Semo
Law Group

Handbook for Service on

The Corporate Board Compensation Committee

TABLE OF CONTENTS

Semo Law Group
1800 M Street, NW
Suite 730-S
Washington, DC 20036
202-833-7366

INTRODUCTION

This Handbook is written as a guide for those serving on the compensation committee of the board of directors of a public company, though many of the observations apply with equal force to those serving privately held companies and not-for-profit organizations.
The guidance is premised upon general principles of corporate law. The law of any particular state, however, is likely to apply these principles in accordance with each state's own laws and traditions of jurisprudence. Accordingly, this handbook is not a substitute for legal counsel. Readers are encouraged to seek trained legal guidance when exercising corporate responsibilities.

The structure of this guide is to provide an overview of the responsibilities of directors and then focus upon the special concerns of those serving on a compensation committee.

The Role of Corporate Directors

Corporations are legal entities with rights and constraints prescribed by state, and increasingly federal, law. Generally, a corporation is entrusted to directors, persons elected by the shareholders, who are responsible for overseeing the conduct of business of the corporation. In turn, the directors are authorized to appoint officers. The board of directors is not required to operate the day-to-day business of the corporation. Boards of directors do not operate uniformly.

Boards of directors have been categorized into two camps. The first camp has been called the consultative board, which operates by overseeing its officers and providing broad guidance within which the officers are expected to operate. The second camp has been called the compliance board, which operates to assure compliance with requirements of statutory and regulatory laws. A compliance board tends to be more involved in overseeing compliance efforts. Boards of directors often operate with aspects of each model as circumstances present themselves.

Recent events in public companies have re-focused public discussion of the proper balance of responsibilities and accountability of directors. As a result of the public outrage with corporate behavior, federal regulation of public companies was enacted. The Sarbanes-Oxley Act of 2002 ("SOX") set forth duties for directors to enhance public oversight of corporate actions. Specifically, Sox prescribed rules for auditor independence and responsibilities for corporate audit committees with respect to the appointment, compensation and oversight of the public accounting firms engaged to perform audit services; requires enhanced disclosure of management's assessment of internal controls; and, requires the development of a code of ethics for senior financial officers. SOX delegated regulatory authority to the Securities and Exchange Commission to promulgate regulations to further the achievement of the objectives of the SOX law. As part of its regulatory oversight, the Commission now requires the compensation committee of the board of directors to certify to the full board its evaluation of management's proposed disclosure of compensation in the corporation's annual report.

THE RESPONSIBILITIES OF CORPORATE DIRECTORS

Today's newspapers frequently discuss the aspirational ideals of corporate governance that go beyond the minimal legal requirements of corporate law. Today's director is expected to fully inform himself of the material facts and circumstances connected with matters coming before the board, to obtain skilled counsel with respect to such matters, and to have contingency plans ready to meet the challenges corporations may reasonably anticipate. Failure to achieve the aspirational goals can result in public criticism and give rise to efforts by shareholders to replace directors, but only failure to exercise the legal requirements, discussed below, will result in liability. This distinction is important even though persons serving as directors do not cavalierly expose their good reputations to public attack. Accordingly, following benchmarks of good governance are important, even if not required as a matter of law.

The duties owed by the directors of a corporation are generally the duties of due care and loyalty. Some discussions argue that there is a third duty, a duty of good faith. However, the duty of loyalty and of good faith are so intertwined that most often it is not meaningful to discuss a duty of good faith as a third duty.

The duty of due care requires that a director act like an ordinarily prudent person managing their own affairs, best advancing the interests of the corporation. Generally, this assumes that the director will steer the corporation to select a course of conduct to achieve the most benefit at the least cost to it.

The duty of loyalty for a director requires action with the best interest of the corporation at heart. Unless the director acts with loyalty to the corporation, the concern is that a poor bargain will result.

