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Compensation Committee Guide

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About This Compensation Committee Guide

This Compensation Committee Guide (this "Guide") provides an overview of the key rules applicable to compensation committees of listed U.S. companies and practices that compensation committees should consider in the current environment. This Guide outlines a compensation committee member's responsibilities, reviews the composition and procedures of the compensation committee, and considers important legal standards and regulations that govern compensation committees and their members. This Guide also recommends specific practices to promote compensation committee effectiveness in designing appropriate compensation programs that advance corporate goals. Although generally geared toward directors who are members of a public company compensation committee, this Guide also is relevant to members of a compensation committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

This Guide contains sample compensation committee charters as Exhibits. These Exhibits aim to be useful in assisting a compensation committee in performing its functions. However, it would be a mistake to simply copy published models. The creation of charters requires experience and careful thought. It is not necessary that a company have every guideline and procedure another company has in order to be "state of the art" in its governance practices. When taken too far, an overly broad committee charter can be counterproductive. For example, if a charter explicitly requires review or other action and the compensation committee has not taken that action, the failure may be considered evidence of lack of due care. Each company should tailor its compensation committee charter and written procedures to what is necessary and practical for the particular company.

This Guide is not intended as legal advice, cannot take into account particular facts and circumstances and generally does not address individual state corporate laws.

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Compensation Committee Guide

TABLE OF CONTENTS

Page

Introduction

Compensation Matters Take Center Stage

The past decade's mounting focus on executive pay reached new heights in 2010 as the Great Recession fueled increased legislative, regulatory and shareholder activism with respect to executive compensation. This activism culminated in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which imposes the following new obligations with respect to compensation and related governance issues:

- public companies must include in their annual proxy statements a nonbinding resolution seeking shareholder approval of named executive officer ("NEO") compensation at shareholder meetings at least once every three years, and must include a separate nonbinding vote at least once every six years to determine how often this say-on-pay vote will be held (every one, two or three years);

- public companies must, in connection with a merger or similar transaction, provide disclosure in tabular format of all "golden parachute" compensation arrangements between the target or acquiror, on the one hand, and the NEOs of each company, on the other hand, and in many cases submit to a shareholder advisory vote those arrangements between a soliciting party (typically the target) and its NEOs;

- compensation committees of public companies may select a compensation consultant, legal counsel or other adviser only after taking into consideration competitively neutral independence factors determined by the Securities and Exchange Commission (the "SEC");

- the SEC must adopt a rule instructing the securities exchanges to prohibit the listing of issuers that do not have independent compensation committees (except for controlled companies and foreign private issuers that disclose annually to shareholders why they do not have an independent compensation committee);

- the SEC must amend the proxy rules to require disclosure of the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer) to the total annual compensation of its chief executive officer;

- the SEC must adopt a rule requiring public companies to include disclosure (graphic or otherwise) in annual proxy meeting materials showing the relationship between executive compensation and corporate financial performance; and

- the SEC must promulgate a rule requiring public companies to adopt policies that mandate clawbacks of compensation that was paid to a current or former executive officer during the three-year period preceding the date on which the company is required to prepare an accounting restatement as a result of material non-compliance with the securities laws, if the compensation is determined to have been based on erroneous data.

Perhaps as important as the swelling regulatory burdens imposed on compensation committees during the past year is the challenging dynamic that has emerged as a result of the ever escalating pressure on directors to reign in executive compensation. Making compensation decisions that are consistent both with the needs of the company and the various "one-size fits all" legislative, regulatory and "best practice" mandates is a balancing act that all successful compensation committees must master. Achieving these goals while maintaining collegiality between members of compensation committees and senior management is the greatest challenge facing the compensation committee today.

Compensation committees should design compensation programs with great care, focusing first and foremost on the incentives that the programs promote. Directors should also bear in mind the heightened sensitivity to pay packages that could be deemed "excessive." A compensation committee that follows normal procedures and considers the advice of legal counsel and an independent consultant should not fear being second-guessed by the courts, which continue to respect compensation decisions so long as the directors act on an informed basis, in good faith and not in their personal self-interest. In the final analysis, the ability to recruit and retain world-class executives is essential to the long-term success of a company.

Given the ongoing shift in the corporate governance landscape, there is a renewed focus by directors on the proper role of a compensation committee. This Guide describes the duties of compensation committee members and provides information to enable them to function most effectively. This Guide begins with a discussion of the responsibilities of the compensation committee and the fiduciary duties of its members. It then outlines different means of compensating executives and the tax and other rules that apply to compensation arrangements. A discussion of change-in-control arrangements follows the discussion of types of compensation. The next section of this Guide focuses on shareholder proposals and relations, including a discussion of say-on-pay votes. This Guide next examines regulation of compensation at financial institutions, including the restrictions imposed on participants in the Troubled Asset Relief Program ("TARP"). The discussion then shifts to compensation committee composition, compensation committee meetings and compensation committee charters. Finally, this Guide addresses compensation of directors.

This edition of the Guide has been updated to reflect the current environment. Significant updates include:

- an updated section on "clawback" provisions, which discusses the new clawback mandated by Dodd-Frank (see Section E of Chapter III);

- a new chapter on shareholder proposals and relations, which includes an extensive discussion of Dodd-Frank say-on-pay mandates (see Chapter VI); and

- an updated chapter on restrictions imposed on financial institutions, including the final interagency guidance on risk in incentive compensation (see Chapter VII).

I

Key Responsibilities of Compensation Committee Members

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

A. Responsibilities Imposed by the Securities Markets and Dodd-Frank

1. New York Stock Exchange Requirements

The NYSE requires that all listed companies subject to its corporate governance listing standards have a compensation committee composed entirely of independent directors[1] with a written committee charter.[2] The NYSE further requires that the compensation committee carry out a number of minimum responsibilities. While the responsibilities of a compensation committee may be delegated to subcommittees, each subcommittee still must be composed entirely of independent directors and have a published charter.[3]

Under the NYSE rules, a compensation committee must (a) review and approve goals and objectives relevant to chief executive officer ("CEO") compensation, (b) evaluate the CEO's performance in light of such goals and objectives and (c) either as a committee or together with the other independent directors determine and approve the CEO's compensation based upon such evaluation. In determining the long-term incentive component of CEO compensation, the NYSE suggests that a compensation committee consider (1) the company's performance and relative shareholder return, (2) the value of similar incentive awards to CEOs at comparable companies and (3) the awards given to the CEO in past years.[4] Compensation committee responsibilities regarding CEO

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[1] The NYSE definition of "independent" is explored in detail in Chapter VIII of this Guide.

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

[3] A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

[4] The NYSE clarifies that a compensation committee is not precluded from approving awards so as to comply with applicable tax laws, such as § 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), with or without ratification by the

(footnote continued)

compensation do not preclude discussion of CEO compensation with the board of directors generally.

In addition, under the NYSE rules, a compensation committee must recommend non-CEO executive officer compensation to the board of directors. This requirement means that a listed company's compensation committee must recommend compensation of the president, principal financial officer (the "CFO"), principal accounting officer (or, if there is no principal accounting officer, the controller), any vice president of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions. A compensation committee also is charged with recommending to the board of directors the approval of incentive and equity-based compensation plans that are subject to board of director approval.

If a compensation committee desires to have the aid of a compensation consultant, the compensation committee must be vested with the sole authority to retain and terminate the consultant and to approve the consultant's fees and other retention terms. Additionally, the NYSE reiterates and adopts the SEC requirement that a compensation committee produce a report on executive officer compensation required to be included in the listed company's annual proxy statement or annual report on Form 10-K.

Lastly, a compensation committee must conduct an annual self-evaluation of its performance. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants also have established advisory services to assist a committee with the evaluation process. A compensation committee must decide how to conduct its evaluation. In making the decision, it is not required that the directors receive outside assistance, and no specific means of evaluation is prescribed. A compensation committee may elect to do the evaluation by discussions at meetings. Documents and minutes created as part of the evaluation process are not privileged, and care should be taken not to create ambiguous records that may be used in litigation against the company and its directors.[5]

(footnote continued)

board of directors. A further discussion of certain implications of § 162(m) of the Code is set forth in Chapter IV of this Guide.

[5] For a brief discussion of the factors a compensation committee should consider in its annual self-evaluation, *see* David C. Karp, *Other Key Oversight Committees: The Nominating and Corporate Governance Committee and the Compensation Committee*, in The Practitioners Guide to the Sarbanes-Oxley Act, Part V, Ch. 2, at 23 (2005).

2. NASDAQ Requirements

The NASDAQ does not expressly require that its listed companies have a formal, independent compensation committee. However, as discussed below, the requirements of the proxy rules, other federal securities laws, the Code and the NASDAQ Marketplace Rules render the creation of an independent compensation committee a practical necessity.

The NASDAQ requires that the compensation of the CEO and other executive officers be determined, or recommended to the board of directors for determination, either by a majority of independent directors or a compensation committee composed entirely of independent directors. The CEO is prohibited from attending meetings while the compensation committee members or the independent directors, as applicable, are deliberating or voting on CEO compensation. The NASDAQ places no such restriction on other executive officer attendance and does not prohibit the attendance of the CEO during compensation committee discussions concerning other executive officer compensation.

The NASDAQ provides, however, that, if a compensation committee is composed of at least three members, then, under exceptional circumstances and if certain conditions are met, one director who is not independent under its rules may be appointed to the compensation committee without disqualifying the compensation committee from considering the compensation matters that could ordinarily be entrusted to it had it been fully independent.[6] In addition, a compensation committee or a company's independent directors must approve equity compensation arrangements that are exempted from the NASDAQ shareholder approval requirement as a prerequisite to taking advantage of such exemption.[7]

3. Dodd-Frank Requirements

Dodd-Frank authorizes (but does not require) compensation committees to retain independent advisers and mandates that committees oversee the advisers they retain. Under Dodd-Frank, a compensation committee may engage compensation consultants, legal counsel or other advisers to the compensation committee only after considering factors to be promulgated by the SEC that might affect the independence of such advisers. The SEC has announced that it will promulgate the adviser independence rules in 2011.

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[6] The specific conditions that must be met in order for such exemption to be available, as well as the precise contours of the NASDAQ definition of "independent," are discussed in Chapter VIII of this Guide.

[7] The shareholder approval requirements and the relevant exemptions for certain compensation committee approved plans are discussed in Chapter IV of this Guide.

B. CEO and Executive Officer Compensation

While both the NYSE and the NASDAQ only require that a compensation committee recommend to the full board of directors non-CEO executive officer compensation, vesting complete authority in the compensation committee for such individuals is advisable given the requirements of Section 162(m) of the Code, the insider trading short-swing profit safe harbor of Rule 16b-3 under Section 16(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and state law fiduciary duty jurisprudence, all of which provide substantial incentives for the compensation of executive officers to be determined by a committee of independent directors. A detailed discussion of the requirements of Section 162(m) of the Code and Rule 16b-3 under the Exchange Act is set forth in Chapters IV and VIII of this Guide.

In evaluating and setting executive officer compensation, a compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, a compensation committee should discuss whether, and to what degree, the criteria have been satisfied. In addition, as more fully discussed in Chapter IV of this Guide, it may be necessary for a compensation committee to certify satisfaction of such performance criteria in order to comply with the tax deductibility requirements of Section 162(m) of the Code.

Further, in order to help ensure that compensation and severance packages are justifiable, members of a compensation committee should fully understand the costs and benefits of the compensation arrangements that they are considering. Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment. It may be useful for a compensation committee to utilize a tally sheet, which provides a concise breakdown of the various components of a given executive officer's compensation package.

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

There is no particular allocation of compensation responsibilities that is right for every company. Companies should consider whether the compensation committee will have responsibility for employee compensation beyond that of executive officers. In addition, companies should consider whether the compensation committee will have responsibility for risk oversight in incentive compensation plans for all employees.[8] Limiting a compensation committee's responsibility to executive officer compensation may make sense for many companies so that directors can concentrate their limited time and resources on establishing proper incentives for those employees who are most likely to influence company performance. Ultimately, the full board of directors is

[8] See Section I of this Chapter I.

charged with allocating compensation responsibilities, but the compensation committee may be best equipped to make recommendations to the full board concerning the compensation committee's scope of responsibility.

As noted in Chapter II of this Guide, a compensation committee also may have fiduciary responsibilities under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), for certain employee benefit plans, either as a result of language in plan documents or the compensation committee's own charter, or by virtue of actually exercising such responsibilities. It is possible for a plan to state that the full board of directors or the compensation committee is responsible for administering ERISA plans or for managing the investment of their assets, either of which will implicate ERISA's fiduciary duty rules. It may or may not be appropriate for a compensation committee to assume such responsibilities, but, in any event, companies should ensure that the documentation and actual exercise of fiduciary responsibilities are consistent, and that all who are ERISA fiduciaries are aware of that fact and understand the legal responsibilities it entails. ERISA places special emphasis on "procedural prudence," so it is important for ERISA fiduciaries to follow appropriate procedures, to have full access to all necessary information and expert advice pertaining to their duties, and to keep careful records of their deliberations, decisions and actions when acting in a fiduciary capacity. In addition, it is critically important that ERISA fiduciaries be sensitive to the possibility that their ERISA duties and their responsibilities to the shareholders may conflict, presenting special legal issues that must be addressed. These issues are particularly difficult when assets of an ERISA plan are invested in company stock (as is the case for employee stock ownership plans ("ESOPs") and many 401(k) plans). Obtaining and maintaining an appropriate level of ERISA fiduciary insurance is highly recommended.

D. Development of Compensation Philosophy

A compensation committee must develop a compensation policy tailored to the company's specific business objectives in order to evaluate, determine and meet executive compensation goals. It should be noted that a compensation policy not only makes good business sense, but the SEC requirements for the Compensation Discussion & Analysis section of the annual proxy statement (the "CD&A") require discussion of such a policy.

E. Compensation-Related Disclosure Responsibilities

A compensation committee should oversee compliance with all compensation-related disclosure requirements. Such compliance presents a significant challenge in light of the comprehensive SEC rules regarding disclosure of executive officer and director compensation. Compensation committee members should request that management review with them (1) potential disclosures that may be required in connection with compensation-related actions, including the timing requirements for any such disclosure, and (2) the nature of the information to be disclosed in upcoming public filings, including information relating to compensation committee members themselves. Importantly, under current SEC guidance, a company that receives an SEC comment letter due to noncompliance with executive compensation disclosure rules will have to amend any materially noncompliant filings. Set forth below are the principal components of executive compensation disclosure required each year.

1. Compensation Discussion and Analysis

The CD&A provides investors with material information necessary for an understanding of a company's compensation policies and decisions regarding the NEOs, which generally include the CEO, the CFO and the three most highly compensated executive officers other than the CFO and CEO. In particular, the CD&A must explain the rationale behind all material elements of NEO compensation, including the overall objectives of the compensation programs and the rationale underlying and method of determining specific amounts for each element of compensation.

The CD&A is considered "filed" with the SEC; accordingly, misleading statements in the CD&A expose a company to liability under Section 18 of the Exchange Act. In addition, to the extent that the CD&A is included or incorporated by reference into a periodic report, the disclosure is covered by the CEO and CFO certifications required by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). If forward-looking information is included in the CD&A, a company may rely on the safe harbors for such information.

2. Compensation Committee Report

A company must include a Compensation Committee Report in its proxy statement and its annual report on Form 10-K (incorporation by reference into the Form 10-K from the proxy statement is permitted). The Compensation Committee Report recites whether a compensation committee has reviewed the CD&A, discussed it with management and recommended it to the board of directors. The names of the compensation committee members must appear below the report. In order to help ensure the accuracy of the Compensation Committee Report, the compensation committee should have detailed discussions with management concerning the CD&A in advance of the filing deadline.

3. Additional Annual Disclosure Regarding NEO Compensation

The SEC rules require quantitative elements of executive compensation of NEOs in tabular format, together with narrative explanations and footnotes that describe the quantitative disclosure. The central component of the tabular disclosure is the Summary Compensation Table, which discloses, by category, all compensation earned by each NEO during the prior fiscal year, including compensation attributable to salary, bonus, equity awards, change in pension value, earnings on non-qualified deferred compensation, and perquisites.

Other required tables provide detailed information regarding:

- equity awards and bonus award opportunities granted to NEOs during the last fiscal year;
- outstanding equity awards at the end of the last fiscal year, including vesting schedule and exercise price, to the extent applicable;
- stock options that NEOs have exercised during the last fiscal year and NEO stock awards that have vested during the last fiscal year;
- pension plan participation by NEOs, including accumulated benefits and any payments during the last fiscal year; and
- NEO participation in deferred compensation plans, including executive and company contributions, earnings, withdrawals, distributions, and the aggregate balance at the last fiscal year end.

