is a clearer understanding of the role of retirement provisions. For example, at many high tech companies, compensation consists solely of salary and bonus and stock options. There is no pension plan and no SERP. The purpose of the stock option grant is to provide future wealth that will be more than sufficient to cover an executive's retirement needs. Historically, the model at older, lower-growth companies, where stock appreciation was not as great and therefore was not a factor for providing a nest egg for retirement, was to provide a pension. Retirement provisions were only meant to cover retirement needs, and were never meant to be part of the "scorecard" by which CEOs would be gauging their current compensation package against their peers.

Unfortunately, in large part as a result of surveys that did not distinguish between those two very different compensation models, but just lumped together the full array of benefits employed at different types of companies (and because CEOs at some lower-growth companies and their consultants started eyeing the huge gains being reaped from stock options at high tech companies), many companies with already generous retirement provisions for their executives have added on additional wealth building amounts through stock option and restricted stock grants. Another troublesome development that is compounding the overemphasis on the wealth building side is that companies that are now adding restricted stock grants to the mix are not focusing on the fact, as one respected compensation consultant points out, that they are "double dipping" because retirement plan payments and SERPs are in many ways the equivalent of restricted stock paid out in cash upon retirement.

[Again, this year is a very good time to address the above SERP issues, since virtually every SERP in America will need to be reviewed and amended to comply with new Internal Revenue Code Section 409A.]

The Need to Take Stock Here

Directors (and those of us who counsel boards, as well as academics and shareholders and critics) need to step back and focus on the total amount of wealth that has already been delivered to our top executives—and question what purpose retirement provisions now serve for top executives of many companies. Especially when the accumulated and projected amounts derived from stock options and restricted stock are added up, it will become clear that retirement payments for many CEOs and other top executives are no longer appropriate. [Indeed, we are hopeful that some responsible CEOs (particularly at companies that have scaled back pensions for employees) will speak out here and set an example for others to follow.]

Perks—Directors (and Shareholders) Are Still Not Being Provided the Full Picture

In our May-June 2004 issue (at pg 7), we stressed the importance of boards receiving *all* the information about the true value of the perks that a CEO may be receiving. During the past year the heat has gotten greater in this very sensitive area, as more media articles and thoughtful analysis and guidance have honed in on perks. That, in turn, has increased the resolve of regulators and has impacted employee morale and loyalty at given companies.

Most recently, our focus piece this past June (see our May-June 2005 issue) on airplane perks and the May 25th *Wall Street Journal* article on perks have now provided important information and guidance that every director (not just compensation committee members, because this goes to setting the tone and culture of a company from the top down) at a company that uses a corporate jet should read closely. What is particularly troublesome is that, while some CEOs are treating the company jet as their own personal transportation, some lawyers and company staff are presenting numbers to their boards and preparing perk disclosures for proxy statements (that directors sign off on and are accountable for) that mis-characterize the personal use as business related. Equally troublesome (and also misleading) is that the numbers being disclosed appear to be only a fraction of either (a) the true costs to the company, or (b) *the true value to the executive*.

Disclosing "The True Value to the Executive"

It seems fundamental that compensation committees, when assessing the total compensation being delivered to the CEO, should be provided with a chart summarizing all CEO perks, including, most importantly, company jet usage by the CEO (and his or her family and friends), which includes the value to the executive if s/he had to pay out-of-pocket to charter a comparable plane. Directors need to factor into the compensation equation the fact that some CEOs view the jet as an important status symbol among peers and place a very high value on their use of the plane. [Indeed, a CEO who uses the jet to commute to and from his home in another state or his vacation home on weekends, or to fly off to play golf at prestigious country clubs, views the jet as a very important component of his/her compensation.]