Fortunately for persons serving as a director, a presumption is usually given to the director that he acted in accordance with his legal duties. The director is assumed to have acted on an informed basis and in the honest belief that the action taken was in the best interests of the corporation. This presumption is commonly known as the *business judgment rule*. This presumption is generally recognized in order to balance the risk of liability upon a director against the relatively small upside gain the director might realize from the authorized action.

The business judgment rule is only a presumption in favor of a director and is subject to attack by those seeking to hold a director accountable. The business judgment rule will not protect a director where:

- There is evidence of fraud;
- There is evidence of self-dealing;
- There is evidence of a failure to duly investigate before acting;
- There is evidence of a failure to become adequately advised; or
- There is evidence of a reckless indifference to the interests of the corporation.

Also, because the business judgment rule focuses on the action taken by a director, each director stands alone in defending his own conduct. Courts do not want to engage in the business of second guessing actions of directors. As a result, a bad outcome does not determine liability. While the business judgment rule can be a shield for directors, it is not a bar to litigation.

While it should be obvious, the business judgment rule does not provide a defense where the director has failed to exercise any judgment!

Elements of the Duty of Care

The statement that the duty of care requires a director to act as a reasonably prudent man in the conduct of his own affairs begs the question of what conduct is taken by a reasonably prudent man in managing his own affairs. Generally, the cases search whether the decision was the product of a ***process*** that was deliberately considered in good faith or was otherwise rational.

In the duty of care context one can identify the elements of a prudent process. The benchmarks of a prudent process include the following:

- Collecting the material facts from which an informed decision can be made;
- Assuring that one has the appropriate expertise to apply to the decisions being made;
- Assuring that one has engaged appropriate expertise to inform himself with respect to the decision to be made;
- Assuring that the engaged expert is providing unbiased information or that the bias of the expert is disclosed and understood so that the information provided can be weighed appropriately;
- Assuring that any delegation of decision making authority has been made to persons having — or having the ability to access—requisite expertise.

Elements of the Duty of Loyalty

It is an axiom of fiduciary duty that the agent may not use his position of trust and confidence to further his private interest at the expense of his principal. A director must not act (or fail to act) in a manner that would cause injury to the corporation or deprive it of a profit which their skills might properly bring to the corporation. A director must use his skill to the benefit of the corporation.

Only in very rare circumstances is a director expected to act on both sides of a transaction, such as in setting the compensation of the directors themselves. The standard of care for that transaction is addressed generally by statute and requires that the directors be able to demonstrate the fundamental fairness of the decision made.

The Delaware General Corporation Law specifically vests the directors with statutory authority to establish their own compensation, providing: "(h) Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors." 8 Del. C. §141(h). However, the power to set their own compensation is subject to review. "Like any other interested transaction, directoral self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation." Telkon Corp. v. Meyerson, 802 A.2d 257, 265 (Del. 2002).

A director should be sensitive to the duty of loyalty and act accordingly. This extends to the manner in which the director exercises the duty of care. Reliance upon the agent of an adverse party will certainly call into question whether the director was acting for the good of the corporation or was complicit in failing to discharge the obligations owed the corporation.

THE ROLE OF THE COMPENSATION COMMITTEE

The role of the director serving on the compensation committee has overtaken the service on the audit committee in terms of responsibility and public scrutiny. The days of the director serving on the compensation committee who can merely rubber-stamp management's recommendations for compensation — whether presented by management or by management's selected consultant — are coming to an end. Corporations need an engaged compensation committee to address:

- Setting forth the corporate goals and objectives against which management's performance will be measured;
- Establishing a fair compensation arrangement with senior management that aligns their interest with those of the corporation with respect to both short term and long term objectives;
- Developing contingency plans for succession of senior management;
- Establishing performance based compensation arrangements that reward value added performance and filter out performance results that are not related to management's actions;
- Monitoring the award of equity grants where discretion to make the awards has been given to executive officers;
- Making recommendations with respect to the corporation's incentive compensation and equity-based compensation plans;
- Reviewing and evaluating management's performance against the stated goals and objectives; and
- Reviewing the corporation's "Compensation Discussion and Analysis" to be included in the corporation's annual proxy statement.