Finally, companies must describe the circumstances in which an NEO may be entitled to payments and/or benefits upon termination of employment and/or in connection with a change in control and quantify the value of these payments and benefits as of fiscal year end. As discussed in greater detail below, companies may wish to consider utilizing in their annual proxy statements the format prescribed by Dodd-Frank for disclosing and quantifying change-in-control protections in proxy statements relating to corporate transactions.[9]

4. Director Compensation Table

The SEC rules also require a Director Compensation Table that must provide disclosure regarding director compensation during the prior fiscal year that is comparable to the Summary Compensation Table for NEOs, including disclosure with respect to perquisites, consulting fees and payments or promises in connection with director legacy and charitable award programs.

5. Compensation Committee Governance

Narrative disclosure regarding the governance of a compensation committee is also required by SEC rules. The narrative disclosure must describe a company's processes for determining executive and director compensation, including: the scope of authority of the compensation committee; the extent to which the compensation committee may delegate its authority; and any role of executive officers and/or compensation consultants in making determinations regarding executive and/or director

[9] See Section A.3 of Chapter VI of this Guide.

compensation. If compensation consultants play a role in determining executive and/or director compensation, a company must identify the consultants, state whether they are engaged directly by the compensation committee, and describe the nature and scope of their assignment.

Dodd-Frank requires a compensation committee to consider the independence of compensation consultants, legal counsel or other advisers to the compensation committee, based on factors to be promulgated by the SEC that might affect the independence of such advisers, in connection with their engagement, and mandates annual proxy disclosure indicating whether the compensation committee has retained a compensation consultant and whether the work of the compensation consultant has raised any conflicts of interest. Heightened requirements enacted in December 2009 already required disclosure of fees paid to compensation consultants and their affiliates under certain circumstances. As such, companies should implement appropriate disclosure controls to keep track of consulting fees and whether or not the applicable circumstances require disclosure.

6. Risk and Broad-Based Compensation Programs

To the extent that risks arising from a company's compensation programs for employees generally (not just executives) are reasonably likely to have a material adverse effect on the company, the SEC rules require a stand-alone discussion in the annual proxy, independent from the CD&A, of the company's compensation programs as they relate to risk management and risk-taking incentives. The threshold under the rules—reasonably likely to have a material adverse effect—sets a high bar for disclosure. A company should engage in a systematic process involving participants from its human resources, legal and finance departments, in which it (1) identifies company incentive compensation plans, (2) assesses the plans to determine if they create undesired or unintentional risk of a material nature, taking into account any mitigating factors, and (3) documents the process and conclusions. If a company concludes that its programs are not reasonably likely to have a material adverse effect, no disclosure is required, although as a practical matter Institutional Shareholder Services ("ISS") has encouraged disclosure about the review process and the company's conclusions and, to the extent no disclosure is provided, the SEC may seek confirmation from the company that the risk review was done and it was determined that disclosure was not required. While the compensation committee need not be involved in the evaluation of risk as applied to incentive compensation arrangements themselves, the compensation committee should satisfy itself that management has designed and implemented appropriate processes to make such evaluations.

7. Recent Developments

Dodd-Frank features a range of executive compensation-related provisions, including with respect to say-on-pay and say-when-on-pay, shareholder approval of golden parachute compensation, independence of compensation committees and their advisers, and a variety of additional disclosure rules. For a discussion of say-on-pay, say-when-on-pay and say-on-golden-parachutes, including the disclosure requirements relating to these votes, see Section A of Chapter VI of this Guide.

In addition to the requirements relating to the various votes referred to above, Dodd-Frank mandates annual proxy disclosure (1) indicating whether the compensation committee has retained a compensation consultant and whether the work of the compensation consultant has raised any conflicts of interest (controlled companies are exempt), (2) demonstrating the relationship between executive compensation and financial performance, (3) stating the ratio between the CEO's compensation and the median compensation of all other employees, and (4) indicating whether employees or directors may engage in hedging transactions on company stock. The SEC has announced that it intends to promulgate rules with respect to the items identified above in 2011.

8. Conclusion

The importance of clear, thorough compensation disclosure that effectively conveys the business rationale for executive compensation decisions is greater than ever, due to the significant attention from the SEC, media and corporate governance activists, and the imposition of mandatory say-on-pay. Companies should expect heightened focus on, and accordingly clearly explain the basis for, pay levels, termination and change-in-control payments, benchmarking practices, the existence and nature of compensation clawback policies and the relationship between particular compensation arrangements and risk.

F. Internal Controls

As part of the compensation committee's responsibility to oversee compliance with legal rules affecting compensation, it should oversee compensation disclosure procedures and the company's compensation-related internal controls. Companies should supplement disclosure controls and internal controls with a system to track and gather the information required under the compensation disclosure rules. Individuals to be included in the Summary Compensation Table must be determined by reference to total compensation (excluding the amounts included in the change in pension value and non-qualified deferred compensation columns). As such, companies should make sure that they have systems in place to track all of the includible components of compensation for their executive officers, including the value of perquisites, tax gross-ups and amounts paid/accrued in connection with a termination of employment or a change in control.

G. Equity Compensation Grant Policy

Companies should review the manner in which equity compensation awards are granted to employees and directors. While any given company's equity grant practices will be tailored to the company's particular business and administrative needs, each company should consider establishing a written equity compensation award grant policy that complies with, and specifies that grants will be made in accordance with, state law, the compensation committee charter and the applicable equity compensation plans. All parties involved in the granting of awards should be provided with copies of the policy and should familiarize themselves with its key terms.

H. Management Succession

The board's role in selecting and evaluating the CEO and senior leadership, and planning for succession, is a critical element of the company's strategic plan and should be approached with an "expect the unexpected" mindset. A leadership gap can undermine confidence in the future of the company as well as the company's ability to navigate immediate and evolving challenges.

To the extent companies have not given responsibility for succession issues to their nominating and governance committees, companies should consider charging the compensation committee with the responsibility of ensuring the existence of an appropriate management development and succession strategy. In addition to safeguarding against a leadership vacuum, careful succession planning is an excellent way to meet compensation challenges, as studies indicate that it is considerably more expensive to recruit senior talent from outside an organization than from inside, and pay packages for outside recruits are often more publicized and scrutinized than compensation arrangements for internal candidates.

There are no prescribed procedures for planning succession; therefore, a board should review succession plans on a regular rather than reactive basis. Ultimately, the integrity, dedication and competence of the CEO and senior management are critical to the success of a company, and the board should take care to implement a sensible, company-specific succession plan.

I. Role of Risk in Compensation Programs

1. The Role of the Compensation Committee in Risk Oversight of Incentive Compensation

The public and political perception that undue risk taking was central to the recent breakdown of the financial and credit markets has fueled an extensive legislative and regulatory focus on risk management and risk prevention. The SEC has adopted disclosure rules that require discussion in proxy statements of the board's role in overseeing risk and the relationship between a company's overall employee compensation policies and risk management. Risk management and compensation has also received heightened focus by shareholder activists and other "good governance" proponents, such as ISS. In addition, as a direct outcome of these public and political pressures, TARP requires each compensation committee of a TARP recipient to undertake periodic risk assessment of its institution's compensation plans and to exclude incentives to take unnecessary and excessive risks that threaten the value of the institution. In June 2010, the Federal Reserve jointly with other regulatory agencies issued final guidance relating to the safety and soundness of incentive compensation that requires all financial institutions, whether or not TARP recipients, to evaluate incentive compensation and related risk management, controls and governance processes, and to address deficiencies or processes inconsistent with safety and soundness.

Given these developments, risk oversight of incentive compensation arrangements should now be a priority of all compensation committees. While the compensation committee cannot and should not be involved in actual day-to-day risk *management* as applied to incentive compensation arrangements, directors should, through their risk *oversight* role, satisfy themselves that management has designed and implemented risk management processes that (1) evaluate the nature of the risks inherent in compensation programs, (2) are consistent with the company's corporate strategy and (3) foster a culture of risk-aware and risk-adjusted decision-making throughout the organization.

As noted above, the compensation committee generally needs only to be responsible for setting compensation of executive officers. However, the potential for excessive risk in incentive compensation programs is not limited to programs that cover executive officers. Accordingly, we generally recommend that the compensation committee receive reports related to the identification and mitigation of excessive risks in programs for non-executive officers as well as executive officers.

Risk in incentive compensation programs cannot be examined in isolation. In overseeing risk in incentive compensation programs, the compensation committee should take into account the company's overall risk management system and tolerance for risk throughout the organization and should discuss with members of the committee charged with risk oversight the most material risks facing the business. Companies may wish to consider including on the compensation committee a member of the audit or other committee that oversees risk generally. Through a coordinated approach, the board can satisfy itself as to the adequacy of the risk oversight function and understand the company's overall risk exposures.

The ability of the compensation committee to perform its oversight role effectively is, to a large extent, dependent upon the flow of information among the directors, senior management and the risk managers in the company. Compensation committee members need to receive sufficient information with respect to the material risk exposures affecting the company and the risk management strategies, procedures and infrastructure designed to address them.

Businesses necessarily incur risk in the pursuit of profits, and excessive risk aversion can be harmful to essential corporate goals. Moreover, the field of risk analysis as applied to compensation programs is an emerging one in which the most successful techniques are still evolving and disagreement exists as to some of the most fundamental questions. Nevertheless, the assessment of risk in incentive compensation arrangements, the accurate calculation of the appropriate way to reward risk, and the prudent mitigation of risk should be incorporated into the design of all incentive compensation arrangements. Risk reviews of incentive compensation arrangements should attempt to ensure that the level of risk embedded in incentive compensation arrangements is not excessive and is consistent with the corporation's articulated strategy.

2. Management's Risk Analysis

Risk analysis of incentive compensation programs often begins with assembling a risk-identification team. The team should include representatives from business units, as well as the human resources, legal, audit, finance and, if applicable, risk management departments. By establishing an integrated cross-disciplinary team, management can help ensure that there is adequate expertise and information flow across different corporate functions and business units.

Once a company establishes its risk identification team, the team should inventory existing incentive compensation programs. As noted above, plans subject to risk review should include those that cover individuals or groups of employees, whether or not they are executive officers, who have the ability to materially influence financial results.

After identifying the relevant incentive compensation programs, management should consider the range of material risks inherent to its businesses as well as the time horizons over which those risks may materialize. Relevant risks may include risks related to operations, finance, liquidity, markets, counterparties, legal issues, compliance and misconduct, among others. Management should understand risks that have a small probability of being realized but would be disastrous if they occurred.

Once management has identified risk factors, a company can consider the individual variables of the relevant compensation programs that may increase and decrease risk. The following is a non-exhaustive list of some of the features that may impact the risk profile of an incentive compensation program.

- The number of participants in each program

Less Risk	**More Risk**
Fewer participants	More participants

- The plan metrics

Less Risk	More Risk
Risk adjusted metrics (*e.g.*, economic profit)	Revenue or transaction-based metrics
Multiple metrics	Single metric
Negative discretion	No discretion
Based on general performance of corporation or business unit	Based solely on revenue or profit generated by employee

- Measurement, determination and adjustment of payout

Less Risk	More Risk
Smaller aggregate and individual payouts	Larger aggregate and individual payouts
Tiered goals and award levels with narrower bands and/or increments	All or nothing goals, larger increments and narrower range between threshold and maximum performance
Capped payout	Uncapped payout
Longer performance period	Shorter performance period
Deferred payout	No deferral of payout
Clawback	No clawback

- The maximum amount of potential revenue and potential losses or liabilities that could result from the businesses covered by the program and/or the plan

Less Risk	More Risk
Small revenue, potential losses, liabilities or payout	Large revenue, potential losses, liabilities or payout

After management has identified any programs that could incentivize employees to assume excessive risks, management should consider risk mitigation techniques to calibrate those programs to the risk profile of the organization. Management should periodically update the compensation committee on its efforts in this regard. Below is a non-exhaustive list of potential mitigation tactics.

Lengthen Performance Period or Implement Clawbacks. Consider implementing a performance period that is as long as the time horizon of risk. Alternatively, permit compensation clawbacks during the risk time horizon.[10]

Deferral of Payment/Transferability of Stock. Consider deferring payment, or implementing holding periods or transferability restrictions on stock, until after the time horizon of risks has elapsed. Consider adjusting compensation during the deferral period to reflect actual losses or other manifestations of bad performance. Deferral of awards may be most effective where risks, or the time horizon of risks, are difficult to identify or quantify.

Calibrate Payouts to Account for Risk. If two activities generate the same amount of revenue or profits and the risk associated with one activity is materially different from the other, consider whether the payouts under the incentive programs should differ, all else being equal. This method of adjustment may be most effective where risks associated with a particular activity are easily quantified.

De-Leverage Payouts. The rate at which compensation increases for attainment of goals in excess of threshold performance should be decreased such that there are payouts for a broader range of results but payouts are not supercharged for above target performance or completely denied for below target performance.

Governance Adjustments. Companies should strengthen internal controls and governance processes in the design, implementation and monitoring of incentive compensation arrangements.

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[10] For more on clawbacks, see Section E of Chapter III of this Guide.

II

Fiduciary Duties of Compensation Committee Members

A. Fiduciary Duties Generally

Decisions by members of compensation committees with respect to executive compensation generally are subject to the business judgment rule.[11]

1. Business Judgment Rule

Under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Under this presumption, directors' decisions will not be disturbed unless a plaintiff is able to carry its burden of proof in showing that a board of directors has not met its duty of care or loyalty.[12]

a. Duty of Care

The core of the duty of care may be characterized as the directors' obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of experts.[13] To show that a board of directors has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of "gross

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[11] *See, e.g.*, *Campbell* v. *Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 800 (6th Cir. 2001) ("evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts").

[12] *See, e.g.*, *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984). Under 8 Del. Code Ann. § 102(b)(7), a Delaware company may in its certificate of incorporation either eliminate or limit the personal liability of a director to the company or its shareholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (1) breach of the director's duty of loyalty to the company and its shareholders or (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Many Delaware corporations either have eliminated or limited director liability to the extent permitted by law. The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good-faith omissions. *Arnold* v. *Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

[13] *Smith* v. *Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (holding that, in the context of a proposed merger, directors must inform themselves of all "information . . . reasonably available to [them] and relevant to their decision" to recommend the merger); *see also Aronson*, 473 A.2d at 812 ("under the business judgment rule director liability is predicated upon concepts of gross negligence").

negligence." In addition, Delaware statutory law permits directors in exercising their duty of care to rely on certain materials and information.[14] Accordingly, directors charged with approving compensation arrangements should be familiar with the purpose of the arrangements, the nature of the benefits and should reasonably understand the costs; in so doing, directors may reasonably rely on the reports of their committees and advisers.

b. Duty of Loyalty

The duty of loyalty requires directors to act in the best interests of the corporation. Subsumed within this duty of loyalty is the directors' duty to act in good faith. In the landmark *Disney* case,[15] shareholders filed suit alleging that the board of directors did not act in good faith in approving the roughly $140 million employment and termination package of former Disney president Michael Ovitz. While the Delaware Chancery Court ultimately exonerated the board of directors, the court caused a great deal of controversy in the initial stages of the case when it denied the directors' motion to dismiss. According to the court's initial opinion, if the facts alleged in the complaint were proven at trial, the directors would have been found to have breached their fiduciary duty of "good faith" in approving the hiring and termination. While some academics and corporate gadflies applauded the court's initial decision, the business world wondered whether the court's decision served as a harbinger of potentially massive personal liability for disinterested directorial business decisions—when analyzed under the lens of 20-20 hindsight—even though the directors derived no personal benefit from those decisions. The court's ultimate decision exonerating the Disney directors quieted these concerns.

The *Disney* decision helps delineate the scope of protection of directors against personal liability for claimed breach of fiduciary duty. Negligence—that is, a failure to use due care—should not result in personal liability unless the director failed to act in "good faith." The court ruled that an appropriate measure for determining that a director has acted in good faith is whether there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities." The court ruled that a director fails to act in good faith when the director (1) "intentionally acts with a purpose other than that of advancing the best interests of the company," (2) "acts with intent to violate applicable positive law" or (3) "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[16]

The *Disney* decision also made clear that, although directors are encouraged to employ evolving best practices of corporate governance,

[14] 8 Del. Code Ann. § 141(e).

[15] Id.

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

directors will not be held liable for failure to comply with "the aspirational ideal of best practices." In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self interest, and, in so doing, they will be free from "*post hoc* penalties from a reviewing court using perfect hindsight." As the court noted, shareholder redress for failures that arise from faithful management "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."[17]

In the *Disney* case, the Delaware Supreme Court also rejected a claim that the Ovitz pay package amounted to corporate waste because the contract providing for his severance pay had a rational business purpose—that of attracting Mr. Ovitz to join Disney. The rational business purpose test is a high hurdle for claims based on waste. Nevertheless, this past February, the Delaware Chancery Court refused to dismiss a corporate waste claim against the Citigroup board arising from the payment of $68 million to the retiring CEO, Charles Prince.[18] In return for the $68 million payment, Prince agreed to sign non-compete, non-disparagement, and non-solicitation agreements and a release of claims against Citigroup. The Chancellor's refusal to dismiss the waste claim was based on his desire to review information regarding the value of the various promises made by Prince relative to the payments he received. Results of this review bear watching by compensation committees and their advisers.