As is coming to light now, the one or two or three or four hundred thousand dollars that a company is showing in its proxy statement as the value of a CEO's airplane perk may, in many instances, be several times below the real value to the executive—that is, what it would cost the executive if s/he had to charter a comparable jet. [We note that in one proxy statement, that cost was pegged at $7,000 per hour ("based on a competitive analysis of comparable leased aircraft"), and is the price at which that company reimburses its CEO for the use of his private jet for business purposes.] Also, when a company purchases a new jet that will be used in large part for travel by its CEO, these purchases have not been disclosed or explained in the proxy statement. [It has been suggested to us by a respected colleague that companies should implement a new disclosure standard: "proportionate cost". If the corporate jet costs the company $10 million per year to own and operate (including the amortization of the jet's purchase price), and 25% of that plane's use is personal use by an executive, that executive's use of the plane should be valued at $2.5 million.]

Those responsible for reviewing or preparing perk disclosures in this year's upcoming proxy statements should be mindful of Alan Beller's warning about perk disclosure: "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… 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… 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)."

To sum up, the compensation committee should (a) understand the "real value" of all perks, (b) factor their "real value" (not their disclosed cost) into tally sheets and compensation decisions, and (c) disclose their "real value" in the proxy statement to enable shareholders, also, to have all the information necessary to assess the CEO's total compensation.

More Compelling Reasons

Perhaps more fundamental, however, is the resultant impact on employees' morale and behavior (and the public's trust in the system) when they see CEOs taking advantage of perks that they can well afford to pay for like everyone else. We strongly commend to everyone the Intel and Potlatch Corporation disclosures about perks. We would encourage many more compensation committees and CEOs to reexamine their own perk policies and question whether they are justified (*e.g.*, from a cost/benefit, employee relations, shareholder relations perspective) and to provide similar "no perks" language in their proxy statements.

Lastly, no CEO who has worked hard all his or her life to get to the top of the ladder and to be respected by peers and those in the community, as well as the general public, needs to see it all tarnished as Jack Welch has experienced with the disclosure of his airplane and other perk liberties (and as GE felt in an SEC action for its inadequate perk disclosures).

Severance and Termination Payouts—Directors Need to Focus on "Need"

Severance and termination payouts are an area that is drawing increased media and investor scrutiny and ire today. The most recent example of the consequences a board will now face when inappropriate amounts are paid to departing executives is the recently filed shareholder derivative action where each of Morgan Stanley's directors faces potential personal liability for the amounts paid to the departing CEO and president.

Here is another area where some boards have completely lost sight of (or never fully understood) the purpose of severance payments. Similar to retirement payments (as we discussed above), the primary purpose of a severance payment is to tide an executive over until another source of income is found. So, the first question that directors should ask is whether any severance is even necessary or is the executive already being provided for in the event of a termination.

[Another significant purpose of a severance payment is to compensate an executive for the risks (both financial and reputational) of moving to a new position (and leaving his or her old position). The more years that the executive spends at the new position, the more those risks decrease. For example, a CEO who has just left a lucrative and successful position with Company A to move his or her family across the country to work for Company B is generally far more in need of severance protection than a CEO who has worked for Company C for five or more years (in which case, the CEO and compensation committee should revisit whether there is any need now for severance).]

In short, the board should weigh "need": how much wealth has already been delivered by the company to the executive and accumulated through previous compensation, particularly option and restricted stock gains (realized and unrealized). At a minimum, any board making a decision about severance should have before it a cumulative tally sheet that provides all the numbers of all past compensation, in particular accumulated wealth from option and restricted stock grants. Also, those counseling boards about severance arrangements will want to point out to directors that the SEC has brought enforcement actions against General Electric (Rel. No. 34-50426, September 23, 2004) and W.R. Grace (Rel. No. 34-39156, September 30, 1997) for failing to fully and adequately disclose all the retirement benefits provided.

Then, in assessing what amount to pay, if any, a board should look to the cause of the termination of employment (and the costs of the executive's actions that led to the departure). [Also, in the context of an acquisition where the executive continues to work for the successor company, one must question whether it makes sense to pay a severance.]

With boards and courts much more knowledgeable now, we would be surprised to see boards successfully claim as a defense that they simply accepted the advice of experts. Particularly where the amounts involved are large, courts will expect to see that tough questions were asked of the "experts" (and that there was independent evaluation of the expert's recommendations)—and that adequate, responsible deliberations took place (and were documented) to show that supportable fiduciary decisions were, in fact, made. Boards will only have themselves to kick for not anticipating the consequences of their severance decisions and the resulting shareholder suits that could expose directors to personal liability.

