HIGHLIGHTS AND PITFALLS

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

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

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

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

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

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

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

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

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

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

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

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

**And Even Us Chickens**

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

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

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

**What Now Is Expected of Compensation Committee Members**

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

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

It is clear that regulatory and judicial expectations also have changed. Earlier this year, the IRS began conducting audits at dozens of companies targeting perk practices. And news of the SEC’s enforcement investigation into disclosure of perks (see our September-October 2003 issue) and Corp Fin’s recent consideration of rulemaking in the Item 402 and 404 areas indicates that compensation practices will be a high priority for the SEC going forward.

In fact, the SEC has begun using its enforcement powers with vigor to force executives to disgorge prior compensation. For example, in mid May, Warnaco’s former CEO, CFO and General Counsel gave back $1.3 million, $264,000 and $165,000, respectively, as part of a settlement of an action related to misleading disclosures. A similar bonus disgorgement as part of an enforcement settlement with an Enron executive followed a week later. And the SEC already has used its new powers under Section 1103 of Sarbanes-Oxley to freeze $37.6 million in termination pay and bonuses negotiated by two top officials of Gemstar while they were under suspicion of cooking the company’s books. [In mid May, the 9th Circuit overturned a district court decision that had supported the SEC’s placement of these funds in an escrow account.]

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

**How We Got Here**

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

**The Roadmap for Compensation Committees**

Getting past the trappings of revamped committee charters, requisite number of meetings and ongoing education requirements, the following are twelve basic steps (our “Twelve Step Program”) that compensation committee members should now be focusing on—and that courts and regulators and shareholders should now be expecting.

Up front, we must confess that a lot of what follows took us quite a while to see clearly—because the knowledge and information necessary to see the complete picture is so compartmentalized that it is not easy to put it all together.

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

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

**Step One: True Independence—When a Director’s Pocketbook and Reputation are “On The Line”**

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

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

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

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

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

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

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

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

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

Step Four: Deferred Compensation—Problems with Annual “Interest” and Total Accumulated Amounts
Many companies maintain deferred compensation plans that allow executives to set aside up to 100% of salary
and bonus. These plans became more popular after the Section 162(m) million dollar cap was adopted by
Congress. However, the SEC’s disclosure requirements predated this popularity and Item 402 only calls for dis-
closing the incremental amount of interest between 120% of the current interest rate and the rate the compa-
ny actually pays on the deferred sums. Nobody fully appreciated a decade ago what might end up not having
to be disclosed.

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

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

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

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

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

Step Five: SERPs—A Four Letter Acronym?

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

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

As widely reported, former Tyco CEO Dennis Kozlowski is trying to collect on a $4.5 million per year SERP, worth an estimated $50 million in current value. In addition to playing with years of service, SERP payout amounts at some companies have been inflated by including bonuses and other payments in the calculation. One respected compensation consultant says that compensation committees should view SERPs as the equivalent of restricted stock that is simply paid out in cash. As a result, they should be treated as a form of long-term
compensation, and that those companies that have both SERPs and restricted stock (or other long-term compensation) are, in essence, double dipping. Whether or not one agrees with that characterization, what is clear is that a lack of understanding of SERPs has enabled many executives to receive additional compensation that has not been factored into the final tally.

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

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

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

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

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

The same goes for the company jet on which the free ride by the NEO’s spouse may not count as having any perk reporting value “since the jet was already flying to that destination.” Some companies have gone a step further, claiming that, where the use of a company jet for personal travel is mandatory for “security purposes,” all use of the jet is “business” rather than “personal.” The Staff made it clear last year that this rationale won’t fly to avoid the requirement to report personal usage as a perk. (See our January-February 2004 issue). Investors likely have taken note of a recent study by Professor David Yermack of New York University's Stern School of Business (posted on CompensationStandardsConference.com) finding that companies that allow corporate jet use for personal travel underperform the rest of the market.