2. Adopting or Amending Compensation Arrangements in the Context of Corporate Transactions

Adopting or amending compensation arrangements in the context of takeover activity or certain negotiated transactions can result in heightened judicial scrutiny. If the adoption or amendment of a compensation arrangement is deemed a defensive measure taken in response to an actual or threatened takeover, the adoption will be subject to judicial review under an "enhanced scrutiny" standard,[19] which looks both to the board of directors' process and its action. That said, a compensation arrangement will not be subjected to enhanced scrutiny merely because a board of directors adopts a compensation arrangement in the face of a takeover threat; in order for enhanced scrutiny to apply, a board of directors must have entered into the compensation arrangement as a defensive measure.[20] If the arrangement was adopted as a defensive

[17] *Id*. at *2.

[18] *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009).

[19] *See, e.g., Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Gilbert* v. *El Paso Co.*, 575 A.2d 1131 (Del. 1990) (analyzing the "golden parachute" employment arrangement among target's defensive measures subject to enhanced scrutiny).

[20] *See, e.g., Moore* v. *Wallace Computer Servs.*, 907 F. Supp. 1545 (11th Cir. 1994) ("In addition ... the facts that such agreements are commonplace among chief executives of major companies and that Cronin's severance package was identical to that of his

(footnote continued)

measure, the directors carry the burden of proving that their process and conduct satisfy a two-pronged test (known as the *Unocal* standard):[21]

- a board of directors must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," which may be shown by the directors' good faith and reasonable investigation; and

- a board of directors must show that the defensive measure chosen was "reasonable in relation to the threat posed," which may be demonstrated by the objective reasonableness of the course chosen.[22]

If directors can establish both prongs of the *Unocal* test, their actions will receive the protections of the business judgment rule. While the *Unocal* standard still provides a board of directors reasonable latitude in adopting defensive measures,[23] executive compensation plans adopted in response to a takeover threat may result in a court more closely examining a board of directors' process and actions.[24] Therefore, adopting or amending change-in-control employment arrangements in advance of an actual or threatened takeover may be advisable whenever possible.[25]

(footnote continued)
predecessor persuade this Court that the adoption of the golden parachute agreement was not a defensive measure.").

[21] *Unocal*, 493 A.2d at 946.

[22] *Id*. at 955.

[23] *See, e.g.*, *Unitrin, Inc.* v. *American Gen. Corp*., 651 A.2d 1362 (Del. 1995).

[24] *See Gilbert*, 575 A.2d at 1141 (applying *Unocal* standard in reviewing defensive measures, including golden parachutes and ESOPs, where "everything that [defendant directors] did was in reaction to [the] tender offer"); *Int'l Ins. Co.* v. *Johns*, 874 F.2d 1447 (11th Cir. 1989) (stating that the intent of the company's board in enacting a golden parachute is determinative of the standard used; when enacted in response to a takeover threat, the *Unocal* enhanced scrutiny standard applies).

[25] *See Buckhorn, Inc*. v. *Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987) (applying *Unocal* scrutiny to ESOPs and golden parachutes enacted in response to a tender offer, but applying the business judgment rule to protect amendments to those employment contracts enacted before the tender offer); *Moore Corp. Ltd*. v. *Wallace Computer Servs., Inc*., 907 F. Supp. 1545 (D. Del. 1995) (refusing to apply *Unocal* scrutiny to golden parachutes negotiated before a tender offer, but applying *Unocal* enhanced scrutiny to the failure to redeem a poison pill); and *In re Western Nat'l Corp. S'holder's Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000) (applying business judgment rule to board-approved employment agreement granting large severance payment and accelerated vesting of options because applicable employment agreement was adopted before potential acquiror was a shareholder and agreement was negotiated and recommended by disinterested directors).

When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the most exacting standard, "entire fairness" review, which requires a judicial determination of whether a transaction is entirely fair to shareholders.[26] Such conflicts may arise in situations where directors (1) appear on both sides of a transaction, as in adoption of compensation arrangements for the directors themselves, or (2) derive a personal financial benefit that does not generally benefit the company and its shareholders.[27] In determining whether a transaction is entirely fair, "the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide."[28]

In the context of director and executive compensation, entire fairness scrutiny is most likely to apply where directors have approved a compensation plan specifically applicable to themselves. Even if the compensation arrangements directly benefit insider directors, their approval should be protected by the business judgment rule if approved by an independent committee or by the disinterested directors.[29] However, when directors who directly benefit from a proposed plan are delegated with the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.[30] In light of this treatment, it is generally advisable that the responsibility for adopting director compensation be delegated to a company's corporate governance and nominating committee, subject to the approval of the entire board of directors.

B. Fiduciary Duties Under ERISA

ERISA is the federal law governing employee retirement and welfare benefit plans. Although its original enactment was spurred by a Congressional concern for adequate funding of traditional defined benefit pension plans, ERISA has imposed from the beginning a comprehensive set of requirements for many types of broad-based benefit plans, including savings plans, such as the well-known "401(k)" plan, ESOPs, and medical and other insurance-type plans. A key component of ERISA is the

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[26] *See, e.g.*, *Weinberger* v. *UOP, Inc.*, 457 A.2d 701 (Del. 1983).

[27] *See, e.g.*, *Ivanhoe Partners*, 535 A.2d at 1334.

[28] *Cinerama, Inc.* v. *Technicolor*, 663 A.2d 1134, 1140 (Del. Ch. 1995).

[29] *See Tate & Lyle PLC* v. *Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, *20 (Del. Ch. May 9, 1988) (permitting outside directors to approve compensation for insider directors after conducting reasonable inquiry and obtaining full board of director approval); *Puma* v. *Marriott*, 283 A.2d 693 (Del. Ch. 1971) (applying the business judgment rule instead of Unocal to review a company transaction with a controlling shareholder where the transaction was approved by independent directors).

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

imposition of fiduciary duties and liabilities on all individuals and entities that are named as fiduciaries in plan documents or who actually exercise responsibilities that ERISA considers to be fiduciary in nature. ERISA fiduciary duties are said to be the highest of such duties known to the law. It is critical, therefore, for compensation committee members to understand how fiduciary responsibilities for company plans are allocated and the extent to which they themselves may be ERISA fiduciaries.

A person may become a fiduciary under ERISA by being specifically named as such in a plan document, by being identified as such under a procedure set forth in the plan or by exercising fiduciary responsibilities. A person that appoints a fiduciary is a fiduciary with respect to the appointment. Further, a named fiduciary may delegate fiduciary responsibilities to another person, who thereby becomes a fiduciary. Compensation committees may, therefore, be considered ERISA fiduciaries for many reasons, including as a result of language in their charters or in plan documents, as a result of exercising administrative responsibilities for ERISA plans, by virtue of involvement in managing the assets funding ERISA plans, or because they appoint plan fiduciaries (which may include employees of the company as well as third-party institutions such as trust companies or investment managers).

ERISA requires that fiduciaries exercise their fiduciary duties prudently and solely in the best interests of plan participants. While it is not impermissible for an individual or entity that acts as a plan fiduciary also to have another role that affects the plan, fiduciaries must be alert to the possibility of conflicts of interest, which can pose particularly difficult issues. Consider, for example, the common situation in which an individual who has responsibility for selecting the investment choices to be offered to 401(k) plan participants—including company stock—learns, in his or her capacity as a member of a board of directors, of confidential information that may, when announced, cause a significant and long-term drop in the company's stock price: the individual's fiduciary duty under ERISA to offer only prudent investment choices to plan participants could come into conflict with the individual's duty under the federal securities laws not to use confidential information before it is made public and with the business strategy being pursued on behalf of shareholders generally. This type of fact pattern has generated many lawsuits against directors and executives in recent years. Major corporate transactions also can present situations in which ERISA and corporate responsibilities may come into conflict, particularly for plans that invest in company stock.[31]

Many companies choose to have company employees and/or independent third parties, rather than members of the board of directors, serve as ERISA fiduciaries. In such cases, however, the responsibility to appoint those fiduciaries often remains with the full board of directors or

[31] For more on these issues in the context of mergers and acquisitions, *see* Jeremy L. Goldstein, *Employer Securities in Mergers & Acquisitions: What You Need to Know*, M&A Lawyer (July/August 2005).

the compensation committee. As noted above, those who appoint fiduciaries are themselves fiduciaries, and, while they do not have the same breadth of ERISA fiduciary responsibility, must still exercise their appointment powers prudently and solely in the best interests of plan participants. This responsibility includes exercising some oversight over the performance of the appointees.

III

Methods of Compensation

A. Understanding and Pursuing Compensation Goals and Objectives

"Pay-for-performance" has been the past decade's mantra for "best practices" in executive compensation. While compensation programs should be designed so that compensation increases as corporate or individual performance metrics are met or exceeded, the financial crisis has highlighted the challenges and risks of measuring performance on a short-term basis and produced an increased emphasis on forms of compensation that preserve and enhance the long-term value of the company.

The highest priority for a company in designing a compensation program should be the economic incentives created and the behavior promoted. Companies should balance the need to retain employees with the need to incentivize them, and should balance the need to compensate employees in a manner that rewards growth and appropriate risk taking with the need to preserve the business. With respect to performance-based compensation, companies should select performance criteria that reflect true measures of operating performance and a compensation committee may consider preserving some negative discretion to adjust downward award amounts in the event of anomalous results.

Careful thought needs to go into the structure and design of compensation programs to help ensure that they protect against the creation of short-term windfalls for employees that do not match long-term sustained benefits for shareholders. Moreover, a compensation committee should seek programs that it believes are in the best interests of shareholders generally, and not seek programs that are merely intended to appease individual shareholder critics and the media at any given moment. These groups may have short-term interests that do not take into account the future well-being of the company and may have interests that are inconsistent with the interests of shareholders generally.

The different types of compensation described below are not mutually exclusive alternatives. Companies can and should consider granting a mix of types of compensation based on their business needs. A compensation committee should determine, in its business judgment based on the particular needs of the business, the appropriate mix of fixed compensation (*e.g.*, annual base salary) and variable compensation (*i.e.*, short- and long-term performance incentives), as well as the form of compensation (*e.g.*, stock options, restricted shares, restricted stock units or cash-based payments). No particular compensation vehicle (*e.g.*, stock options) should be off the table simply because it has been criticized in the media or by shareholder activists.

B. Equity Compensation

The manner in which most companies provide executives with equity compensation continues to evolve. We have set forth below the material characteristics of various types of equity compensation awards in order to aid committee members in understanding the issues involved in the design of equity compensation alternatives. To facilitate decision-making with respect to the granting of equity compensation awards, compensation committees should familiarize themselves with the economic, tax and accounting implications of granting different forms of equity compensation.

1. Stock Options

Stock options provide employees with the opportunity to buy shares of company stock at a fixed price during a specified period of time, allowing the employee to benefit from appreciation in the value of company stock. Stock options typically have an exercise price equal to the fair market value of the underlying stock on the date of grant. Vesting of stock options generally is contingent upon an employee's continued employment for a specified period of time (service-based options) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based options) or may result in vesting at an earlier point in time (performance-accelerated stock options).

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

Benefits	***Drawbacks***
• Generally deductible under Section 162(m) of the Code[32] without the need to establish additional performance goals if strike price is equal to or greater than fair market value on grant date. • Generally not subject to Section 409A of the Code if strike price is equal to or greater than fair market value on grant date, it is based on "service recipient" stock and there is not otherwise any deferral feature.	• An accounting charge must be recognized following the grant even though no economic benefit may be derived by the optionee (although it is possible that the value ultimately achieved by the optionee will exceed the charge initially recognized). • Because stock option holders receive a benefit if the stock price increases, but have no downside if the price decreases, stock option holders may be

[32] Section 162(m) of the Code, as well as the other Code provisions and the stock exchange rules referenced in the charts in this Chapter III, is outlined and discussed more fully in Chapter IV of this Guide.

Benefits	*Drawbacks*
• Because stock options are not considered outstanding shares until exercised, they are not counted in the denominator for calculating earnings per share. • Optionees only realize a benefit from the award if the value of the stock exceeds the exercise price and do not realize any loss if the stock price never exceeds the exercise price.	incentivized to pursue riskier strategies. • Potential disconnect between amount of pay received by optionee and amount of expense to company. • Because optionees typically have a long period during which to exercise their stock options, a well-timed exercise can result in significant gain even where the company's stock does not provide commensurate long-term gain for shareholders. • The grant of stock options results in an increase of so-called "overhang," which ultimately can result in dilution of existing shareholders if the stock options are exercised. We note that institutional shareholders often measure dilution based on outstanding stock options or even reserved option shares. • The accelerated Form 4 reporting requirements under Sarbanes-Oxley have resulted in the implementation of more stringent preclearance procedures for exercises and sales by executive officers. • In a falling stock market, underwater stock options may lose retentive value. • Internal controls surrounding the grant of stock options have increased in complexity.

2. Stock Appreciation Rights

Stock Appreciation Rights ("SARs") provide employees the right to receive an amount equal to the appreciation in value of company stock over a certain price during a specified period of time. Upon exercise of a SAR, the company pays the employee cash, stock or a combination thereof equal in value to the underlying stock's appreciation.

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

Benefits	***Drawbacks***
• SARs that may be settled only in cash are not equity compensation under the NYSE and the NASDAQ rules. Accordingly, no shareholder approval under such rules is required with respect to plans under which only these awards may be granted.	• SARs settled in cash instead of stock will not increase the employee's holdings of company stock.
• Like stock options, SARs generally are not subject to Section 409A of the Code if the strike price is equal to or greater than fair market value on the grant date and the SAR is based on service recipient stock.	• SARs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the SARs).
• The exercise of SARs does not require the holder to tender an exercise price for which he or she may need to borrow against the exercise proceeds or engage in a broker-assisted cashless exercise, either of which must be carefully structured to avoid a violation of Section 402 of Sarbanes-Oxley.	• SARs settled in cash will require an outlay of cash by the company.
• SARs settled in cash instead of stock do not give rise to subsequent sales required to be reported on Form 4.	
• SARs settled in cash instead of stock will not result in equity dilution.	

3. Restricted Stock

Restricted stock is a grant of shares of company stock subject to specified vesting provisions and limitations on transfer. Vesting of restricted stock typically is contingent upon an employee's continued employment for a specified period of time (service-based restricted stock) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based restricted stock) or may result in vesting at an earlier point in time (performance-accelerated restricted stock).

The benefits and drawbacks of using restricted stock are as follows:

Benefits	***Drawbacks***
• Holders of restricted stock share in the upside and the downside of an increase or decrease of share price, which directly aligns the interests of restricted shareholders and shareholders.	• Employees will receive some value from restricted stock even if the stock performs poorly.
• From the perspective of employees, restricted stock may represent a more tangible benefit than stock options.	• Certain institutional shareholders have requested that companies limit the number of "full value" awards such as restricted stock that companies grant to their employees and directors.
• Holders of restricted stock can vote and receive dividends.	• Shares of restricted stock are outstanding and are included in the denominator for computing "diluted" earnings per share.
• The ability of employees to make a Section 83(b) election may enable an employee to achieve a favorable tax result if the value of the restricted stock appreciates during the vesting period (although such elections are uncommon at public companies).	• Restricted stock is not deductible under Section 162(m) of the Code unless its grant or vesting is performance-based.
• Restricted stock generally is not subject to Section 409A of the Code.	
• Holders of restricted stock will realize value even if the price of company stock decreases during or after the vesting period. Accordingly, restricted stock may have greater retentive value than stock options in a down market, and may not encourage risky strategies as could be the case with stock options or SARs.	