Surveys (A Non-Tool): Compensation Committees Can No Longer Afford To Accept Survey Numbers

Perhaps the most significant development over this past year regarding compensation committees' reliance on surveys was what Fred Cook revealed and the guidance he conveyed in his June speech to directors. We have intentionally cut short our discussion here so that, instead, readers will take a moment right now to read (or re-read) what Fred said and his accompanying two-page bullet points on, "How Use—and Misuse—of Executive Compensation Surveys Leads to Upward Escalation of CEO Compensation." Also, please take a moment to refer back to what we said in our September-October 2004 issue (at pg 1), which is just as relevant and timely today. Our final comment is actually borrowed from what we said last year:

> 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.

Now that Fred Cook has spoken out, we trust that other compensation consultants—and more importantly, directors and responsible CEOs—will put those surveys aside and get back to what is appropriate. [Indeed, it is not far fetched to envision a court concluding that a compensation committee that simply accepted survey numbers (post Fred Cook's speech) did not meet its fiduciary obligation to avail itself of all material information reasonably available before making a business decision.]

ROLES/RESPONSIBILITIES/OPPORTUNITIES

Compensation Consultants and The Need to Tell It Like It Is—And like It Should Be

We have been encouraged that some compensation consultants have begun to speak out more publicly about what is still wrong and what needs to be fixed. A prime example is Fred Cook's speech. The suggestions he put forth have not only resonated in boardrooms, but also several major compensation consulting firms have circulated the text of his speech to all their consultants within their firms as essential reading.

In large part, however, consultants are still reluctant to tell it like it is. We still hear from leading consultants, in private, that they are frustrated with clients who are not asking the tough questions and who are still going along with excessive compensation. Unfortunately, most consultants fear that if they speak up too strongly, they will lose their client to a competing consulting firm. (Each firm has a story to recount to back up its concern.)

What this tells us is that compensation committees must do a better job in making it clear to their compensation consultants that the committee really wants to hear the cold hard truth—and that they are prepared to make changes, including discontinuing and, where appropriate, rolling back prior actions. But, it also tells us that consultants can no longer sit back in their old mode as passive responders to only what the client asks. Many consultants are still reluctant to initiate. If boards are to rely on consultants as experts, consultants have an obligation to be proactive. We see some progress here, but there is a need for more. Consultants can't just keep pointing a finger in private at boards—they must also make the effort now and *educate* their clients and point out specifically what is still in need of fixing.

Proxy Disclosures—Our Role As Counsel

This past year brought much improvement to proxy statement disclosures, particularly after Alan Beller's speech at last year's Executive Compensation Conference. We are continuing to see improvement. (A good resource for keeping abreast of the latest practices is the Borges and Melbinger blog section on CompensationStandards.com.)

However, as one leading corporate and securities lawyer has stressed to us, "We need to focus on our responsibilities as in-house and outside counsel… I'd love to have more occasions to deal directly with the compensation committee, and have them ask me questions such as, are we complying not just with the letter of the disclosure rules, but also the spirit? Is there anything you think we should voluntarily disclose even if not required under the line items of 402?" In addition, we, as counsel, should not accept the excuse that some disclosures may harm employee or labor relations or will just result in adverse press. If a compensation arrangement will harm employee relations or "look bad" in the press, that alone should be a signal to the compensation committee that it should reconsider the appropriateness of the arrangement.

We, as counsel, must constantly remind ourselves that our role here is not limited to disclosure. We can no longer afford to be just scribes. We have an obligation to our employer (the company) to fully educate our boards (and ourselves). We, too, need to understand the full scope of our top executives' compensation—and to point out to our boards what is still in need of fixing.

Directors Must Take Charge—That Now Means Reassessing, Modifying, and Even Rolling Back Years of Built-In Excesses

We have seen some significant progress at a number of boards over this past year. For example, some boards are now calling for tally sheets. However, once the compensation committee uses the tools described above and sees the totality of all the components set forth in one place, directors at a number of larger companies, in particular, will be faced with the inescapable fact that not only has cash and stock compensation gotten way out of line, but that the heretofore inadequately understood and undisclosed pay components have taken the total numbers (and the company's internal pay equity) so out of line that modifications—and even rollbacks—may be the only corrective solution.