If a company were to report the real values and costs of perks, including actual purchase or rental price and maintenance costs of the executives’ limousines, jets and apartments, etc., these numbers could be embarrassing, to say the least. As we have seen with Koslowski’s $18 million New York apartment or GE’s $11.3 million apartment for Jeffrey Immelt (or the countless other New York apartments maintained for CEOs), it is misleading not to report these numbers by taking the position that the incremental cost of non-business use doesn’t meet the $50,000 reporting threshold.
Directors should not leave themselves open to embarrassment (or worse) by not knowing the real costs and benefits their CEOs are receiving. A question we received from in-house counsel during the Q&A following the March webcast on “What the Top Compensation Consultants are NOW Telling Compensation Committees” says it all. Essentially the question boiled down to: “What perks do we actually have to disclose to our compensation committee?” The answer is that directors should be demanding a full, detailed description of each and every benefit provided to the CEO (and each NEO)—one colleague calls it a “perk audit”. It is irksome that management (and counsel) are still screening this essential information so that directors are not being provided the fullest disclosure—and that directors do not appear to be asking the tough questions to ferret out the full cost to the company of providing personal benefits to executives.

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

Personal Benefits
Intel seeks to maintain an egalitarian culture in its facilities and operations. Officers are not entitled to operate under different standards from other Intel employees. We do not provide officers with reserved parking spaces or separate dining or other facilities, nor do we have programs for providing personal benefit perquisites to officers, such as permanent lodging or defraying the cost of personal entertainment or family travel. Our health care and other insurance programs are the same for all eligible employees, including officers. Our loan programs, although modest in nature, are not available to executive officers. There are no outstanding loans of any kind to any executive officer, and since 2002, federal law has prohibited any new company loans to executive officers. We expect our officers to be role models under our Corporate Business Principles, which are applicable to all employees, and officers are not entitled to operate under lesser standards.

**Step Seven: Overlooked Severance and Termination Payouts**

Another component of CEO compensation that often gets overlooked and, as a result, is not factored into the full compensation equation is severance payouts under varying scenarios. These are payments beyond the SERP payments that executives will receive as part of their retirement benefits. From a litigation perspective, it is noteworthy that the Disney and Cendant complaints both alleged that the compensation committee did not discuss the size of potential payments in the event of the exiting executive's termination.

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

**Tallying Top Executives’ Total Compensation**

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

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

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

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

**The Remaining Five Steps**

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

**The Plaintiffs’ Lawyers, Institutional Investors and Regulators**

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

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

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

**Advancing The Ball**

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

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

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

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

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

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

- all the relevant articles and client memos (including memos and guidance from the compensation consulting firms)
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- actual new plans and features and practices
- ongoing articles and guidance on new developments and practices
- Q&A/Discussion Forum in which the top consultants and the top compensation lawyers are actively participating, sharing ideas and practice tips
To address this need, and in anticipation of the October 20 compensation conference, we have now put together a Task Force made up of over 80 leaders in the field—the top compensation lawyers, compensation consultants and critics. With our help, this Task Force is in the midst of putting together practice pointers, documents and materials for CompensationStandardsConference.com, a special website available to those that intend to attend the compensation conference, either live or via webcast. Because we have already gathered and posted some extremely useful materials, rather than wait until the conference, we have decided to make these materials (including an Electronic Version of this issue of The Corporate Counsel, complete with links to important supporting materials and resources addressing each of the points and suggestions covered in the issue) available right now to provide an ongoing resource for those that sign up for the conference. (Note, we have also posted the working draft of the remaining five steps, containing important guidance and suggestions.)

**New Developments**

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

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

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

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

—J.M.B.

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

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. 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. Editor: Michael Gotteman, LLB. Harvard University, Farelia Braun + Martell LLP, San Francisco (mgotteman@fbm.com)

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- **The NASPP TRIAL MEMBERSHIP**
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This major one-day conference will be unlike any other. The top compensation consultants, the top critics and key regulators, will be sharing their own inside knowledge—and practical what-to-do-now guidance—that compensation committee members (and their advisors) need NOW.

Why do you need this practical guidance now? The answer is simple: PERSONAL LIABILITY. With directors facing the prospect of potential personal liability for their compensation decisions—not covered by D&O insurance as borne out by recent court decisions—attendance at this conference truly is a “must.”