4. Restricted Stock Units

Restricted stock units ("RSUs") consist of awards in the form of phantom shares or units, which generally are valued based on company stock. RSUs may be settled in cash, stock or both. As is the case with restricted stock, vesting of RSUs may be service-based, performance-based and/or performance-accelerated. The benefits and limitations of using RSUs as a means of compensation are the same as restricted stock, except:

Benefits	*Drawbacks*
• Because RSUs are not "property" under Section 83 of the Code and merely represent a general unsecured promise to pay a future amount, an employee may postpone taxation beyond vesting (the company's deduction is similarly delayed) until such time as the RSUs are settled. Accordingly, RSUs can allow employees to retain an interest in company stock and, consequently, company performance for an extended period of time without triggering a tax liability. • No administrative burden with respect to stock certificates or electronic share transfers until shares are paid. • RSUs that can be settled only in cash are not equity compensation under the NYSE and the NASDAQ rules. Accordingly, no shareholder approval is required with respect to RSUs under such rules. • RSUs settled in cash instead of stock will not result in shareholder dilution. • RSUs are reportable on the proxy statement beneficial ownership table if they must be settled in stock or may be settled in stock at the holder's election, so that if the holder were currently terminated he or she would get the underlying stock without the need to satisfy any additional vesting requirements. • Because RSUs are not property (making a Section 83(b) election unavailable), companies do not have the difficulty of administering Section 83(b) elections for broad employee populations.	• If RSUs may be settled only in cash, or in stock or cash at the company's election, RSUs are not reportable on the proxy statement beneficial ownership table. • Because RSUs are not property, grantees cannot make a Section 83(b) election. • RSUs settled in cash instead of stock result in a cash outlay. • RSUs settled in cash instead of stock will not increase the employee's holdings of company stock. • RSUs are not deductible under Section 162(m) of the Code unless their grant or vesting is performance-based or the receipt of income from the award is deferred until the executive is no longer subject to Section 162(m) of the Code. • RSUs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the RSU). • RSUs which provide for the deferral of payment post-vesting may be subject to Section 409A of the Code, depending on their terms.

C. Retirement Programs

In addition to the other compensation programs described above, compensation committees often provide executives with retirement benefits under either defined contribution plans (*e.g.*, 401(k) plans) or defined benefit plans (*e.g.*, pension plans that provide a fixed retirement benefit based on years of service and final pay). These arrangements can either be (1) "qualified plans," which provide the company with tax benefits but generally must be provided to a large portion of the workforce and are subject to limitations on, among other things, the aggregate benefit payable to participants under the plans and complex rules under the Code and ERISA or (2) "non-qualified plans," which may be limited to senior executives and provide them with additional retirement benefits that are not subject to the limitations imposed under the Code and ERISA.

When designing non-qualified retirement plans, companies should be sure to understand the cost of the arrangements, including any implications that increases in annual compensation may have on that cost. Moreover, as these programs generally represent a general unsecured promise by the company to pay amounts to executives in the future, they effectively result in executives being creditors of the company. As creditors of the company, executives with large pension benefits may be incentivized to act more conservatively with regard to risk taking and capital investment, especially as they approach the stated retirement age when their pensions become payable.[33]

D. Perquisites

No perquisites should be provided to executive officers without full disclosure to the compensation committee. Any compensation or other benefit received by any officer from any affiliated entities (using a low threshold for the definition of an affiliated entity) should be carefully reviewed to confirm compliance with the company's code of business conduct and ethics and applicable law. Perquisite programs and company charitable donations to any organizations with which an executive is affiliated should be carefully scrutinized to make sure that they do not create any potential appearance of impropriety.

Regulators and institutional shareholders are giving intense scrutiny to executive compensation. While the rhetoric may in many cases be overblown, procedure and disclosure are often as important as the substance of underlying compensation packages. While criticism cannot always be avoided, actions taken by a well-informed and objective compensation committee, which are then appropriately disclosed to shareholders, will be shielded from liability. Recently, some companies have modified perquisite programs by increasing annual base salaries and eliminating perks, by limiting the aggregate value of perquisites to less

[33] *See* David Yermack and Raghu Sundaram, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation*, New York University School of Law, New York University Law and Economics Working Papers, Paper 22 (May 3, 2005), *available at* http://lsr.nellco.org/nyu/lewp/ papers/22 (analyzing data on the CEO pension plans of 237 of the Fortune 500 companies from 1996 to 2002) and Jeremy L. Goldstein, *Deferred Compensation Arrangements: Corporate Governance and Compensating Management with Debt*, Wall Street Lawyer (September 2006).

than the proxy disclosure threshold and/or by entering into arrangements whereby the company is reimbursed by the executives for perks that the company provides.

E. Clawback Provisions

Clawback policies provide companies with the ability to recoup incentive-based compensation in certain circumstances, such as a financial restatement or commission of an act detrimental to the company. Over the past several years, clawback policies have increased dramatically in prevalence. According to a recent study by Equilar, from 2006 to 2010, the prevalence of Fortune 100 companies with publicly disclosed clawback policies increased from 17.6% to 82.1%. That number will soon increase to 100% due to the mandatory clawback policy included in Dodd-Frank that is described below.

Clawback policies provide a number of benefits to a company, including enhancing shareholder confidence in executive accountability, promoting the accuracy of financial statements, and alignment of risks and rewards. In addition, many institutional investors favor clawback policies and the adoption of such a policy can result in favorable press and public perception. Of course, there are also countervailing considerations. If inappropriately designed, clawback policies can result in unfair treatment of executives and pressure on compensation committee members to enforce the policies, even where directors do not believe that it is appropriate to do so.

If a company chooses to adopt a clawback policy, it should address several key design issues. The most fundamental questions are:

- What acts will give rise to the right to clawback compensation (*i.e.*, financial restatements or broad range of acts)?

- Will the acts require misconduct on behalf of the executive?

- Who will be covered by the clawback policy (*i.e.*, executive officers or larger population)?

- During what period of time will the right to clawback exist (*i.e.*, will it be perpetual or sunset)?

- Will "due process" protections apply (*e.g.*, executive's right to be heard before the board of directors prior to enforcement, super-majority vote of the board required to enforce and/or reimbursement of executive's legal fees if he or she prevails in a dispute over the clawback)?

- Will amounts clawed back be repaid on a pre-tax or after-tax basis?

- Will the clawback be in the form of a policy adopted by the board or the compensation committee (in which case enforcement typically would be through a lawsuit against the executive claiming unjust enrichment), or one or more agreements between the company and the executives giving the company contractual clawback rights?

There is no "right" answer to each of the foregoing questions and each company should tailor its clawback policy to address company-specific needs. However, it is important to give due consideration to each feature of a policy to optimize its effectiveness for the company.

Some of these decisions will likely soon be preempted due to Dodd-Frank. Dodd-Frank requires that the SEC promulgate rules requiring listed companies to adopt a policy that mandates clawbacks of compensation that was paid to a current or former executive officer during the three-year period preceding the date on which the company is required to prepare an accounting restatement as a result of material non-compliance with the securities laws, if the compensation is determined to have been based on erroneous data. The SEC is further required to direct the securities exchanges to prohibit the listing of companies that do not comply with those rules. As of the date of publication of this Guide, the SEC has not issued those rules, and many questions regarding the Dodd-Frank clawback mandate remain unanswered. What is clear, however, is that the Dodd-Frank clawback will be much broader than the only currently existing statutory clawback, which is the one provided under Section 304 of Sarbanes-Oxley. Most significantly, the Dodd-Frank clawback (1) will require each listed company to adopt a written policy, whereas the Sarbanes-Oxley clawback operates on its own as a matter of law, (2) does not require there to have been any misconduct in order for compensation to be subject to clawback, as does Sarbanes-Oxley and (3) covers all current and former executive officers of a listed company, whereas Sarbanes-Oxley only covers the chief executive officer and chief financial officer.

Until the SEC issues rules implementing the Dodd-Frank clawback, companies may wish to wait before adopting a new clawback policy or amending an existing one. Absent a compelling reason, there likely is no need to spend effort carefully structuring a clawback that is virtually certain to need revising in the near future.

IV

Laws and Rules Affecting Compensation

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

1. General

Section 162(m) of the Code generally disallows a publicly traded company's federal income tax deduction for compensation paid to "covered employees" in excess of $1 million during a company's taxable year. The $1 million deduction limit covers all types of compensation, including cash, property and spread on the exercise of options. However, there are important exceptions to the deduction limitation, including performance-based compensation keyed to a preestablished, objective, nondiscretionary goal and formula, which are described in detail below.

In light of Section 162(m), a publicly traded company generally is left with two choices: (a) forgo a federal income tax deduction for compensation during a taxable year in excess of $1 million to any one of its "covered employees," or (b) adopt compensation practices so that any compensation in excess of $1 million either (1) consists of performance-based compensation structured to comply with the requirements of the performance-based compensation exception or (2) is deferred to a time when the recipient is no longer one of the company's "covered employees." For financial institutions receiving government assistance under TARP and for certain health insurance providers, the deduction limitation has been lowered from $1 million to $500,000 and there is no exception for performance-based compensation.

2. "Covered Employees" Subject to the Limitation

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

While the exclusion of the CFO from Section 162(m) may be beneficial to companies whose CFOs receive compensation in excess of $1 million that does not otherwise comply with the performance-based exception of Section 162(m), the limitations of Section 162(m) generally apply to a company in the taxable year in which the compensation would otherwise be deductible, and Congress may ultimately amend the statute to provide that CFOs are covered employees. Indeed, the Emergency Economic Stabilization Act of 2008 ("EESA") amended Section 162(m) for financial institutions participating in TARP to be more stringent and to apply to CFOs. Accordingly, even though there are only four executive officers potentially covered by Section 162(m), companies should cast a broad net when determining the executive officers who potentially could be considered "covered employees" when designing their compensation programs.

3. Performance-Based Compensation Exception

The $1 million deduction limit does not apply to compensation that meets the following requirements:

- the compensation is payable solely on account of attaining one or more preestablished, nondiscretionary and objective performance goals (options and SARs granted with a strike price at or above fair market value meet this requirement);

- the performance goal is determined by a compensation committee, or a subcommittee thereof, of the board of directors comprised solely of two or more "outside" directors;

- the material terms of the performance goal under which the compensation is to be paid are disclosed to shareholders and approved by a majority of the shareholders voting in a separate vote; and

- before the compensation is paid, the compensation committee certifies that the performance goals and any other material terms were satisfied.

4. Section 162(m) Compliance Procedures

Compensation committees should have their incentive compensation plans and arrangements and the manner in which they are administered reviewed by counsel to determine whether they are in fact complying with the requirements of the performance-based exception from Section 162(m), where such compliance is intended. Compensation committee members should familiarize themselves with the basics of Section 162(m) and take them into account in structuring executive compensation. Moreover, a compensation committee should confirm that the proxy statement disclosure relating to Section 162(m) is accurate and that the proper internal controls to ensure compliance in this area have been implemented. In particular, a compensation committee should consider designating a single individual at the company as the compliance person for Section 162(m) and should consider requesting periodic updates on Section 162(m) so that its requirements are fully understood.

B. Section 409A of the Internal Revenue Code

Section 409A of the Code imposes penalties on participants in deferred compensation arrangements that do not comply with the strict requirements of the rules. Given the far-reaching impact of Section 409A, companies have rightly devoted, and continue to devote, a great deal of time and resources to implementing and operating programs in compliance with Section 409A. While a compensation committee should satisfy itself that the company is aware of and is complying with the legislation, the committee need not spend inordinate amounts of time trying to understand the intricacies of the technical rules that have no impact on the arrangements' commercial terms.

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

1. General Rules

The NYSE and the NASDAQ listing standards require listed companies to obtain shareholder approval of most equity compensation plans. A compensation committee should be aware that these rules may require shareholder approval of proposed plans and material plan amendments. The NYSE and the NASDAQ rules exclude the following types of plans from the shareholder approval requirement:

- arrangements under which employees receive cash payments based on the value of shares rather than actual shares (*e.g.*, cash-settled phantom stock);
- arrangements that are made available to shareholders generally (such as a typical dividend reinvestment plan);
- arrangements that merely provide a convenient way for employees, directors or other service providers to purchase stock at fair market value;
- plans intended to qualify under Section 401(a) of the Code (qualified pension, profit-sharing, and stock bonus plans) or Section 423 of the Code (employee stock purchase plans);
- "parallel excess plans," a narrowly defined category of excess benefit plans;
- equity grants made as a material inducement to an individual's becoming an employee of the issuer or any of its subsidiaries;
- rollover of options and other equity awards in connection with a merger or acquisition; and
- post-acquisition grants to those who are not employees of the acquiror at the time of acquisition of shares remaining under a target plan that had been approved by the target's shareholders (although use of such share reserves in connection with the transaction will be counted by the NYSE and the NASDAQ in determining whether the transaction must receive shareholder approval as an issuance of 20% or more of the company's outstanding common stock).

2. Material Revisions

The NYSE and the NASDAQ rules provide the following examples of revisions to equity compensation plans that are considered “material” and, therefore, require shareholder approval:

- a material increase in the number of shares available under the plan, other than an increase solely to reflect a reorganization, stock split, merger, spin-off or similar transaction;
- an expansion of the types of awards available under the plan;
- a material expansion of the class of individuals eligible to participate in the plan;
- a material expansion of the term of the plan;
- a material change to the method of determining the strike price of options under the plan; and
- a deletion or limitation of any provision prohibiting repricing of options.

In light of the requirement that material amendments be approved by shareholders, a compensation committee should consider requesting that newly adopted plans be drafted to ensure maximum flexibility in the types of awards that can be granted and the terms and conditions thereof.

V

Change-in-Control Compensation Arrangements

A. Addressing Executive Uncertainty

Executives of a company that is the subject of a merger or other acquisition proposal often become the focus of a great deal of pressure, including the pressure caused by uncertainty as to their own future if a combination takes place. Executive recruiters often take advantage of the uncertainties created by these situations to attempt to induce executives of a target company to consider alternative employment. To offset these pressures and to recruit and retain executives, we recommend (and most public companies have adopted) executive compensation programs containing change-in-control provisions for senior management.

Change-in-control employment agreements are not intended to deter combinations, but, by reducing the personal uncertainty and anxiety arising from a merger, they can help to assure full and impartial consideration of takeover proposals by a company's management and can aid a company in attracting and retaining key executives. Careful attention must be paid, however, to the applicable statutes and regulations to make sure that all tax and other legal concerns are properly reflected in the form of agreement that is adopted.

B. Arrangements

1. Change-in-Control Employment Agreements

Many companies have adopted change-in-control protections for senior management. Typically, these protections include a change-in-control severance or employment agreement. A change-in-control employment agreement often becomes effective only upon a change in control or in the event of a termination of employment in anticipation of a change in control. A standard form of agreement usually provides for a two- or three-year term after the change in control during which time the status quo is preserved for the executive in terms of duties, responsibilities and employee benefits. In the event that the status quo is not preserved and the executive resigns or the executive's employment is terminated by the company, the executive would be entitled to severance pay (generally a multiple of base salary and annual bonus).

Most change-in-control employment agreements also contain provisions addressing the so-called "golden parachute" excise tax. The federal golden parachute tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20% excise tax upon the recipient and nondeductibility of such payments by the paying company. Excess parachute payments result if the aggregate payments received by a "disqualified individual" that are "contingent on a change in control" equal or exceed three times the individual's "base amount" (the average annual taxable compensation of the individual for the five years preceding the year in which the change in control occurs). In such a case, the excess parachute payments are equal to the excess of (1) such aggregate change-in-control payments over (2) the employee's base amount. In other words, the excise tax and nondeductibility rules apply not just to the excess over three times the base amount, but, once triggered, apply to the whole amount in excess of the base amount.

Three approaches to dealing with golden parachute tax penalties in change-in-control agreements generally are taken:

- payments can be "grossed up" so that the employee is in the same after-tax position as if there were no excise tax;
- payments that are contingent on a change in control can be "cut back" to 299.9% of the base amount, so that no payments are considered parachute payments; or
- payments that are contingent on a change in control can be cut back only if the result is to give the employee a larger after-tax return than if the payment were not cut back.

After an analysis of the amounts involved, many companies have adopted a "gross-up" provision in order to ensure that the excise tax does not undo the intended goals of the arrangement. In addition, gross-ups often are provided for reasons of equity because the excise tax punishes promoted employees in favor of those who are not promoted, employees who do not exercise options in favor of those who do and employees who elect to defer compensation in favor of those who do not. Moreover, the tax is more likely to apply to employees who receive change-in-control acceleration of performance-based compensation than it is to apply to those who receive acceleration of time-based awards. In light of the high marginal cost of grossing up parachute payments if they exceed the 299.9% safe harbor by a small amount, which may result in little after-tax benefit to the executive, an agreement should require a minimum after-tax benefit to the executive before the gross-up applies. In the absence of this threshold being met, a cutback provision should apply. This hurdle may be expressed as an absolute dollar number or as a percentage of an executive's safe harbor. For example, agreements often provide that no gross-up will apply unless total payments exceed 110% of the executive's safe harbor.