[In addition, in many situations circumstances have simply changed due to the CEO's tenure and/or success with the company, as well as unforeseen external factors (*e.g.,* stock market values). In these cases, employment agreement modifications need to be made to reflect changed circumstance.]

As we set forth in our September-October 2004 issue (at pg 3), it is not as difficult as one might at first believe to fix past mistakes and correct and roll back past excesses. Directors and counsel will want to re-read that discussion and also see the excellent Task Force piece posted on CompensationStandards.com that provides thoughtful, practical guidance on 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".

Three Questions For Compensation Committees

We offer three guiding questions for compensation committees:

1. Do we know and understand each element of compensation, its cost to the company, and the actual dollar benefit it provides (or will provide) to each executive? (And, do we know the actual amount of accumulated wealth, realized and unrealized, resulting from previous equity grants?)

2. Do our proxy disclosures fulfill the spirit, not just the letter, of the disclosure rules by providing a comprehensive and understandable presentation of all elements of total compensation?

3. When we compare the actual compensation to the company's and executive's performance, are we absolutely convinced that the amounts are necessary and appropriate to retain and motivate an executive we want to retain (or stated differently, address each and all elements of compensation and ask, if this were eliminated or cut-back, what would happen)?

Other Necessary Fixes

We are heartened that many compensation committees have implemented important changes over this past year, for example, following our suggestions and those posted by our Task Force members with respect to (a) employment agreements (*e.g.*, eliminating automatic renewal provisions, fixing cause provisions and tightening up clawback provisions), (b) severance and golden parachute provisions (*e.g.*, adding double triggers, running all the numbers for severance payouts, eliminating tax gross ups and vesting accelerators, taking out of formulas all the components that can dramatically balloon the numbers, and moving from 3x to 1x salary only), (c) 162(m) (reviewing all the payments exceeding the $1million cap and fully disclosing and addressing them in the compensation committee report) and (d) internal controls (addressing potential vulnerabilities by insisting on tally sheets that play out all payout scenarios). We would like to thank our Task Force of 75 leading responsible authorities in the field for sharing with all of us invaluable practice pointers addressing the above that have truly improved the corporate governance standards at many companies over this past year. Readers who have not yet discovered the wealth of great practical pointers that are being provided by the Task Force, may wish to scroll down the left hand column of the home page of CompensationStandards.com.

Help/Resources For Compensation Committees

One message we took from the recent *Disney* opinion is that courts, in judging the actions of directors, will look to whether they "failed to inform themselves of all material information reasonably available when making a decision." Today, boards have knowledge and tools before them that did not exist even a few years ago. For directors who sit on compensation committees, there are now a few "consensus" basic reads. High on many advisors' essential reading lists for directors are:

- The 12 Step Guidance for Directors (Part I and Part II—including this issue)
- Alan Beller's October 20, 2004 Speech
- Fred Cook's Speech to Directors

We are also gratified that so many consultants and both in-house and outside counsel are pointing their directors to CompensationStandards.com as the single ongoing resource for compensation committees. We also deeply appreciate that so many leading directors and highly respected lawyers and consultants have volunteered their time to participate in this year's 2nd Annual Executive Compensation Conference—and to continue to provide ongoing guidance on the website. With all of us working together, we are optimistic about the prospects of restoring trust and integrity to the system and to strengthening the morale and loyalty within our companies. [Indeed, there are increasing examples of boards and CEOs that are acting to cut back excessive pay, everything from reducing or eliminating perks to comprehensive revisions of executive compensation packages. (See the growing list of examples being posted on CompensationStandards.com.)]

A Closing Word

As with our original Twelve-Step Guidance, the purpose here has not been to cast blame, but to get past all the rhetoric and lofty sounding principles to provide practical guidance—and tools—to enable directors (and those of us who counsel boards) to take the necessary corrective actions.