In recognition of the widespread need and interest in this one-of-a-kind Conference and the demands on directors’ time—we are making this important event as accessible as possible! You can attend in person, by video conference, video webcast or audio webcast.

Here are some highlights from this practical conference:

- What Every Director Now Needs to Know and Do
- What is the Appropriate Amount of Compensation for CEOs
- What to Do About Reviewing Outstanding CEO Pay Packages, Contracts and Accumulated Options Gains (including obligations to re-examine/modify/roll back)
- The Role of the Compensation Committee—Avoiding Personal Liability
- The Inside Scoop—Red Flags—Revealing Questions to Ask
- What You Need to Know (and haven’t been told) about Perqs, SERPs, Severance, Deferred Compensation, and more
- How to Calculate and Tally-Up All the Components
- Surveys and Benchmarking—What is Wrong
- What the Minutes Now Need to Reflect
- What Now Needs to be Disclosed in the Proxy Statement
- Best Ideas, Features & Practices in the New Environment
- And More …

More details and registration information are available on the reverse side of this flyer.

**Who Should Attend:** Every Compensation Committee member and every advisor—particularly all in-house and outside counsel—every person responsible for implementing executive and equity compensation plans or who counsels or advises boards, audits records, prepares minutes or prepares proxy statement disclosures.

For more information go to TheCorporateCounsel.net or CompensationStandardsConference.com
A "One Stop" Reference Tool

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

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- ongoing practice pointers, articles and guidance on new developments and practices
- a Q&A/Discussion Forum in which the top consultants and the top compensation lawyers are actively participating, sharing ideas and practice tips

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

With our help, this Task Force is in the midst of putting together practice pointers, documents and materials for a special website—CompensationStandards.com—available to those who intend to attend the compensation conference, either live or via webcast. Rather than wait until the conference, we have decided to make these materials (plus an electronic version of The Corporate Counsel complete with links to important materials and resources addressing each of the points and suggestions covered in the issue) available right now to provide an ongoing resource for those that sign up for the conference now. (And, we have now posted all the pointers and suggestions in the draft of the remaining five steps.)

When/Where: October 20, 2004 in San Francisco. (We have intentionally coordinated the timing of this conference to be the day before the NASPP 2004 Annual Conference, so that those lawyers and advisors attending the NASPP conference will also be able to attend this major conference.)

Cost/Access: For this essential conference—and to gain immediate access to CompensationStandardsConference.com—we offer the following alternatives so that all the key players will have access to all the critical, practical guidance that you will need in the days to come:

1. Live in San Francisco (also includes access to webcast archive):
   [Note, also includes attending a post-conference reception where you can ask one-on-one questions of all the participants.]
   [____] $895, or
   [_____] $495, a reduced rate for anyone who also registers for the 2004 NASPP Annual Conference or anyone from a company or firm that has registered someone else for the Video Conference or Webcast version of our Compensation Conference.

2. Live (and Archive) via Video Conference, Video Webcast or Audio Webcast—To Boardrooms, Conference Rooms and Desktops
   [This rate also entitles you to unlimited access to the archives of the Conference which will enable reshowing and replaying of the sessions to key people within your company/firm and will facilitate scheduling Compensation Committee meetings around targeted sessions, etc.]

Choose one from the following alternatives, which are designed to make it as easy as possible for every compensation committee member and every person responsible for advising boards or implementing plans to attend:

- [____] $895 single person rate
- [____] $995* Three-Person Rate, a reduced rate for those at a company or firm that are both (a) subscribers to both The Corporate Counsel and The Corporate Executive and (b) NASPP members
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- [____] $2495* SPECIAL UNLIMITED RATE [For those that do not qualify for the above rates. Note, however, you may enter a no-risk trial for any of the above and qualify for the reduced rates.] The reduced rates are our way of saying “Thank You!” to our loyal subscribers (and to encourage those who have not yet discovered our acclaimed newsletters, The Corporate Counsel and The Corporate Executive, or the NASPP to enter no-risk trials, particularly for these critical months ahead.)

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What Every Compensation Committee Needs to Know—and Do—Now!

San Francisco – October 20, 2004

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