ISS has identified the adoption of golden parachute excise tax gross-ups in new or materially modified agreements as a "problematic pay practice" that is likely to result in a negative recommendation on a say-on-pay vote or, where there is no say-on-pay vote or where concerns expressed by ISS on a say-on-pay vote are not addressed in the following year, a "withhold the vote" recommendation for the compensation committee or even the entire board of directors. Companies that have implemented golden parachute excise tax gross-ups in preexisting agreements and have determined that such gross-ups are in the best interests of the company and its shareholders need not eliminate them to avoid scrutiny by ISS, as ISS generally will make its recommendations taking into account only agreements that are new, extended or materially amended. Those companies that wish to preserve such gross-ups should only amend the arrangements that contain the gross-ups with great care as such amendments could de-grandfather the arrangements and result in ISS review for these purposes. While an extension of an existing agreement will trigger ISS review, the automatic renewal of an agreement with an "evergreen" provision generally will not be deemed an "extension" for that purpose.[34]

2. Stock-Based Compensation Plans

In addition to employment agreements, companies should review the status of their stock-based compensation plans for change-in-control provisions. Plans often contain provisions for acceleration of stock options, lapse of restrictions on restricted stock and deemed achievement of performance goals on performance stock awards upon a change in control or upon a severance-qualifying termination thereafter. Stock plans also often provide an extended post-termination exercise period for stock options and SARs upon terminations of employment following a change in control (*e.g.*, the lesser of three years or the remainder of the original term). Since these provisions may result in parachute payments, plan amendments should be considered and implemented in the context of an overall review of change-in-control employment protections and the associated costs should be analyzed in that context. In designing employee stock plans, as well as other types of benefit and compensation plans, companies should be sensitive to the need to retain key personnel through the closing of a transaction in order to help ensure that the board of directors is delivering to the acquiror an intact management team.

3. Separation Plans

In addition to change-in-control employment agreements with senior executives, many public companies have adopted change-in-control separation plans, or so-called "tin parachutes," for less senior executives, sometimes covering the entire workforce. These separation plans either formalize informal policies or provide enhanced severance in the event of a layoff occurring within one or two years after a change in control. These plans generally provide for severance benefits determined on the basis of seniority/position, pay and years of service or some combination of these factors, and may provide continuation of benefits with the company paying all or a portion of the expense and outplacement services. Severance usually is payable following an involuntary termination without cause or a constructive termination, such as relocation, decrease in base salary or wages, or material diminution in duties.

Due to the large numbers of people involved, separation plans should be adopted after a careful review of the estimated costs, including an analysis of the potential impact of golden parachute excise tax

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[34] See Section A of Chapter VI of this Guide for a more detailed discussion of say-on-pay votes and ISS.

provisions of the Code on the payments and benefits provided under the plan. The last minute addition of enhanced severance costs may make a merger infeasible. Further, targets should be sensitive to the fact that in an in-market merger involving branch closings or similar reductions in force, an acquiror may be forced to adopt the target's severance policies so that employees of the acquiror who are laid off are not treated worse than similarly situated target employees.

4. Deferred Compensation Plans

Due to the credit risk associated with the payment of deferred compensation and other unfunded non-qualified plan benefits, plans often provide for, or participants elect, an immediate lump-sum payment of the entire account balance upon a change in control without regard to prior elections as to timing and method of distribution. Any such election should be reviewed to ensure that it complies with Section 409A of the Code.

VI

Shareholder Proposals and Shareholder Relations

Shareholder advocacy groups continued in 2010 to press for a more direct shareholder role in executive compensation matters, and realized their most tangible achievement to date with the Congressional enactment in July of mandatory say-on-pay. Such groups also continued to advance other compensation-related shareholder proposals, and key shareholder advisory groups, most notably ISS, continued to refine and modify their positions on various compensation matters.

A. Say-on-Pay

Dodd-Frank mandates three different types of nonbinding shareholder votes on compensation matters.

- In its first proxy statement for a shareholder meeting occurring after January 21, 2011, and no less frequently than once every three calendar years thereafter, each public company must submit the compensation of its NEOs to a nonbinding shareholder vote (the "say-on-pay" vote).

- In its first proxy statement for a shareholder meeting occurring after January 21, 2011, and no less frequently than once every six calendar years thereafter, each public company must submit for a nonbinding shareholder vote the question of whether the say-on-pay vote should be held annually, bi-annually or triennially (the "say-when-on-pay" vote).

- In any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets, a public company must submit all golden parachute arrangements covering any of its NEOs to a separate nonbinding shareholder vote, unless the arrangements have already been "subject to" a say-on-pay vote (the "golden parachute say-on-pay" vote). The golden parachute say-on-pay vote mandate will apply to initial filings made on or after April 25, 2011.

The SEC issued final rules relating to the three different votes on January 25, 2011. The final rules delay implementation for smaller reporting companies of say-on-pay and say-when-on-pay (but not golden parachute say-on-pay) until shareholder meetings occurring on or after January 21, 2013.

1. The Say-on-Pay Vote

The say-on-pay vote must cover the compensation of an issuer's NEOs, as disclosed in accordance with Item 402 of Regulation S-K, including the CD&A; it does not cover director compensation, nor does it cover the portion of the proxy disclosure related to compensation and risk with respect to broad-based programs. The vote is a single line-item on the relevant compensation arrangements in their entirety. As discussed below, companies may wish to include within the scope of the say-on-pay vote additional details about golden parachute arrangements, in order to be eligible in the future for exemptions from the golden parachute say-on-pay vote. The SEC rules do not require companies to use specific language or a prescribed format in say-on-pay resolutions, although they include a nonexclusive example of a resolution that would satisfy the applicable requirements. The proxy statement must include an explanation of the effect of the vote (*i.e.*, that it is nonbinding), and future proxy statements must address whether (and if so, how) the company has considered the results of the most recent vote in determining compensation policies and decisions.

The say-on-pay vote will serve as an important barometer of shareholder views of a public company's compensation practices. As discussed below, ISS has indicated that it intends to utilize say-on-pay votes, where offered, as its primary vehicle for expressing dissatisfaction with compensation practices. Recent changes to stock exchange rules preventing brokers from voting uninstructed shares with respect to any say-on-pay vote will for many companies eliminate a historic source of votes supportive of company recommendations. In preparation for the say-on-pay vote, public companies should review the voting guidelines of significant shareholders. Companies should consider advance communication with shareholders or shareholder advocacy groups whose guidelines suggest a risk of a negative vote, and, as always, must use the CD&A as a platform for explaining why their programs and decisions serve the best interests of shareholders.

2. The Say-When-on-Pay Vote

Dodd-Frank requires a nonbinding vote, at least once every six calendar years, to determine the frequency of say-on-pay votes. The new requirements apply to shareholder meetings occurring after January 21, 2011. The SEC rules require that shareholders receive the option to vote for one of four choices (annual, biennial, triennial or abstain). Thus, a company cannot offer a yes or no vote on its preferred option, although the company may make a vote recommendation.[35] Perhaps the most pressing

[35] Note that under the SEC rules, companies may vote uninstructed proxy cards in accordance with management's recommendation for the frequency vote only if the company (1) includes a recommendation for the frequency vote in the proxy statement, (2) permits abstention on the proxy card and (3) includes language regarding how uninstructed shares will be voted in bold on the proxy card.

question for many companies for the 2011 proxy season is whether to recommend an annual, biennial or triennial say-on-pay vote.

From a policy perspective, we believe that a triennial vote is superior to annual and biennial votes. A triennial vote helps align say-on-pay with the goal of avoiding short-termism in corporate governance and executive pay arrangements. Most fundamentally, a triennial approach permits shareholders, directors and managers to evaluate the effects of a company's pay program on long-term performance and is less likely to subject a company's compensation plans to the whims of hedge funds and other constituencies seeking to apply pressures unrelated to long-term corporate performance. In addition, the triennial approach allows shareholders to engage in more thoughtful analysis and voting by providing more time between votes and by causing fewer votes among public companies in any given year. Further, the three-year period between each vote correlates more closely to the business cycle of many companies and provides management with the time necessary to implement improvements and changes to address concerns reflected by a negative vote.

A company should weigh the policy benefits of a triennial vote against the practical advantages of an annual vote. For example, holding an annual vote may make the vote seem like a routine governance matter and result in less attention on the vote than a triennial vote. In addition, providing shareholders with an annual say-on-pay vote gives shareholders an avenue other than director elections to express their dissatisfaction with pay practices at the company and, therefore, may save directors the embarrassment of receiving significant "no" votes. Finally, recommending or holding an annual say-on-pay vote may ultimately help the company avoid antagonizing shareholders that favor an annual vote.

Ultimately, the decision of whether the policy advantages of the triennial vote should trump the potential practical advantages of the annual vote will depend in part on whether recommending a triennial vote will result in negative consequences for a company. In this regard, ISS has recently stated in its Frequently Asked Questions regarding its U.S. compensation policies for 2011 that a management recommendation of a biennial or triennial vote will not trigger a negative vote recommendation from ISS on other proxy items, notwithstanding ISS's categorical support of annual say-on-pay votes. Moreover, through mid-January 2011, of the 158 annual proxies filed, 88 companies have recommended a triennial vote, while only 46 have recommended an annual vote, with the remainder almost evenly split between biennial and no preference, suggesting that companies that decide to hold triennial votes will be in the majority. Before making a final determination as to a company's recommendation on the frequency vote, a company should take into account its particular circumstances including: (1) year-over-year consistency of pay structures and amounts, (2) relationships with shareholders and (3) the nature of its shareholder base and its positions on the frequency vote and say-on-pay generally.

A company must disclose on Form 8-K its decision regarding the frequency of the say-on-pay vote in light of the results of the say-when-on-pay vote. The Form 8-K must be filed no later than 150 calendar days after the date of the applicable meeting, and in any event no later than 60 calendar days prior to the deadline for submission of shareholder proposals for the subsequent annual meeting. Companies must include in their proxy materials disclosure of the current frequency of say-on-pay votes and when the next scheduled say-on-pay vote will occur.

3. The Golden Parachute Say-on-Pay Vote

Under Dodd-Frank, the golden parachute say-on-pay vote applies to any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets. As noted above, the SEC has clarified that the vote will begin to apply to initial filings made on or after April 25, 2011.

The SEC rules require disclosure in a prescribed tabular format of all golden parachute compensation arrangements in connection with the transaction. For this purpose, the SEC rules define "golden parachute" fairly broadly to encompass all agreements and understandings between the target or the acquirer and each NEO of the target or the acquirer that relate to the transaction. However, the shareholder advisory vote with respect to golden parachute arrangements applies solely with respect to those arrangements between a soliciting party (typically the target) and its NEOs.

If a company previously has submitted golden parachute arrangements to a say-on-pay vote and has not modified those arrangements, the company will not be required to submit those arrangements to the golden parachute say-on-pay vote so long as the company's disclosure for the prior say-on-pay vote satisfied the tabular disclosure and other requirements applicable to golden parachute say-on-pay votes.[36] Companies should consider whether to include the new golden parachute disclosure in their annual proxy statements as a means of eliminating a golden parachute say-on-pay vote in the future, being mindful of the fact that any relief resulting from the voluntary disclosure will be unavailable for arrangements entered into subsequent to the applicable annual proxy statement and will eliminate only the vote, not the disclosure requirement. The limited benefits of the relief may not justify the considerable additional burden associated with satisfying the golden parachute say-on-pay disclosure format. In this regard, ISS has recently stated in its Frequently Asked Questions regarding its U.S. compensation policies for 2011 that it will weigh golden parachute tabular disclosures in its annual proxy disclosures more heavily in its overall say-on-pay vote recommendation, if a company includes such disclosure.

[36] Note that the rules applicable to annual proxy disclosure of termination and change-in-control arrangements, unlike the golden parachute say-on-pay rules, do not prescribe a mandatory tabular disclosure format.

B. Shareholder Proposals

In 2010, institutional investors, individual shareholder activists and academic gadflies continued to submit shareholder proposals with regard to executive compensation practices. We expect that the advent of say-on-pay will likely reduce, but not eliminate, such proposals. Many institutional shareholders subscribe to the services of proxy voting advisers who provide blanket voting policies on such issues, and in many cases rely heavily on the proxy voting guidelines, regardless of an individual company's performance or governance fundamentals. As a result, many shareholder votes are foreordained by a voting policy that is applied to all companies without regard to the particulars of a given company's situation.

In the 2011 proxy season, activists will continue to push their agendas through shareholder proposals as part of their efforts to maintain focus on corporate governance matters. The appropriate course of action with respect to any particular proposal will depend upon the facts and circumstances. In some cases, it may be possible to exclude a proposal under applicable SEC rules. In other cases, a company might resolve a proposal by engaging in dialogue with the shareholder proponent. In still other instances, it may make sense to implement a particular proposal. In formulating responses to shareholder proposals, companies should recognize that activists and proxy advisers carefully monitor company action in this area and may shine a spotlight on those companies that they view as uncooperative. Ultimately, however, executive compensation is a core responsibility of the board, and directors must bear in mind that they are best positioned to establish optimal company-specific compensation programs.

C. Shareholder Advisory Firms

Over the past several years, the influence of shareholder advisory firms in compensation matters has expanded as a result of their widely followed public shareholder voting recommendations on compensation matters put to shareholders. Moreover, a company's compensation practices can influence how these firms recommend that shareholders vote in director elections. The most influential of these firms is ISS. The compensation committee should periodically review updates regarding ISS's positions on pay practices, not so that it can substitute ISS's opinions for its own, but rather as a means of understanding the potential shareholder reaction to, and the best means of explaining, those decisions.

We describe in Section VI.A. above ISS's positions on the say-when-on-pay and golden parachute say-on-pay advisory votes. In addition, in late 2009 ISS announced that the say-on-pay vote will be the primary vehicle through which ISS will express its view on a company's pay practices. ISS will no longer object to pay practices through withhold recommendations on compensation committee or director reelection votes, unless the company's so-called "problematic pay practices" are in its view "egregious or continuing" or unless concerns raised by ISS in connection with a say-on-pay vote are not in its view sufficiently addressed in the subsequent year.

Since 2010, in developing its recommendations, ISS generally takes an “integrated, holistic” approach in reviewing a company’s executive compensation program, which includes an overall evaluation of pay-for-performance and pay practices, rather than evaluating each pay program and pay practice separately. ISS will determine what, if any, problematic pay practices a company exhibits, as well as grade it on pay-for-performance, and through that analysis develop a positive or negative recommendation on a company’s say-on-pay vote. For this reason, companies should remain aware of, and current on, the list of problematic pay practices. That list is long, and includes:

- employment contracts containing multi-year guarantees for salary increases, non-performance-based bonuses and equity compensation;

- an “overly generous” new-hire package for a CEO (*i.e.*, excessive “make whole” provisions without sufficient rationale or any other “problematic pay practices” listed in ISS’s policy);

- “abnormally large” bonus payouts without justifiable performance linkage or proper disclosure (*i.e.*, includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance);

- “egregious” pension or supplemental executive retirement plan payouts (*i.e.*, inclusion of additional years of service not worked that result in significant benefits provided in new arrangements, inclusion of performance-based equity awards in the pension calculation);

- “excessive” perquisites (*i.e.*, perquisites for former and/or retired executive such as lifetime benefits, car allowances, personal use of corporate aircraft or other “inappropriate” arrangements or extraordinary relocation benefits (including home buyouts));

- “excessive” severance and/or change-in-control provisions (*i.e.*, change-in-control payments exceeding three times base salary and bonus or without loss of job or substantial diminution of job duties, new or materially modified agreements that include the executive with the right to resign for any reason and collect severance or an excise tax gross-up);

- tax reimbursements;

- dividends or dividend equivalents paid on unvested performance shares or units, executives using company stock in hedging activities;

- repricing or replacing underwater stock options or stock appreciation rights without prior shareholder approval;

- executives using company stock in hedging activities, such as "cashless collars"; and

- an "excessive differential" between CEO total pay and that of the next-highest paid NEO.

Note that engagement in a small number of these practices may not, in itself, result in an adverse recommendation from ISS. However, there is a list (much shortened for 2011) of other pay practices that ISS deems sufficiently problematic individually to warrant a recommendation to vote against a company's say-on-pay proposal or, in specified circumstances, a director "withhold" vote recommendation. The list of these "egregious" practices includes:

- repricing underwater options without prior shareholder approval;,

- "excessive" perks; and

- new or extended agreements that provide for change-in-control payments that are single trigger, exceed three times salary and bonus, or include an excise tax gross-up. ISS recently clarified that an agreement which automatically renews due to an "evergreen" provision will not be considered a "new or extended agreement" for this purpose.

In a change to its past policy, ISS recently announced that it will no longer consider a company's commitment to eliminate a problematic pay practice in the future as a way of preventing or reversing a negative vote recommendation. By way of example, many companies received a positive ISS recommendation prior to 2011 even in the face of adopting a new agreement with a golden parachute excise tax gross-up, if combined with a publicly announced commitment that future agreements would not contain a gross-up. It appears that such a strategy will no longer work, even as to commitments made before the policy change was announced, and is another example of the shrinking flexibility that companies wishing to conform to ISS's guidelines will face in the upcoming proxy season.