Notwithstanding its leadership role in establishing compensation of management executives, the responsibility for overseeing the compensation of directors may rest with the corporate governance committee. In such cases, the compensation committee will often provide guidance to the governance committee concerning the range of appropriate compensation and whether the proposed structure aligns director compensation with the interests of shareholders.

The Compensation Committee Charter

A charter should be adopted for the compensation committee to clearly specify its responsibilities. A written charter is required for New York Stock Exchange ("NYSE") listed companies. (NYSE Corporate Governance Guideline Rule 303A.05). A well constructed charter also will identify clearly the periodic tasks expected of the committee, a set of deliverables against which the committee can be held accountable.

NYSE Corporate Governance Guideline Rule 303A.05 provides:

*(**a**) Listed companies must have a compensation committee composed entirely of independent directors.*

*(**b**) The compensation committee must have a written charter that addresses:*

*(**i**) the committee's purpose and responsibilities – which, at minimum, must be to have direct responsibility to:*

*(**A**) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and*

*(**B**) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans that are subject to board approval; and*

*(**C**) produce a compensation committee report on executive compensation as required by the SEC to be included in the listed company's annual proxy statement or annual report on Form 10-K filed with the SEC;*

*(**ii**) an annual performance evaluation of the compensation committee.*

A charter also may vest the committee with the authority to act in the name of the board of directors in those areas entrusted to it or clearly constitute the committee only as advisory.

A charter should also identify term limits to assure rotation among board members while also assuring institutional memory. Rotation of directors on the committee will assure that the committee does not have a vested interest that might interfere with a brutally honest assessment of whether compensation arrangements are fulfilling the purposes originally set and the purposes that are important as time moves forward.

Compensation Committee Composition

An effective compensation committee will require that a number of skill sets be brought together. Among its members, the compensation committee should have members and advisers with knowledge of: human resource management, finance, the principal industries in which the corporation is engaged, risk management, taxation, and law. The committee should be small enough that its members will be engaged and take ownership of their responsibilities, yet large enough to bring together the knowledge needed to evaluate the compensation arrangements.

The compensation committee should be comprised of independent directors; none should be employed by the corporation or have relatives employed by the corporation in senior management positions. A director who represents another party that is — or seeks to be — an important business associate of the corporation, whether a supplier or service vendor, should not be considered independent. Rules of the NYSE require that all members of the compensation committee be independent.

NYSE Corporate Governance Guideline Rule 303A.02 addresses "independence" as follows:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination.

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

(iii) (A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm;

(C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

Of course, in order to do its work the compensation committee will frequently meet with the CEO and other corporate leaders in order to consider their industry knowledge of the marketplace for executive talent and their assessment of the performance of the management team.

Managing the Business of the Compensation Committee

There is a wide variation in practice on the use of outside advisors. In some companies, the executive in charge of human resources or the corporation's general counsel staff will attempt to manage the committee's work and serve as a go-between to outside professionals. This model usurps the independent function of the committee. Instead, the committee will be better served with a direct relationship with its own independent consultant and even with independent legal counsel, for reasons discussed below.

The need for truly independent advisors has been underscored by the Committee on Corporate Laws of the American Bar Association Section of Business Law in its Corporate Director's Guidebook, where it suggests:

*The compensation committee should be empowered to hire (**without management influence in the selection process**) outside counsel, compensation specialists, consulting firms, or other experts to assist in the evaluation of director, CEO, and senior executive compensation **so that it need not rely solely upon corporate personnel or outside specialists selected by management for advice and guidance.***

Committee on Corporate Laws of the American Bar Association Section of Business Law, Corporate Director's Guidebook, Fifth Ed. 2007, pp. 78-79.