It is now up to each of us to take those actions. Perhaps the first step here will be to furnish a copy of this issue to colleagues, particularly fellow directors and CEOs. (You have our permission to make unlimited copies for this purpose.) And, to add as the first order of business on the agenda for your next compensation committee meeting, adoption/implementation of the four basic tools covered above, as well as a review of other necessary fixes as outlined above. (In that connection, we encourage our readers to share with us your progress.)

NEW DEVELOPMENTS

Although we have little space remaining for our regular New Developments section, we did want to say a few things about the *Disney* decision (which further underscores the importance of the guidance above).

The Disney Decision

As our readers know, on August 9, Chancellor Chandler of the Delaware Chancery Court issued his long-awaited opinion, holding in favor of all the defendants in the Disney trial. While different commentators have focused on different aspects of the opinion (see the law firm memos and commentary posted on CompensationStandards.com), here are a few things directors can take away from all this.

• Don't overlook the importance of Chancellor Chandler's opinion last year in letting the case go to trial. This has opened the door for many more lawsuits against directors.

• As pointed out in the Gibson Dunn & Crutcher analysis, "while the Court provided the directors relief from potential liability, adherence to better processes and practices could have spared the individual directors years of litigation and many hours of depositions." (Not to mention, we might add, the bad personal publicity and the very real prospect of out-of-pocket liability that has loomed over each director.)

• Lastly, as Chancellor Chandler stated in the introduction to his opinion, "it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board … took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced." We wonder whether a court looking at actions (and failures to act) that took place today could find that directors breached their fiduciary duty by (a) not following what today would be considered basic practices and (b) not availing themselves of the basic tools now before them for making compensation decisions—in effect, ignoring the Chancellor's statement: "For the future, many lessons of what not to do can be learned from defendants' conduct here."

In short, could a court, facing a current situation (especially given the learning and red flags and tools that are now before directors) hold against the directors, finding that they "failed to inform themselves of all material information reasonably available before making a business decision?"

We are eagerly awaiting the discussion on these and other issues involving director duties in the compensation context with Professor Charles Elson, Chief Justice Myron Steele and Vice Chancellor Stephen Lamb, which will be aired nationwide as the lead-in session for the upcoming Executive Compensation Conference.

Making Changes Today Should Not Expose You to Liability for Past Practices. Those of us who counsel boards that may be reluctant to fix a past mistake for fear that it could bring attention to a past action that may have breached a fiduciary duty, should find comfort in the court's statements that it will not apply current "best practice" standards to past actions. On the other hand, a board that now recognizes a past mistake that does not fix it or that attempts to rationalize it, may find that the intentional inaction or cover up could amount to the very type of "bad faith" that would result in liability.

Conference Update

We are humbled by the groundswell of interest in the upcoming Conference. The Chicago Hyatt Regency is already close to filling the entire conference room block. (We are currently having the hotel expand the block. If you encounter any problem with the hotel, reiterate "the Executive Compensation/NASPP Conference block" and then call our office at (925) 685-5111 for assistance.)

For all those planning to take advantage of the video webcast, we are anticipating last minute overload and access problems at those companies and firms that have not taken the time in advance to go to the website and register for all those within your company, including those at different locations (especially outside directors). We encourage all our readers to go to www.CompensationStandards.com to do so now to avoid any problems.

Just Announced: JPMorgan President Jamie Dimon to Speak

As we go to press, we are pleased to announce that respected and charismatic chief executive, Jamie Dimon, will be our Luncheon Speaker at the Conference to speak to fellow CEOs and directors in the audience in Chicago and across the country via the video webcast. As the former CEO of Citigroup and Bank One, and now as President of JPMorgan Chase, Jamie Dimon possesses a unique perspective. Those who have heard him speak know that Jamie Dimon speaks with conviction.

It is important that every director and every CEO out there hears what John Reed (our keynote) and Jamie Dimon will be saying. They both are committed to restoring trust in the system by returning to responsible compensation—joining the growing list of respected directors and CEOs who are taking actions to make a difference today.

Thirty Years

This issue marks the completion of thirty years of writing *The Corporate Counsel.* (Our very first issue was our November 1975 issue.) And, as we hope our readers can see, we are as committed as ever to giving you our very best.

—*J.M.B*

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

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