In addition, ISS generally will issue an adverse say-on-pay vote recommendation if there is what it terms a "pay-for-performance disconnect," meaning that for companies with one- and three-year total shareholder return in the bottom half of their respective industry groups and CEO pay increases on a year-over-year basis, there was not a sufficient relationship between CEO pay and company performance. Not only will a pay-for-performance disconnect likely result in an adverse say-on-pay recommendation from ISS, it also may cause a recommendation to vote against an equity plan proposal if an excessive number of awards not based on performance are deemed to be the major contributor to the pay-for-performance misalignment.

We recommend that compensation committees remain cognizant of ISS's current policies and take them into account in structuring pay programs. However, because of the "one size fits all" nature of the ISS evaluation process, in the final analysis a compensation committee should make decisions that comport with its company's individual circumstances and needs. To that end, it is noteworthy that, in 2010, ISS recommended against say-on-pay at 43 of the 299 companies it evaluated, but only three of those companies received less than majority support from shareholders and the average result was an 89.6% favorable vote.

VII

Special Considerations Applicable to Financial Institutions

Compensation practices at financial institutions continue to be a major focus of the press, the public and the governments and regulatory agencies in the U.S. and Europe. As we continue to navigate the recovery of the financial services industry, directors of financial institutions, and compensation committee members in particular, need to be mindful of the increased focus on the structure and risk profile of compensation arrangements, and especially how they comport with the principles of "safety and soundness."

While the U.S. financial institutions that continue to have obligations outstanding under TARP are managing to live with the compensation restrictions imposed under Section 111 of EESA, as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA"), non-TARP institutions are grappling with the final safety and soundness guidance issued jointly in June 2010 by the Federal Reserve, Treasury, FDIC, OCC and OTS, which for the most part is consistent with the proposed guidance from October 2009. Troubled institutions also must be mindful of the FDIC's golden parachute limitations.

It should also be noted that Section 956 of Dodd-Frank included a specific provision with respect to "covered financial institutions" with assets of $1 billion or more. In particular, Dodd-Frank requires the appropriate regulators to issue guidance regarding the disclosure of all company incentive compensation structures and the prohibition of incentive compensation arrangements that the regulators determine encourage inappropriate risks by covered financial institutions. The implementing regulations for Section 956 are to be issued by April of 2011. While it was initially assumed that the joint agency guidance on sound incentive compensation policies would be the framework for any additional regulations, at an FDIC Board meeting in January of 2011, it was indicated that for the "large and most complex institutions" there will likely be a rule that requires deferrals for senior policymaking executives, indicating a more prescriptive approach similar to the European Union's proposed regulations.

Set forth below are brief summaries of the final guidance on the safety and soundness of incentive compensation policies, the restrictions under Section 111 of EESA and the FDIC's golden parachute limitations. This summary generally identifies where the compensation committee has a specific responsibility or obligation and notes that the complexity of the regulatory framework surrounding the compensation arrangements of financial professionals will likely continue to result in increased responsibilities for compensation committee members at financial institutions.

A. Safety and Soundness Guidance

In June of 2010, the bank regulatory agencies jointly issued final guidance for financial institutions on incentive compensation. All banking organizations are now expected to evaluate incentive compensation and related risk management, control and governance processes, and to address deficiencies or processes inconsistent with safety and soundness. This evaluation is to be done with a view to the three core principles described in the guidance—that incentive compensation should:

- provide employees incentives that appropriately balance risk and reward;

- be compatible with effective controls and risk management; and

- be supported by strong corporate governance, including active and effective board of directors oversight.[37]

The third principle is of primary importance to compensation committee members of banking organizations. The guidelines emphasize governance and board-level oversight and provide that the board of directors of an organization is ultimately responsible for insuring the organization's incentive compensation arrangements ("ICAs") for all covered employees—not just senior executives—are appropriately balanced and do not jeopardize the safety and soundness of the organization. The guidance makes clear that the organization, composition and resources of the boards of directors of banking organizations should permit effective oversight of ICAs. In particular, the guidance requires that a compensation committee take the following actions with respect to a company's ICAs:

- Actively oversee ICAs and directly approve the ICAs for senior executives.

- Monitor the performance, and regularly review the design and function, of ICAs.

- For banking organizations that are significant users of ICAs, review the arrangements on both a backward-looking and forward-looking basis.

The guidelines expressly call for the involvement of functions such as compliance, internal audit and risk management in the incentive compensation process. It is therefore likely that both management and the

[37] As used in the proposed guidance, the term "board of directors" refers to the members of the board who have primary responsibility for overseeing the incentive compensation system of a banking organization and, for purposes hereof, it is assumed that the compensation committee serves this function.

compensation committee will need to evolve towards a more consultative and multidisciplinary approach, in particular during the adjustment period as new compensation best practices evolve from the increased regulatory scrutiny on incentive compensation. The guidance also indicates that the compensation committee should have access to a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate to the nature, scope and complexity of the organization's activities.

While the regulators have recognized that the restructuring of ICAs will be an iterative process, institutions are encouraged to take a thoughtful and incremental approach to addressing any perceived imbalances in the risk profile of their incentive compensation programs. At this stage, compensation committee members of financial institutions should be ensuring that management is developing a plan for implementing the final guidance and considering the guidance when evaluating proposed compensation arrangements.

As the regulation of compensation arrangements at banking organizations increases, the duties of compensation committee members will also expand. It is essential for compensation committee members to understand these duties and take the action necessary to see that the organization has adequate resources to respond to the requests of the various regulators and implement compliant compensation programs. The consequences of failing to meet the standards of the compensation guidelines are not insignificant, as the guidelines provide that supervisory findings on incentive compensation will be included in exam reports and incorporated into supervisory ratings. In addition, supervisory or enforcement action may be taken if incentive compensation or related controls, risk management or governance pose a risk to safety and soundness and acceptable curative measures are not being taken.

B. Section 111 of EESA and the Implementing Interim Final Rules

In February 2009, the ARRA amended certain provisions of the EESA to impose additional restrictions on institutions receiving TARP assistance, which restrictions were implemented through Interim Final Rules issued by the Treasury in June 2009. The restrictions applicable to TARP recipients address a variety of topics, including severance, incentive compensation and the deductibility of compensation under Section 162(m) of the Code. TARP executive compensation and corporate governance rules also impose additional duties on the compensation committee, primarily relating to monitoring the relationship between compensation arrangements and risk.

The compensation committee of an institution that has received government assistance under TARP should understand, and take care to oversee compliance with, the statutory restrictions, as well as any contractual limitations set forth in the stock purchase agreement entered into with the Treasury pursuant to TARP. While those institutions that continue to be TARP recipients have adapted to the restrictions and procedural obligations imposed by EESA, the limitations continue to present challenges, especially with respect to recruiting, retention and succession planning, in large part because there are now many competitor banks that are out of TARP.

Set forth below is a summary of the compensation limitations applicable to TARP recipients that are not considered to have received "exceptional assistance."

1. Employees Subject to Compensation and Governance Standards

TARP executive compensation and corporate governance rules place various restrictions on compensation arrangements with senior executive officers ("SEOs") and up to 20 additional most highly compensated employees of TARP recipients. The SEOs are generally the five "named executive officers" identified in the TARP recipient's annual proxy reporting compensation for the prior year and the "most highly compensated" employees are generally up to 20 employees with the highest total annual compensation for the prior year, as determined under the federal securities rules (*i.e.*, the rules that determine the executives who appear in proxy statements). Accordingly, traders, investment bankers and other highly paid employees may be subject to the compensation limitations. A newly hired CEO or CFO will, under Treasury guidance, also be considered an SEO in the year of hire.

2. No Limits on Annual Base Salaries

There are no limitations on the amount of base salary that may be paid to employees of TARP recipients, and the Interim Final Rules expressly permit the payment of base salary in stock or stock units, including stock or stock units that have restrictions on transferability, so long as the payment is denominated in dollars, accrues on a schedule consistent with base salary and is not subject to vesting conditions. So-called "salary stock" has become a common component of compensation at TARP recipients, and it appears that the increases in base salary due to salary stock have in some cases continued through higher cash base salaries following repayment of TARP.

3. Prohibitions on Bonuses, Incentive Compensation and Retention Awards

The statute prohibits the payment or accrual of bonuses, incentive and equity compensation and retention awards to SEOs and up to 20 additional most highly compensated employees (the number of whom depends on the level of financial assistance). There is an exception for restricted stock or restricted stock units so long as (a) the award is subject to a minimum two-year service requirement, (b) the shares underlying the award are not transferable (other than for tax withholding) until TARP or portions thereof (based on 25% increments) are repaid and (c) the value of the grant is not more than one third of the annual compensation of the individual for that year, including the grant itself. The Interim Final Rules contain a narrow exception to the limitation on bonuses and incentive compensation for commissions that are consistent with past practice at the TARP recipient as of February 17, 2009, which exception does not include, for example, fees earned from investment banking, initial public offerings or proprietary trading. In addition, there is an exception for bonuses, retention awards and other incentive compensation required to be paid under valid employment contracts in effect as of February 11, 2009.

4. Prohibition on Golden Parachutes

The statute prohibits golden parachute payments to SEOs or any of the next five most highly compensated employees. The Interim Final Rules define golden parachutes to include not only payments in connection with a departure, but also payments in connection with a change in control. The rules also define golden parachute payments to include the accelerated vesting of equity and other compensation. TARP recipients and employees may not avoid the prohibition by deferring a golden parachute payment past the end of the TARP period. Finally, the rules contain exceptions from the prohibition, including for payments under qualified plans, payments made due to death or disability and deferred compensation payments for services previously performed. The Interim Final Rules provide some relief from Section 111 golden parachute rules in the change in control context.

5. Prohibition on Gross-Ups

The Interim Final Rules impose a prohibition not included in the statute on the payment to SEOs and the 20 next most highly compensated employees of tax “gross-ups” on compensation such as golden parachutes and perquisites. There is a limited exception for certain international tax equalization arrangements.

6. Specific Compensation Committee Duties Under EESA

Section 111 of EESA imposes specific duties on the compensation committee of a TARP recipient, most notably the responsibility to engage in a risk review of executive and employee compensation arrangements. TARP requires that an independent compensation committee be established and maintained during the TARP period, and, for this purpose, independence is generally determined pursuant to Item 407(a) of Regulation S-K under the Exchange Act. While many of the TARP rules are limited to the period during which financial assistance (other than warrants) is outstanding, there are certain obligations that continue in the immediate post-TARP period, primarily relating to certification and reporting requirements.

a. Semi-Annual Risk Review and Annual Certification

A compensation committee must engage in a risk analysis of the TARP recipient’s compensation plans every six months. In particular, a compensation committee is charged with identifying, discussing, evaluating and reviewing:

- with the senior risk officers, the SEO compensation plans to ensure that such plans do not encourage unnecessary and excessive risks that threaten the value of the company;

- with the senior risk officers, the employee compensation plans in light of the risks posed to the TARP recipient by such plans and how to limit such risk; and

- the employee compensation plans to ensure that they do not encourage manipulation of the company's reported earnings to enhance compensation of company employees.

Because a risk review on this broad scale is a potentially complicated and time-intensive task, a team of legal, human resources and internal controls/risk employees should develop a methodology for cataloging and evaluating the compensation plans, perhaps in conjunction with outside advisers. A compensation committee can then review and approve the methodology, with the management team reviewing and analyzing the compensation plans within the framework and parameters of the pre-approved methodology. In this way, a compensation committee can focus on those plans that are considered to have the greatest risk profile and can fulfill its risk oversight function most effectively.[38]

Section 111 of EESA requires that a compensation committee provide a narrative that describes the manner in which compliance with the risk review standards were achieved, including the risks posed by the plans, how these risks were limited and how the plans do not encourage behavior focused on short-term results rather than long-term value creation. A compensation committee must also certify the completion of the required reviews of the SEO compensation plans and employee compensation plans. The narrative description and certification must be provided annually during the TARP period to the Treasury and set forth in the Compensation Committee Report required pursuant to Item 407(e) of Regulation S-K.

b. Disclosure Relating to Compensation Consultants

The EESA rules also mandate that annually during the TARP period a compensation committee provide to the Treasury and the TARP recipient's primary regulator a narrative description of:

[38] See Section I of Chapter I of this Guide for a more extensive discussion of risk management in compensation.

- whether the TARP recipient, the board of the TARP recipient or the compensation committee of the TARP recipient has engaged a compensation consultant; and

- all types of services (including non-compensation related services) that such compensation consultant or any of its affiliates has provided to the TARP recipient, the board of the TARP recipient or the compensation committee of the TARP recipient during the past three years (including "benchmarking" or comparisons employed to identify a certain percentile level of compensation).

c. Luxury Expenditures Policy

Section 111 also requires the board of directors[39] of a TARP recipient to adopt an excessive or luxury expenditures policy covering entertainment or events, office and facility renovations, aviation or other transportation services and other similar items, activities or events for which the TARP recipient may reasonably anticipate incurring expenses or reimbursing employees to the extent such expenditures are not reasonable for staff development, reasonable performance incentives or other similar reasonable measures conducted in the normal course of business operations.

C. FDIC Golden Parachute Regulations

In addition to the TARP limitations described above, payments to executives of "troubled" financial institutions may be further limited under the "golden parachute" rules of the FDIC. Subject to certain exceptions, the FDIC rules prohibit troubled insured depository institutions (or their holding companies) from making golden parachute payments to any "institution-affiliated party" ("IAP"), which includes the institution's directors, officers and employees, among others. The FDIC rules generally define "golden parachute payments" as compensatory payments (or agreements to make compensatory payments) to an IAP by a troubled insured depository institution that are contingent on, or payable after, the termination of the IAP's primary employment or affiliation with the institution, with exceptions for certain bona-fide deferred compensation payments, qualified retirement plan payments, limited payments under nondiscriminatory severance pay arrangements and payments under certain employee welfare benefit plans. As a general matter, there are three exceptions or permissible golden parachute payments by troubled institutions: (a) payments that receive the regulator's concurrent, (b) payments for a "white knight" hired pursuant to an agreement when the entity is troubled or to prevent it from becoming so and (c) reasonable

[39] While the Interim Final Rules identify the board of directors as ultimately being responsible for the adoption of the luxury expenditure policy, the compensation committees of TARP recipients appear to have taken a primary role in the development of the policy.

payments not to exceed 12 months' salary in the event of a change in control of the institution not resulting from an FDIC-assisted transaction or the institution being placed in receivership or conservatorship. In October of 2010, the FDIC issued additional guidance on the golden parachute application process.

VIII

Compensation Committee Membership

In enlisting qualified directors to sit as members on a compensation committee, attention must be paid to the various membership requirements imposed by the company's securities market, Section 162(m) of the Code, Rule 16b-3 under the Exchange Act and state law.

A. Independence Standards of the Major Securities Markets[40]

The NYSE requires that members of listed company compensation committees be independent. While the NASDAQ does not require that there be an official independent compensation committee, it does mandate that, in the absence of an independent compensation committee, a listed company's executive compensation decisions be decided by a majority of the independent directors on the board of directors.

Both the NYSE and the NASDAQ have adopted specific rules as to who can qualify as an independent director, and both markets require that the board of directors of a listed company make an affirmative determination, which must be publicly disclosed, that each director designated as "independent" has no material relationship with the company that would impair his or her independence. Such disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude a board of directors from determining that an individual is independent. In addition, the listing standards of both the NYSE and the NASDAQ set forth circumstances that constitute per se bars to a determination of independence.

As a general matter, a director will be viewed as independent only if the director is a non-management director free of any material family relationship or any material business relationship, other than stock ownership and the directorship, with the company or its management, and has been free of such relationships for three years. The following relationships bar a director from satisfying the independence standards of the NYSE or the NASDAQ, as applicable:

- the director is, or has been within the last three years, an employee[41] of the company;[42]

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[40] For additional discussion of the NYSE and the NASDAQ independence requirements, *see* David C. Karp, *Independent Directors,* in The Practitioners Guide to the Sarbanes-Oxley Act, Part V, Ch. 3 (2005).

- an immediate family member of the director is, or has been within the last three years, an executive officer of the company;

- the director is a current partner (or employee, under the NYSE rules) of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);

- an immediate family member of the director is a current partner of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);

- under the NYSE rules, an immediate family member of the director is a current employee of the company's internal or external auditor and personally works on the company's audit;

- the director or an immediate family member was within the last three years a partner or employee of a firm that is the company's external auditor (or internal, under the NYSE rules) and personally worked on the company's audit within that time;

- under the NYSE rules, the director or an immediate family member of the director is, or has been within the last three years, an executive officer of another company where any of the company's present executive officers at the same time serves or served on that other company's compensation committee;

- under the NASDAQ rules, the director or an immediate family member of the director is an executive officer of another entity where at any time during the past three years any of the executive officers of the issuer serve on the compensation committee of such other entity;

- under the NYSE rules, the director is a current employee, or an immediate family member of the director is a current executive officer, of a company that has made payments to, or received payments from, the company for property or services in an amount that, in any of the last three fiscal

(footnote continued)

[41] Both the NYSE and the NASDAQ provide that employment as an interim executive officer does not, in and of itself, disqualify a director from being considered independent following such employment. Under the NASDAQ rules, however, such interim employment cannot last more than one year.