The selection of consultants is under scrutiny today. Careful vetting of the consultant is important for two reasons: first, a well chosen consultant will better aid the Board in reaching good decisions; and, second, careful selection of a consultant will provide a shield from liability for Board members who act in reliance upon the work-product of the consultant. On this latter point, Delaware law, for example, expressly provides that "[a] member of the board of directors … shall in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers … or any other person ***as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."*** 8 Del. C. §141(e),

In the celebrated dispute at The Walt Disney Company, arising from the payment of termination payments to Michael Ovitz, the actions of the compensation committee of the board of directors was scrutinized. Actions taken, and the discussion of actions not taken, were set out in the lengthy discussion of the agreements that provided for the payments. The court examined the actions of the committee under applicable Delaware law and ultimately found that the committee had reasonably relied upon its consultant and that "the fault for the errors or omissions in [the consultant's] analysis must be laid at his feet, and not upon the compensation committee." Importantly, the court determined that "the [consultant] appears to have been selected with reasonable care." Consequently, while much of the process was criticized–underscoring a lack of "best practices," the court determined that the directors were entitled to the protection of 8 Del. C. §141(e) in relying upon the consultant. It is also important to recognize, as the court expressly stated, that reliance upon an expert does *not* require following the expert's guidance, the role of the expert is to assist a board, not supplant it.

As a matter of best practice, the committee is expected to use an independent consultant and, if it does not, to explain why it chose not to do so. Institutional investors are increasing insisting that committees do so.[1] An independent consultant, at a minimum, is one that does not work for the company's human resource department nor one engaged for special projects by the company (such as to counsel on mergers, acquisitions or spin-offs, or downsizing programs). A committee might also be reluctant to engage a consulting firm that has considerable business from key competitors. The magnitude of fees earned from the company as opposed to fees earned for services provided to the compensation committee will range 10 to 1, or more. Recent studies performed by the U.S. Congress Committee on Oversight and Government Reform have reported that in those companies where the compensation committee utilizes a consultant with a conflict of interest, executives tend to be paid as much as 67% higher compensation.

During December 2007, the Majority Staff of the House Oversight Committee released its study of conflicts of interest among compensation consultants.[2] As a result, this year began with the need for the compensation committee to consider these astounding findings:

> Compensation consultant conflicts of interest are pervasive. In 2006, at least 113 of the Fortune 250 companies received executive pay advice from consultants that were providing other services to the company.
>
> The fees earned by compensation consultants for providing other services often far exceeded those earned for advising on executive compensation. In 2006, the consultants providing both executive compensation advice and other services to Fortune 250 companies were paid almost 11 times more for providing other services than they were paid for providing executive compensation advice. On average, the companies paid these consultants over $2.3 million for other services and less than $220,000 for executive compensation advice.

1 *On May 12, 2008, for example, Denise L. Nappier, Treasurer for the State of Connecticut, led a coalition of 21 institutional investors representing more than $1.4 trillion in calling for the Securities and Exchange Commission to require greater disclosure of information of the independence of board compensation consultants.*

2 *Majority Staff of the House of Representatives Committee on Oversight and Government Reform, Report on Executive Pay: Conflicts of Interest Among Compensation Consultants (December 2007).*

> Some compensation consultants received more than $10 million in 2006 to provide other services. One Fortune 250 company paid a compensation consultant more than $11 million for other services in 2006, over 70 times more than the company paid the consultant for executive compensation services. Another Fortune 250 company also paid a compensation consultant over $11 million for other services, over 50 times more than it paid the consultant for executive compensation advice.

Similarly, a compensation committee should have a relationship with its own legal counsel. The committee cannot — and should not — expect complete candor from in-house counsel that report to senior management nor from outside firms that work (or from those that seek to work) for management. As in the case of consultants, in-house expertise must report to management, and outside expertise hope to earn much more representing the company than it can expect to earn from work for the committee. Here, the committee also must evaluate that their chosen counsel seeks only to represent the committee and is not seeking to obtain other work from the corporation as that objective should be weighed as much as consideration of an actual conflict.