[42] Both the NYSE and the NASDAQ define "company" to include a parent or subsidiary in a consolidated group with the company.

years, exceeds the greater of $1 million or 2% of such other company's consolidated gross revenues;

- under the NASDAQ rules, the director or an immediate family member of the director is a partner, controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year or $200,000, whichever is more;[43]

- under the NYSE rules, the director or an immediate family member of the director has received during any 12-month period within the last three years more than $120,000 in direct compensation[44] from the company (other than in director and committee fees and pension or other forms of deferred compensation for prior service (*provided* that such compensation is not contingent in any way on continued service) and compensation received by an immediate family member for service as a non-executive employee);[45] and

- under the NASDAQ rules, the director or an immediate family member of the director received any compensation[46] from the company in excess of $120,000 during any 12-month period within the last three years (other than director or committee fees, benefits under qualified retirement plans or nondiscretionary compensation and payments received

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

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

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

[46] Unlike the NYSE rules, the NASDAQ rules are not limited to direct compensation. Accordingly, even indirect compensation must be included in the calculation of the $120,000 threshold. For instance, the NASDAQ provides that political contributions to the campaign of a director or an immediate family member of the director would be considered indirect compensation, and, as such, must be included for purposes of the $120,000 threshold.

by an immediate family member for service as a non-executive employee).[47]

Independence determinations must be based on all relevant facts and circumstances. Thus, even if a director meets all the bright-line criteria set out above, a board of directors still is required to make an affirmative determination that the director has no material relationship with the company. Under the NYSE rules, the principles underlying the determination of independence also must be publicly disclosed in the company's annual report or proxy statement. The NYSE rules also provide that the board of directors may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. The company must disclose any such standard the board of directors adopts. Any determination of independence for a director who does not meet such standards must be specifically explained. In addition, under the SEC disclosure rules, for each director that is identified as independent, the company must describe, by specific category or type, any transactions, relationships or arrangements (other than transactions already disclosed as related-party transactions) that were considered by a board of directors under the company's applicable director independence standards (*e.g.*, the NYSE or the NASDAQ independence rules).

In limited circumstances, the NASDAQ permits one director who does not meet its independence rules to serve on the compensation committee without disqualifying the compensation committee from considering the compensation matters that ordinarily could be entrusted to it had it been fully independent. Specifically, if a compensation committee is comprised of at least three members, one non-independent director who is not a current officer or employee or a family member of an officer or employee may be appointed to the compensation committee if the board of directors, under exceptional and limited circumstances, determines that such individual's membership on the compensation committee is required by the best interests of the company and its shareholders. If the board of directors takes this approach, it must disclose in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its annual report on Form 10-K or 20-F) the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years. The NYSE does not provide a similar exemption.

In addition, newly listed companies on the NYSE or the NASDAQ need only one independent member of the compensation committee at the time of the company's initial public offering, a majority of independent

[47] The NASDAQ rules also permit companies to exclude compensation received by a director for service as an interim executive officer, *provided* that such service did not last longer than one year.

members within 90 days of listing[48] and a fully independent committee within one year of listing.

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

As more fully discussed in Chapter IV of this Guide, compensation paid to a company's CEO and the three other highest paid executive officers (other than the CFO) is not deductible to the extent such compensation exceeds $1 million, unless, among other things, the compensation is approved by a compensation committee consisting entirely of two or more "outside directors."

A director is an outside director if the director (1) is not a current employee of the company, (2) is not a former employee of the company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year, (3) is not a former officer of the company (whether or not he or she receives compensation for prior services) and (4) does not receive "remuneration" (including any payments in exchange for goods or services) from the company, either directly or indirectly, in any capacity other than as a director. A director is deemed to have received remuneration in each of the following situations:

- Remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50%. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the company), and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding; or

- The company paid remuneration, other than *de minimis* remuneration, in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5% but not more than 50% or to an entity by which the director is employed or self-employed other than as a director; remuneration is considered paid when actually paid or, if earlier, when the company becomes liable to pay it.

Payments are *de minimis* if they do not exceed 5% of the gross revenue of the entity receiving the payments for the entity's taxable year. Notwithstanding the foregoing, remuneration is not *de minimis* if it is in

[48] If a newly listed NASDAQ company chooses not to have a compensation committee and to have, instead, a majority of the independent directors discharge the duties otherwise associated with a compensation committee, the company may rely on the NASDAQ's phase-in of one year for its separate requirement that there be a majority of independent directors on the board of directors.

excess of $60,000 or if it is paid for "personal services" to an entity at which the director is employed or self-employed other than as a director. Remuneration is for personal services if:

- the remuneration is paid to an entity for personal or professional services performed for the company, including legal, accounting, investment banking and management consulting services, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

- the director performs significant services (whether or not as an employee) for the company, division or similar organization (within the entity) that actually provides the services to the company, or if more than 50% of the entity's gross revenues (for the entity's preceding taxable year) are derived from that company, subsidiary or similar organization.

Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a company that previously was an affiliated company of the company.

C. Membership Requirements for the Short-Swing Profit Exemption of Rule 16b-3 under Section 16(b) of the Exchange Act

Section 16(b) of the Exchange Act provides that a company insider, such as a director or officer, is liable to the company for any profits resulting from his or her purchase and sale of the company's equity securities within any period of less than six months. The statute and the rules promulgated thereunder are quite broad, such that, absent an exemption, the granting of equity compensation to an officer or director of the company may be considered a "non-exempt" purchase for this purpose and subject the officer or director to liability for short-swing profits if the officer or director has a non-exempt sale which can be matched against that purchase. In an effort to address this issue, the SEC adopted Rule 16b-3 of the Exchange Act, which exempts, among other things, grants and awards by the company of its securities to an officer or director if approved by a committee composed solely of two or more "non-employee directors."

1. Non-Employee Director

Under Rule 16b-3, in order to qualify as a non-employee director, the director cannot (1) be an officer or employee of the company (or of a parent or subsidiary of the company), (2) receive in excess of $120,000 in compensation, either directly or indirectly, from the company (or from a parent or subsidiary) for services rendered as a consultant or in any capacity other than as a director, or (3) have an interest in any "related party" transaction for which disclosure in the proxy statement would be required pursuant to Item 404(a) of Regulation S-K.

Disclosure under Item 404(a) is required for any "transaction" since the beginning of the company's last fiscal year or any currently proposed transaction in which the company is a participant, the amount involved exceeds $120,000 and any "related person" had or will have a direct or indirect material interest. Under the disclosure rules, the term "related person" means any person who was at any time during the relevant period a (1) director or executive officer of the company, (2) any nominee for director (but only if the disclosure is being presented in a proxy or information statement relating to the election of that nominee for director), (3) an immediate family member of a director, executive officer or nominee for director (if the proxy or information statement in which the disclosure is being made relates to the election of that nominee for director) of the company or (4) beneficial owner of more than 5% the company's voting securities or an immediate family member of such owner. "Transaction" for purposes of the rule includes any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. Employment relationships and director compensation otherwise disclosed under Item 402 of Regulation S-K (*i.e.*, the executive compensation disclosure rules) need not be disclosed.

The SEC disclosure rules also make clear that, even if the company disclosed a relevant related-party transaction in the company's filings for the most recent fiscal year, such transaction will not disqualify the director under Rule 16b-3 if the transaction was terminated prior to the director's proposed service as a non-employee director.

2. Ensuring Compensation Committee Membership Compliance

It is possible that a compensation committee member will be independent under the NYSE or the NASDAQ rules, but will not be an outside or non-employee director under Section 162(m) of the Code and/or Rule 16b-3 under the Exchange Act. In the event the compensation committee has directors that are independent but are not outside and/or non-employee directors, full compliance with Section 162(m) of the Code and/or Rule 16b-3 is still possible. As long as a compensation committee possesses at least two directors meeting the definitional requirements of outside and/or non-employee directors, the compensation committee can create a subcommittee consisting solely of two or more outside and/or non-employee directors and delegate responsibility with respect to matters falling within the ambit of Section 162(m) of the Code and/or Rule 16b-3 to the subcommittee. Compliance with Section 162(m) of the Code also might be accomplished without the formal creation of a subcommittee if the non-outside directors recuse themselves from the deliberations and decisions falling within Section 162(m) of the Code.

3. Ensuring Independence Under State Law

Transactions between a company and its directors are subjected to intense judicial scrutiny under state law because of the inherent conflict between the corporate insiders' personal financial interests and the insiders' fiduciary duty to a company and its shareholders. In order to avoid such heightened judicial scrutiny of compensation arrangements, compensation arrangements should be approved by, and negotiated with, directors who are disinterested with respect to the compensation decision at issue.

While Delaware courts have in some instances appeared receptive to arguments that economically independent directors were disqualified by alleged non-economic conflicts of interest, the determination of independence under state law generally requires only economic independence based on a facts-and-circumstances analysis. In one opinion, the Delaware Supreme Court, addressing the independence of certain directors of Martha Stewart Living Omnimedia, Inc.,[49] specifically addressed claims that social connections and personal friendships can result in disqualification from a finding of independence. In deciding *Martha Stewart*, the Court held that allegations of a mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. The Court also reiterated its rejection of the concept of "structural bias," the supposition that the professional and social relationships that naturally develop among members of a board of directors impede independent decision-making.

No doubt, each case of alleged directorial conflict of interest is different. Nonetheless, the *Martha Stewart* decision represents an important restatement of the fundamental principle of corporate governance—the presumption that non-management directors are independent (even if they occasionally play golf with the CEO or attend his or her child's wedding) unless there is real evidence to the contrary.

D. Independence Requirements Under Dodd-Frank

Dodd-Frank requires compensation committee members to satisfy independence standards to be established by the applicable stock exchange. Dodd-Frank contains an exception from these requirements for a "controlled company" that is more than 50% owned by an individual, group or other entity. The SEC has announced that it intends to promulgate proposed rules relating to compensation committee independence in the first quarter of 2011 and to adopt final rules in the second quarter of 2011.

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

IX

Compensation Committee Meetings

A. Meetings and Agenda

A compensation committee must meet with sufficient frequency to perform its duties, and should devote adequate time to planning the timing, agenda and attendees at its meetings. A compensation committee should schedule at least one of its meetings before the company's annual report and proxy statement are filed to discuss the proposed compensation-related disclosures. The number of meetings a compensation committee should hold per year depends upon various factors, including the scope of the compensation committee's responsibilities, the size and business of the company and the nature of the compensation arrangements implemented or to be implemented by the company. The SEC requires that companies disclose the number of compensation committee meetings held during the prior fiscal year in their annual proxy statements. Compensation committee meetings, like board of director meetings, should be sufficiently long to allot adequate time to carry out the duties of the compensation committee. Compensation committees should consider scheduling their meetings for the day before full board of director meetings to permit adequate time to consider and discuss agenda items.

A compensation committee should set aside sufficient time without the presence of the CEO and other executive officers to deliberate and determine the officers' compensation levels. For NASDAQ companies, the CEO may not be present during discussions of his or her compensation, but a similar requirement is not imposed for other executive officers. However, a compensation committee should have access to management as it deems appropriate.

A compensation committee should be active in setting its agendas for the year as well as for each compensation committee meeting. While management, rather than the board of directors, sets the strategic and business agenda for the company, including regulatory and compliance goals, directors should determine the bounds of their oversight and responsibilities. The compensation committee meetings and annual agendas should reflect an appropriate division of labor and should be distributed to the compensation committee members in advance.

B. Quorum Requirements

For a compensation committee to conduct official business at a compensation committee meeting, a quorum of its members must be legally present. Unless otherwise restricted in a company's charter, most states consider a director who participates via telephone or video conference to be legally present (as long as all those present at the compensation meeting can hear and speak to each other). A company's bylaws or a board of directors resolution should set the minimum number of compensation committee members necessary to establish a quorum. If no minimum number is set by a company, then, absent a state law to the contrary, the default minimum quorum requirement for a compensation committee is a majority of its members.[50] Neither the SEC nor the major securities markets have specific guidelines in this regard, although the SEC does require that the proxy statement disclose the number of compensation committee meetings held during the prior fiscal year as well as the name of any director who attended fewer than 75% of the aggregate number of meetings of the full board of directors and the committees on which such director served.

Actions undertaken by a compensation committee in the absence of a quorum are voidable. Thus, the minutes should clearly reflect the presence of a quorum in order to protect valid decisions from attack. To help ensure that a quorum is present: (1) compensation committee meeting notices should be sent sufficiently in advance of a compensation committee meeting and responses promptly reviewed and (2) the chairperson of the compensation committee should consult with the corporate secretary in advance of the compensation committee meeting. In the event a compensation committee meeting takes place without a quorum, it should be noted in the minutes.

C. Minutes

Typically, minutes are prepared of compensation committee meetings, but not of their executive sessions. It is common and prudent practice for such minutes to identify the topics discussed at compensation committee meetings rather than attempt to include detailed summaries. Enough information should be recorded, however, to establish that the compensation committee sought the information it deemed relevant, reviewed the information it received, understood each element of the compensation and otherwise engaged in whatever actions and discussions it deemed appropriate in light of the then-known facts and circumstances. The minutes also should indicate which directors attended, whether they attended in person or via telephone or video conference and whether individuals other than the compensation committee members were present.

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

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[50] This principle flows from the general default rule that a committee of the board of directors is subject to the same corporate process requirements applicable to the entire board of directors. *See, e.g.*, § 8.25(c) of the Model Business Corporation Act (2002). Since the default quorum of the entire board of directors generally is a majority of its members, the same holds true for a board committee, such as the compensation committee.

compensation committee members before approval to ensure that the members are aware of the actions that were taken at the last compensation committee meeting and approve of their characterization in the minutes. Unless otherwise required by state statute or a company's charter or bylaws, it is neither necessary for the minutes to identify the director presenting a motion or resolution nor to separately identify the directors voting for or against a motion or resolution. However, a dissenting or abstaining director should be identified if he or she so requests.

A compensation committee should consider providing a report or a copy of the minutes of each compensation committee meeting to the full board of directors. Directors who do not serve on the compensation committee should have the opportunity to ask the compensation committee questions relating to the compensation committee's charter or the topics covered at the compensation committee meetings.

D. Shareholder and Director Right of Inspection

Careful drafting of minutes is especially important because shareholders may inspect the books and records of the company, including committee meeting minutes. In Delaware, for instance, any shareholder may inspect board of director and committee minutes upon making a written demand under oath and stating a "proper purpose" for making the request. While the proper purpose requirement ensures that shareholders do not have *carte blanche*, activist shareholders increasingly are using this right and a court's willingness to entertain such a demand cannot be foreclosed.[51] A 2005 Delaware Supreme Court order,[52] remanding a lower court decision allowing a company to demand confidential treatment before divulging sensitive information to dissident shareholders, illustrates the scrutiny companies may face when attempting to prevent public disclosure of even ostensibly confidential information. In its order, the Delaware Supreme Court held that the Court of Chancery must balance a company's interest in confidentiality against a shareholder's

[51] At least one Delaware Court of Chancery decision, *Polygon Global Opportunities Master Fund* v. *West Corp.*, 2006 WL 2947486 (Del. Ch. October 12, 2006), did announce several important limitations on the use of this tool in the transactional context and possibly beyond. In *West Corp.*, an activist hedge fund (Polygon Global Opportunities Master Fund) demanded access to West Corporation's books and records after West Corporation announced its intention to undertake a going-private transaction. In denying Polygon Global Opportunities Master Fund's demand, the Court held that, in certain circumstances, public information may be sufficient for the shareholder's stated purpose, the books-and-records statute "is not intended to supplant or circumvent discovery proceedings, nor should it be used to obtain that discovery in advance of the appraisal action itself" and Polygon Global Opportunities Master Fund's desire to investigate alleged board of director misconduct cannot be a proper purpose because Polygon Global Opportunities Master Fund would not have standing to pursue any claims (given that it purchased shares in West only after the announcement of the transaction).

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

communication interest and establish that the confidentiality interest "outweigh[s]" the shareholder's interest.[53]

In litigation, minutes carry added significance given that both Delaware and New York accord corporate minutes a presumption of accuracy. Minutes have been cited in a number of high-profile cases as evidence of directors' alleged lack of care and/or good faith in exercising their fiduciary duties. It is especially important that minutes are carefully and thoughtfully drafted so that an ambiguous litigation record is not created.