Indeed, the most important reason for the compensation committee to incorporate its consultant and attorney as part of their deliberation resource-kit is to be prepared to act quickly should a crisis arise; a crisis is not the time to get acquainted and determine whether confidence in the advice given is deserved.

THE WORK OF THE COMPENSATION COMMITTEE

As the expectations of the work of the compensation committee have expanded, the committee needs to be engaged and make a record of its work which, at a minimum, will include:

Meetings with management: The committee will need to meet with management periodically to understand management's priorities and, as important, the opportunities that are postponed and business issues which receive limited attention as management focuses on the priorities identified by the board of directors.

Performance Reviews of Senior Management: The committee should review the performance of the CEO against performance benchmarks and together with the CEO review the performance of other senior management. Through this process the committee will be reviewing and re-affirming the performance goals for which pay-for-performance awards are made.

Meetings with the Audit Committee: The committee will need to meet with the audit committee to discuss the financial statement impact of compensation arrangements and whether the after-tax cost of compensation is tracking the expected cost as contemplated by the committee.

Meetings with business development teams: The committee will need to meet with management teams to understand the objectives of the component lines of business, the goals, and how each relates to the other. These meetings should be used to evaluate whether the performance goals remain important to the business environment confronted by the corporation.

> *As pay for performance plans receive increased scrutiny by stakeholders, the compensation committee will need to fully understand the performance objectives of the corporation. The requisite understanding can only be obtained from careful examination of the long-term strategy and identification of the short-term goals established to implement the strategy.*

Director Training: The committee will need to evaluate whether its members require special training to understand their responsibilities, how their work-product is used, and evolving best practices.

> *Increased professionalism is expected from directors. Best practices require that directors engage in ongoing study related to their responsibilities. Among the choices for consideration are programs offered by professional organizations and universities. In addition, each Board will want to consider programs appropriate for their own needs.*
>
> *NYSE Corporate Governance Guideline Rule 303A.09 specifically identifies director orientation and continuing education as specific subjects that should be addressed in the disclosure of a listed corporation's governance guidelines.*

Contracting: Not all committees believe that there needs to be a written contract for a CEO. The decision to forego a written contract must be reached carefully. If a written contract is to be entered, the committee will need to have its counsel assist in the negotiation and documentation of the agreement.

Monitoring Total Compensation: Even though compensation for any one year may be viewed as appropriate, the committee should be monitoring total wealth accumulation attributed to compensation. While there is a desire to provide sufficient equity-based compensation to assure that the interests of the executive are aligned with the interests of owners, at some point the equity component is enough.

Each of the foregoing activities is important. Equally if not more important, however, is the need for the committee to be prepared to address must-act-now circumstances. These include:

Retaining a Key Executive: In the event a key executive is being recruited by a rival corporation, the committee must have sufficient general knowledge about the environment to act quickly in the best interests of the Corporation.

Successorship Planning: In the event of a sudden loss of a key executive, including the CEO, the committee must be able to contribute to the process of crafting an offer for a successor.

Enforcing the Contract: In the event of a material breach of an employment contract, the committee must be ready to enforce claw-back rights. Delay in taking prompt action can material damage confidence of shareholders and other stakeholders.

THE SPECIAL PROBLEM OF SETTING DIRECTOR COMPENSATION

While the work of setting executive compensation is difficult, the work of structuring director compensation has its own challenges. The work of establishing director compensation **is not protected by the business judgment rule.** Consequently, it is desirable for the committee to engage advisers who will be candid with the committee and who will not be shaded by the bias that is suspect where an adviser is performing work for management as well.

Delaware law, for example, specifically empowers directors to set their own compensation. The Delaware corporate law provides that "unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors." 8 Del. C. §141(h). The receipt of self determined benefits by directors is subject to judicial review. In such proceedings the directors have the obligation to make an affirmative showing that the compensation arrangements are fair to the corporation. Because of the enhanced scrutiny given to these decisions, the process followed must be documented at least as well as the process followed to set compensation of the corporation's executives.