E. Access to Outside Advisers

In order to enable a compensation committee to deal with any special problems that may arise in the course of performing its duties, a compensation committee should be granted the authority to engage compensation consultants where appropriate. Dodd-Frank authorizes compensation committees to retain outside advisers (after considering factors to be promulgated by the SEC that might affect the independence of such advisers) and requires the committees to oversee the advisers they retain. The NYSE rules already provide that the charter of a compensation committee should give the compensation committee sole authority to retain and terminate any such consulting firm, including sole authority to approve the firm's fees and other retention terms. As noted above, disclosure requirements mandate detailed disclosure of fees and services in respect of consultants who are not independent, and Treasury rules require TARP companies to provide Treasury and other regulators with various compensation consultant disclosures.[54]

Notwithstanding this heavy emphasis on consultant independence, retention of separate advisers for each of the compensation committee and management when considering issues of executive compensation may not always best serve company interests. Such an approach can give rise to inefficiencies in compensation discussions, put a board of directors in the awkward position of receiving conflicting advice, create a bad record if litigation subsequently arises and, perhaps most importantly, create an adversarial relationship between management and the board of directors. While directors should have full access to any consultants that are ultimately retained by the company and have the ability and time to ask focused questions of them, the use of consultants is not legally required,

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[53] On remand, however, the Delaware Court of Chancery engaged in the prescribed balancing and concluded that the company's interest in confidential treatment outweighed the shareholder's interest, and, thus, that the provision of the requested information could properly be conditioned on confidentiality. *See Roy E. Disney* v. *Walt Disney Co*., 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005). Thus, it appears that, at least at the Delaware Court of Chancery level, confidential treatment, under appropriate circumstances, still will be available.

[54] See Section E of Chapter I of this Guide and Section C of Chapter VI of this Guide.

and a consultant's judgment should not be viewed as a substitute for a board of directors' exercise of judgment after careful and informed deliberation. As a matter of good corporate governance, compensation committees should understand the nature and scope of services that consulting firms and their affiliates provide to the company in order to evaluate any actual or perceived conflicts of interests.

F. Compensation Committee Chairperson

While each member of a compensation committee contributes to its effectiveness, the compensation committee chairperson has a unique role. The compensation committee chairperson is responsible for ensuring that compensation committee meetings run efficiently and that each agenda item receives the appropriate level of attention. The compensation committee chairperson also often serves as the key contact between the compensation committee and other directors and senior management.

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

The time commitment resulting from the current regulatory and shareholder activist environment may require additional compensation for directors, and this pressure is especially acute with respect to service on a compensation committee. Although some companies would prefer not to discriminate in compensation among directors, reasonable additional fees for compensation committee members are legal and may be appropriate. Additional compensation for committee chairs is another way to give fair compensation for those members most burdened with responsibilities. Although, as noted in Chapter XI of this Guide, we generally recommend that the responsibility for director compensation be delegated to the corporate governance and nominating committee, in many public companies the compensation committee reviews the compensation for directors, including the compensation of directors serving on the compensation committee.

X

Compensation Committee Charters

Under the SEC executive compensation disclosure rules, a public company must disclose whether or not it has adopted a compensation committee charter, and any such compensation committee charter must be made publicly available on the company's website or attached to the proxy or information statement at least once every three years. In addition, as described below, the NYSE requires its listed companies to adopt a compensation committee charter that must include specified provisions. In light of these requirements, the compensation committee of a publicly held company should have a charter that complies with applicable regulations and securities market requirements rules. That said, any such compensation committee charter should not over-engineer the operation of the compensation committee. If a compensation committee charter requires review or other action and the board of directors or compensation committee has not taken that action, the failure may be considered evidence of lack of due care. The creation of compensation committee charters is an art that requires experience and careful thought; it is a mistake to copy blindly the published models.

Each company should tailor its compensation committee charter to address the company's particular needs and circumstances, limiting the charter to what is truly necessary and what is feasible to accomplish in actual practice. In order to be state of the art, it is not necessary that a company have everything other companies have. A compensation committee charter should carefully be reviewed each year to prune unnecessary items and to add only those items that will in fact help the compensation committee members in discharging their duties.

A. NYSE-Listed Companies Charter Requirements

The compensation committee of a company listed on the NYSE must have a written compensation committee charter that, at a minimum, contains the required provisions specified by the NYSE listing standards.[55] The compensation committee charter must be approved and adopted by the board of directors and should provide:

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

[55] A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

overall responsibility for approving and evaluating all compensation plans, policies and programs of the company as they affect the CEO, other executive officers and significant company compensation matters and policies generally.

- That the compensation committee annually will review and approve corporate goals and objectives relevant to CEO compensation, evaluate CEO performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. It also should be noted that, in determining the incentive-based components of CEO compensation, the compensation committee will consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years.

- That the compensation committee will review and discuss with management the CD&A and, based on this review and analysis, determine whether or not to recommend to the board of directors the CD&A's inclusion in the company's proxy statement and annual report on Form 10-K.

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

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

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

- How compensation committee members are appointed.

- How compensation committee members may be removed.

- The qualifications for compensation committee membership.

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

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

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

It also may be advisable for the charter to provide:

- That the compensation committee will, at least annually, review and approve the annual base salaries and annual incentive opportunities of the CEO and other senior executives. In particular, it should be noted that the compensation committee will review and approve the following as they affect the CEO and other senior executives: (1) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities, (2) any employment agreements and severance arrangements and (3) any change-in-control agreements and change-in-control provisions affecting any elements of compensation and benefits.

- That the compensation committee will receive periodic reports on the company's compensation programs as they affect all employees.

- That the compensation committee will review and approve any special or supplemental compensation and benefits for the CEO and other senior executives and individuals who formerly served as the CEO and/or as senior executives, including supplemental retirement benefits and the perquisites provided to them during and after employment.

- That the compensation committee will review and reassess the adequacy of the compensation committee charter annually and recommend any proposed changes to the board of directors for approval.

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

Exhibit A to this Guide is a model compensation committee charter for NYSE-listed companies. This compensation committee charter is only a model intended to reflect required and recommended provisions for a compensation committee charter of a NYSE-listed company. Companies should customize the model to address their particular needs and circumstances.

B. NASDAQ-Listed Companies Charter Requirements

For companies listed on the NASDAQ, there is no formal requirement that there even be a compensation committee, let alone a written compensation committee charter. Nonetheless, in accordance with best practice and for practical application of a compensation committee's functions, a compensation committee of a NASDAQ-listed company should have a written compensation committee charter delineating its responsibilities. The provisions required by the NYSE and the provisions recommended above may be a helpful blueprint. However, because every company is different, a board of directors, in conjunction with the compensation committee, should carefully consider whether inclusion of any provision is helpful in furthering the performance of the compensation committee's duties.

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

XI

Director Compensation, Indemnification and Directors and Officers Insurance

A. Director Compensation

Director compensation is one of the more difficult issues on the corporate governance agenda and is the subject of increased attention. On the one hand, more is being expected of directors today in terms of time commitment, responsibility, exposure to public scrutiny and potential liability. On the other hand, the higher a director's pay, the greater the chance that such pay can be used against the director as evidence of a lack of true independence.

Indeed, as discussed in Chapter I of this Guide, the SEC's executive compensation rules require tabular disclosure of all director compensation. The required disclosure is comparable to the extensive disclosure that is required for executive officer compensation, except that only information concerning the last fiscal year needs to be disclosed. In addition, as described in Chapter I of this Guide, narrative disclosure of a company's processes and procedures for the consideration and determination of director compensation must be provided.

The NYSE rules do not specify that responsibility for director compensation must be assigned to any particular committee. However, it should be made the responsibility of either a committee of the board of directors, such as the compensation committee or the governance and nominating committee, or the full board of directors. As discussed in Chapter II of this Guide, when directors who would directly benefit from a proposed plan are delegated with the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.[56] In light of this framework, we generally recommend that responsibility for adopting director compensation be delegated to a company's corporate governance and nominating committee, subject to the approval of the entire board of directors. Although we generally recommend that responsibility for director compensation be delegated to the corporate governance and nominating committee, many companies allocate that responsibility to the compensation committee. In either case, the committee's decision with respect to director compensation should always be subject to overall board of director review and override. Care also should be taken that, under normal circumstances, the compensation

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

and benefits of management are not increased at the same time as that of directors, lest doubt be cast on the validity of both actions.[57]

A compensation committee (or other responsible board of director committee, as applicable) should determine the form and amount of director compensation with appropriate benchmarking against peer companies. It is legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time.

While there is a trend to establish stock-based compensation programs for directors, the form of such programs should be carefully considered to ensure that they do not create the wrong types of incentives for directors. In the current environment, restricted stock grants, for example, may be preferable to stock option grants, because restricted stock grants will align director and shareholder interests more directly and avoid the perception that directors are supporting more aggressive risk taking on the part of management in order to maximize director option values.

Perquisite programs and company charitable donations to any organizations with which a director is affiliated also should be carefully scrutinized to assure that they do not jeopardize any director's independence or create any potential appearance of impropriety. Any payments to directors for consulting or other services beyond the regular directors fees should be considered carefully, including in the analysis of the applicable independence standards, and disclosed fully. Note that, under Section 301 of Sarbanes-Oxley, the receipt of any consulting, advisory or other compensatory fee from a company other than in the capacity of a director or committee member will disqualify a director for service on the audit committee.

B. Indemnification and Directors and Officers Insurance

Whatever the directors' compensation program, all directors should be fully indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest coverage permitted by law. Directors also can continue to rely on their exculpation for personal liability for breaches of the duty of care under charter provisions put in place pursuant to Section 102(b)(7) of the Delaware General Corporation Law and similar statutes in other states.

Directors and Officers ("D&O") insurance coverage, of course, provides a key protection to directors. While such coverage is becoming

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

more expensive, it is still available in most instances, and remains highly useful, despite some recent decisions construing the terms of D&O policies less favorably to the insured. D&O policies are not strictly form documents; they can be negotiated. Careful attention should be paid to retentions and exclusions, particularly those that seek to limit coverage based upon a lack of adequate insurance for other business matters, or based on assertions that a company's financial statements were inaccurate when the policy was issued. Care also should be given to the potential impact of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, many companies are purchasing separate supplemental insurance policies covering only directors and officers and not the company (so-called "side-A" coverage) in addition to their normal policies, which cover both the company and the directors and officers individually.

EXHIBIT A

COMPENSATION COMMITTEE CHARTER[58]
(NYSE-Listed Company)

Purpose

The Compensation Committee (the "Committee") is appointed by the Board of Directors (the "Board") to discharge the Board's responsibilities relating to compensation of **[Name of Company]** (the "Company") Chief Executive Officer (the "CEO") and the Company's other executive officers (collectively, including the CEO, the "Executive Officers"). The Committee has overall responsibility for approving and evaluating all compensation plans, policies and programs of the Company as they affect the Executive Officers.[59]

Compensation Committee Membership

The Committee shall consist of no fewer than three members. The members of the Committee shall meet the independence requirements of the New York Stock Exchange (the "NYSE"). At least two members of the Committee also shall qualify as "outside" directors within the meaning of Internal Revenue Code § 162(m) and as "non-employee" directors within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934, as amended.[60]

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

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

[60] Only two members need conform to the membership requirements of Internal Revenue Code § 162(m) and/or Rule 16b-3 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") because satisfaction of such membership requirements may be accomplished by the delegation of the relevant decisions to a conforming two-person subcommittee or by the recusal or abstention of the non-conforming members if at least two conforming members remain. *See* PLR 9811029 (December 9, 1997); American Society of Corporate Secretaries, 1996 SEC No-Act, LEXIS 910 (December 11, 1996).

In addition, compliance with the membership requirements of Internal Revenue Code § 162(m) is only necessary to the extent that the board of directors determines that it is in the best interests of the Company to qualify for the performance-based exemption to the non-deductibility of individual compensation payments in excess of $1 million made to the CEO and the next four highest paid officers (other than the CFO). In addition, compliance with the membership requirements of Rule 16b-3 of the Exchange Act is not the only means available to the board of directors to ensure that grants or awards to

(footnote continued)

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

Meetings

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the Committee members present at that meeting shall designate one of its members as the acting chair of such meeting.

Committee Responsibilities and Authority

1. The Committee shall annually review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives and determine and approve the CEO's compensation level based on this evaluation. In determining the incentive components of CEO compensation, the Committee may consider a number of factors, including, but not limited to, the Company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years.

2. The Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers.

3. The Committee shall, periodically and as and when appropriate, review and approve the following as they affect the Executive Officers: (a) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities; (b) any employment agreements and severance arrangements; (c) any change-in-control agreements and change-in-control provisions affecting any elements of compensation and benefits; and (d) any special or supplemental compensation and benefits for the Executive Officers and individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

(footnote continued)
company officers fall within the Rule 16b-3 short-swing profit safe harbor from Exchange Act § 16(b) liability. The safe harbor also is available if the grants or awards are approved by the full Board if the securities issued to the officers are held by the officers for at least six months or if a majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

4. The Committee shall review and discuss the Compensation Discussion and Analysis (the "CD&A") required to be included in the Company's proxy statement and annual report on Form 10-K by the rules and regulations of the Securities and Exchange Commission (the "SEC") with management, and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.

5. The Committee shall produce the annual Compensation Committee Report for inclusion in the Company's proxy statement in compliance with the rules and regulations promulgated by the SEC.

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

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

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

9. The Committee shall annually review its own performance.

10. The Compensation Committee shall have the sole authority to retain and terminate any advisers to assist it in the performance of its duties and shall have sole authority to approve the advisers' fees and the other terms and conditions of the advisers' retention.

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

EXHIBIT B

COMPENSATION COMMITTEE CHARTER[61] (NASDAQ-Listed Company)

Purpose

The Compensation Committee (the "Committee") is appointed by the Board of Directors (the "Board") to discharge the Board's responsibilities relating to compensation of **[Name of Company]** (the "Company") Chief Executive Officer (the "CEO") and the Company's other executive officers (collectively, including the CEO, the "Executive Officers"). The Committee has overall responsibility for approving and evaluating all compensation plans, policies and programs of the Company as they affect the Executive Officers.

Committee Membership

The Committee shall consist of no fewer than three members. The members of the Committee shall meet the independence requirements of the NASDAQ Stock Market.

At least two members of the Committee also shall qualify as "outside" directors within the meaning of Internal Revenue Code § 162(m) and as "non-employee" directors within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934, as amended.[62]

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

[62] Only two members need conform to the membership requirements of Internal Revenue Code § 162(m) and/or Rule 16b-3 of the Securities Exchange Act of 1934 (the "Exchange Act"), as amended because satisfaction of those membership requirements may be accomplished by the delegation of the relevant decisions to a conforming two-person subcommittee or by the recusal or abstention of the non-conforming members if at least two conforming members remain. *See* PLR 9811029 (December 9, 1997); American Society of Corporate Secretaries, 1996 SEC No-Act, LEXIS 910 (December 11, 1996).

In addition, compliance with the membership requirements of Internal Revenue Code § 162(m) is only necessary to the extent that the board of directors determines that it is in the best interests of the Company to qualify for the performance-based exemption to the non-deductibility of individual compensation payments in excess of $1 million made to the CEO and the next four highest paid officers (other than the CFO). In addition, compliance with the membership requirements of Exchange Act Rule 16b-3 is not the only means available to the board of directors to ensure that grants or awards to company officers fall within the Rule 16b-3 short-swing profit safe harbor from Exchange Act § 16(b) liability. The safe harbor also is available if the grants or awards are approved by the full Board, if the securities issued to the officers are held by the officers for at least six months or if a majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

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

Meetings

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the Committee members present at that meeting shall designate one of its members as the acting chair of such meeting.

Committee Responsibilities and Authority

1. The Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers. The CEO shall not be present during any Committee deliberations or voting with respect to his or her compensation.

2. The Committee shall, periodically and as and when appropriate, review and approve the following as they affect the Executive Officers: (a) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities; (b) any employment agreements and severance arrangements; (c) any change-in-control agreements and change-in-control provisions affecting any elements of compensation and benefits; and (d) any special or supplemental compensation and benefits for the Executive Officers and individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

3. The Committee shall review and discuss the Compensation Discussion and Analysis (the "CD&A") required to be included in the Company's proxy statement and annual report on Form 10-K by the rules and regulations of the Securities and Exchange Commission (the "SEC") with management, and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.

4. The Committee shall produce the annual Compensation Committee Report for inclusion in the Company's proxy statement in compliance with the rules and regulations promulgated by the SEC.

5. The Committee shall monitor the Company's compliance with the requirements under the Sarbanes-Oxley Act of 2002 relating to loans to directors and officers, and with all other applicable laws affecting employee compensation and benefits.

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

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

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

9. The Committee shall have the sole authority to retain and terminate any advisers to assist it in the performance of its duties and shall have sole authority to approve the advisers’ fees and the other terms and conditions of the advisers’ retention.

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