Compensation arrangements for directors involve different decisions than those relating to compensation of the executives. Compensation of directors should be structured to align the interest of the director with those of the shareholders and to compensate for the effort required. The interests of directors and shareholders are aligned through the requirement that directors acquire, or receive as compensation, certain amounts of stock. These holdings should have enough strings attached to have the director's interest aligned with long-term shareholders.

There is ongoing debate about the proper role of performance compensation for directors. Generally, the director recognizes reward for good stewardship and leadership by the increase in value of the company's stock. There is concern that rewarding current earnings at the expense of investing in long-term growth will disadvantage the company and shareholders.

Director compensation is no longer nominal. Committees need to balance: payment for the time and responsibility undertaken; the frequency of meetings for the board and of committees of the board; and to the special needs that committee chairmen may have.

THE LANGUAGE OF EXECUTIVE COMPENSATION

Each member of the compensation committee must understand the jargon of compensation. This begins with understanding how the compensation philosophy is expressed. Phrases, including: pay for performance; competitive with comparable companies; targeted levels of operational achievement; must have meaning in context. The following must be understood:

Cash Compensation: This is the base pay that will be paid in accordance with the company's payroll practice and any cash bonus.

Cash Incentive Award (Bonus Compensation): These are payments based upon achievement of specified objectives for one or more business segments. The objectives upon which the award is based will vary from year to year and may require discretionary determination of whether the objectives were satisfied.

Qualified Deferred Compensation Plans: Qualified deferred compensation plans are ones that are generally available to a wide cross-section of employees. Under existing law, however, the amount of compensation that may be taken into account to determine either contributions for the individual's account or to determine the individual's defined benefit at retirement is limited to $250,000, adjusted periodically to reflect inflation. Because of the limits in the amount of compensation that may be taken into account, these plans only replace a small percentage of an executive's compensation (even if providing a substantial retirement benefit in absolute dollars).

Non-Qualified Deferred Compensation: Non-qualified deferred compensation refers to a broad category of compensation that is intended to be paid after employment ends. These arrangements are very flexible. The addition, however, of Internal Revenue Code section 409A has complicated the design of these programs as failure to meet a safe harbor will result in both income tax and penalty taxes upon the recipient.

Stock Based Compensation: Stock options have been favored as a form of compensation that aligns the interest and accomplishments of management with those of shareholders. In up-markets, options have been sought by management both because of their tax favored status and the perceived value of owning shares that are growing in price. In down markets, management is not so enamored with stock based compensation, and compensation committees find themselves negotiating the deal as they evaluate whether to re-load options or provide other compensation.

Restricted Stock: Stock, coupled with a required holding period, is used to compensate management as well as to align the interests of management with those of the shareholders.

Split-Dollar Arrangements: Split-dollar arrangements are used by employers to provide life insurance benefits to an employee or group of employees. Under these arrangements the contract rights and costs are "split" between the employer and employee. Since 2002, the tax treatment of these policies changed making them less desirable. In Notice 2002-8 and regulations issued in 2003, the IRS explained its position to tax split-dollar arrangements either based upon the economic benefit granted or as a loan transaction. Further complication has been added by the addition of Code section 409A. The Service has issued guidance on the application of Section 409A. Notice 2007-34.

Health and Welfare Arrangements: Executive compensation usually will include coverage of executives in plans generally available to employees for health insurance, group life insurance and disability insurance. In addition to these generally available benefits, special programs may supplement these base benefits.

Perquisites and Personal Benefits: Many other types of compensation are offered and paid to executives. These include, by way of example (and certainly not exhaustive): automobile allowance or company car, use of company airplane, housing, parking, tax preparation, financial planning, executive physical examination, tickets to theater venues and sporting events, country/eating club dues, pet care, and executive coaching. Currently, many companies are agreeing to "gross-up" benefits, meaning that the corporation is undertaking to pay the executive's tax obligation arising from the receipt of the benefit.

Post-Employment Benefits: Several forms of compensation are offered to executives depending upon the circumstances relating to their separation from the company. These benefits might only include severance payments or, if separation is due to retirement, it might include retiree health insurance, use of a corporate office with administrative support.

Understanding the Regulatory World

As explained earlier, the duty of directors arises from state law and particular covenants in corporate charter documents. In addition, however, the work of the compensation committee is affected by a variety of federal laws as well. With respect to many of these requirements, however, the directors — including those on the compensation committee — will be able to rely on the corporation's officers to execute compliance. For example, the undertakings in the first instance to comply with tax and securities laws reporting are appropriately entrusted to officers, such as ascertaining the appropriate tax treatment of payments and the proper reporting of payments for reports required under the securities laws. Even though much of this work will be for the officers to oversee, the compensation committee will need to act independently in discharging its responsibility to review and comment on aspects of the reports. The following responsibilities, specifically, preparation of the compensation and disclosure and analysis section of the annual report, must be the work of the committee with respect to which the committee must obtain its own, independent advisers.

The CD&A

On July 26, 2006, the SEC adopted comprehensive amendments to its rules for executive compensation disclosure and disclosure of compensation paid to directors (the "Amendments"). These regulations were published in a 436-page release on August 11, 2006, at www.sec.gov/rules/final/2006/33-8732.pdf. The Amendments provide for a discussion of compensation in a new format — the Compensation Discussion and Analysis ("CD&A") section— modeled after the Management Discussion and Analysis section of past reports. The Amendments include the express requirement that the compensation committee provide a report for the proxy statement and state: (1) whether it has reviewed the CD&A section of the report with management and (2) whether, based upon that review, the compensation committee has recommended to the full board that the CD&A be included in certain SEC filings. As the CD&A serves a function with respect to the disclosure of compensation paid to officers and directors similar to the analytic function served by the Management Discussion and Analysis provides for the financial statements, members of the compensation committee are "on-the-hook." The compensation committee will be expected to assure that it has the requisite skill and information to meaningfully provide such certification.

The CD&A is a comprehensive disclosure statement prescribed by the regulation. The CD&A is highly company-specific; the SEC has made clear that companies should avoid boilerplate disclosures. While the elements required to be addressed are identified in the regulation, the responsive information will vary greatly by company. As compensation committees struggle with their first efforts to fulfill their obligations under this new regulatory process, in many—if not most—cases there will be a painful recognition of the lack of documentation of past practices and past decision making.

The requirements for the CD&A are set forth in section 402(b) of Regulation S-K [3]. In short, the committee must address the six questions:

(1) What are the objectives of the corporation's compensation programs;

(2) What achievements are the compensation program designed to reward;

(3) What are all the elements of compensation;

(4) Why the corporation chooses to pay each element;

(5) How the corporation determines the amount (and, where applicable, the formula) for each element to pay; and

(6) How each compensation element and the corporation's decisions regarding that element fit into the corporation's overall compensation objectives and affect decisions regarding other elements.

Of course, the task of addressing these easily framed questions is quite complex. These questions prescribed in Item 402(b)(1), include for the first time a disclosure of the guidelines used to determine compensation for the three most highly-compensated executive officers other than the principal executive officer and principal financial officer. This disclosure will address the overall objectives of the compensation program and each element of compensation provided. It is expected that this will be quite time consuming as most suspect that compensation committees have not historically been rigorous in developing formal compensation programs and measuring each element of such programs. While there is likely to be consultants' reports which may provide some history, minutes of the deliberation of the compensation committee — i.e., the committee's own statement and explanation for its action—are likely to be sparse or nonexistent.

The regulation directs that the following aspects of compensation be addressed: [4]

(b) Compensation discussion and analysis. (1) Discuss the compensation awarded to, earned by, or paid to the named executive officers. The discussion shall explain all material elements of the registrant's compensation of the named executive officers. The discussion shall describe the following:

(i) The objectives of the registrant's compensation programs;

(ii) What the compensation program is designed to reward;

(iii) Each element of compensation;

3 *17 C.F.R. Section 229.402(b)(1).*

4 *17 C.F.R. Section 229.402(b)(2).*

(iv) Why the registrant chooses to pay each element;

(v) How the registrant determines the amount (and, where applicable, the formula) for each element to pay; and

(vi) How each compensation element and the registrant's decisions regarding that element fit into the registrant's overall compensation objectives and affect decisions regarding other elements.

(2) While the material information to be disclosed under Compensation Discussion and Analysis will vary depending upon the facts and circumstances, examples of such information may include, in a given case, among other things, the following:

(i) The policies for allocating between long-term and currently paid-out compensation;

(ii) The policies for allocating between cash and non-cash compensation and among different forms of non-cash compensation;

(iii) For long-term compensation, the basis for allocating compensation to each different form of award (such as relationship of the award to the achievement of the registrant's long-term goals, management's exposure to downside equity performance risk, correlation between cost to registrant and expected benefits to the registrant);

(iv) How the determination is made as to when awards are granted, including awards of equity-based compensation such as options;

(v) What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;

(vi) How specific forms of compensation are structured and implemented to reflect these items of the registrant's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goal(s) or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more specified named executive officers or to all compensation subject to the relevant performance goal(s);

(vii) How specific forms of compensation are structured and implemented to reflect the named executive officer's individual performance and/or individual contribution to these items of the registrant's performance, describing the elements of individual performance and/or contribution that are taken into account;

(viii) Registrant policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;

(ix) The factors considered in decisions to increase or decrease compensation materially;

(x) How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);

(xi) With respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment(s) at, following, or in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (e.g., the rationale for providing a single trigger for payment in the event of a change-in-control);

(xii) The impact of the accounting and tax treatments of the particular form of compensation;

(xiii) The registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership;

(xiv) Whether the registrant engaged in any benchmarking of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and

(xv) The role of executive officers in determining executive compensation. Instructions to Item 402(b).

Understanding the Watchdogs

In addition to its new regulatory duties, the compensation committee will need to assess its performance against evolving expectations of its obligations under evolving principles of good corporate governance. Several organizations now exist that actively monitor the performance of corporate directors. It is important for the compensation committee to follow the work of these organizations and evaluate for itself whether the positions being advocated make sense for the corporation being served. These organizations have raised many thoughtful issues and the compensation committee should know the issues of the day and have taken them into account.
Indeed in the CD&A the committee may have its opportunity to be heard first.

CONCLUSION

Service on the compensation committee requires that the directors school themselves on the process of determining and structuring compensation appropriate for the organization being served. These directors not only need to follow the principles for all directors but must be ready to provide the additional services required to execute the job well.

A director accepting service on the compensation committee in addition to all other duties that fall upon a director must:

- Be prepared to devote the time required to do the job well. This means that the director must limit the other undertakings he might otherwise accept;
- Be prepared to diligently pursue understanding of the corporation's business strategy for today and for tomorrow so that the compensation structure rewards actions aligned with the corporate strategy;
- Be prepared to say "no" to compensation awards when not earned;
- Be prepared to demand that agreement provide for recapturing unearned compensation;
- Be prepared to recommend appropriate changes to compensation packages to retain or recruit talent;
- Be prepared to be accountable for the process used to set compensation; and
- Be prepared to constantly monitor and evaluate changes in the world competition for the best management talent.

A director serving on a compensation committee, like each other director, should follow rules of good corporate governance, and should see to the proper preparation of corporate records. Each director should assure that he is covered by adequate errors and omissions coverage.

As stated at the beginning of this guide: this handbook is not a substitute for legal counsel. Readers are encouraged to seek trained legal guidance when exercising corporate responsibilities.