0001 [ST: 16-1] [ED: 16-5] [REL: 3] (Beg Group) Composed: Thu May 17 13:20:18 EDT 2007
XPP 7.3C.1 Patch #3 SC_63962 llp 066 [PW=500pt PD=684pt TW=360pt TD=548pt]
VER: [SC_63962-Local:14 Jul 06 14:11][MX-SECNDARY: 18 Apr 07 15:24][TT-: 30 Aug 06 13:14 loc=usa unit=ch0016] 0

CHAPTER 16

EXECUTIVE COMPENSATION: LEGAL AND REGULATORY CONSIDERATIONS; "BEST PRACTICES" GUIDELINES

Bart Schwartz

http://www.pbookshop.com

SYNOPSIS

§16.01 Evolution of Law on Executive Compensation
- **[1] Older Cases on Reasonableness of Executive Compensation**
- **[2] Stock Option Statutes and Cases**
- **[3] Application of Business Judgment Rule in Executive Compensation Cases**
- **[4] Board's Business Judgment Not Entitled to Deference When Directors Are Not Independent**
- **[5] Continuing Viability of the Doctrine of Corporate Waste in Interested Director Cases, Even Where There Has Been Shareholder Ratification**
- **[6] Cases on Change-in-Control Contracts**

§16.02 Tax Laws Designed to Restrain "Excessive" Executive Compensation
- **[1] Section 162(m) of the Internal Revenue Code**
- **[2] Golden Parachute Tax Laws (IRC §§ 280G, 4999)**

§16.03 Shareholder Approval Requirements for Equity Compensation Plans
- **[1] NYSE Approval Requirements for Equity Compensation Plans**
  - **[a] NYSE General Requirement of Shareholder Approval for Equity Compensation Plans**
  - **[b] Categories of Plans Not Considered Equity Compensation Plans Under the NYSE Rule**
  - **[c] Material Revisions of Equity Compensation Plans Under the NYSE Rule**
  - **[d] Options Repricings Under the NYSE Rule**
  - **[e] Exemptions from NYSE Shareholder Approval Requirement**
    - **[i] General Rule Regarding Exemptions**
    - **[ii] Employment Inducement Awards**
    - **[iii] Mergers and Acquisitions**

0002 [ST: 16-1] [ED: 16-5] [REL: 3] Composed: Thu May 17 13:20:18 EDT 2007
XPP 7.3C.1 Patch #3 SC_63962 llp 066 [PW=500pt PD=684pt TW=360pt TD=548pt]
VER: [SC_63962-Local:14 Jul 06 14:11][MX-SECNDARY: 18 Apr 07 15:24][TT-: 30 Aug 06 13:14 loc=usa unit=ch0016] 0

[iv] Qualified Plans, Parallel Excess Plans and Section 423 Plans

[2] NASDAQ Approval Requirements for Equity Compensation Plans

[a] NASDAQ General Requirement of Shareholder Approval for Equity Compensation Plans

[b] Exceptions to the NASDAQ Shareholder Approval Requirement

[3] Practical Implications of Shareholder Approval Requirements

§16.04 Sarbanes-Oxley Section 304 (Forfeiture of Certain Bonuses)

§16.05 Corporate Governance "Best Practice Guidelines" on Executive Compensation

[1] Proliferation and Importance of Executive Compensation Best Practices

[2] Specific Best Practice Recommendations

[a] Pay-for-Performance

[b] Stock Ownership Guidelines

[c] Equity-Based Compensation

[i] Use of Stock Options and Restricted Stock, Generally

[ii] Specific Guidelines for Equity-Based Compensation

[A] "Mega-grants"

[B] Repricing and Discount Options

[C] Performance Vesting

[D] Holding Periods and Retention Requirements

[E] Timing and Dating of Option Grants

[3] Employment and Change-in-Control Contracts

16-A Golden Parachute Tax Regulations, 26 CFR § 1.280G-1

16-B Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee — Executive Summary

16-C Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee — Appendix E: Guidance Pertaining to Executive Employment Contracts

16-D TIAA-CREF Policy Statement on Corporate Governance—Executive Compensation (and Appendix thereto on Guidelines for Assessing Compensation Plans)

http://www.pbookshop.com

§ 16.01 Evolution of Law on Executive Compensation

In its earliest stage of development, the law of executive compensation as a corporate governance issue was entirely judge-made. Some of the older cases recognized a cause of action for excessive compensation (which might be thought of, and survives, as a species of a claim for corporate waste but which, during an earlier era, seemed to take on a life of its own as a legal theory). In the last part of the twentieth century, however, the business judgment rule reigned supreme in connection with challenges to executive compensation as in other areas; courts routinely rejected "excess compensation" claims when disinterested board majorities had approved the challenged payments on adequate information and after due deliberation. More recently, in the post-Enron era, some courts, while not

0003 [ST: 16-1] [ED: 16-5] [REL: 3] Composed: Thu May 17 13:20:18 EDT 2007
XPP 7.3C.1 Patch #3 SC_63962 llp 066 [PW=500pt PD=684pt TW=360pt TD=548pt]
VER: [SC_63962-Local:14 Jul 06 14:11][MX-SECNDARY: 18 Apr 07 15:24][TT-: 30 Aug 06 13:14 loc=usa unit=ch0016] 0

tampering with the fundamental elements of the business judgment rule, have given increased scrutiny to executive compensation decisions. In all events, interested-director transactions remain subject to attack as a waste of corporate assets, in some cases even where there has been shareholder ratification.

In addition, at various times, concerns over excessive executive compensation were addressed through SEC disclosure rules, tax legislation and rules, and self-regulatory organization ("SRO") rules and listing requirements.[1] Under the current state of the law, therefore, board counselors must consider case law on executive compensation, tax rules, SEC disclosure requirements, and SRO corporate governance listing requirements. Except for the SEC disclosure requirements (which are beyond the scope of this treatise[2]), these are discussed, in turn, below. In addition, increasingly vocal shareholder activists and other corporate watchdogs have, in some cases, adopted executive compensation guidelines and, with increasing frequency, have made shareholder proposals on issues of executive compensation. Boards and board compensation committees need to take these trends and considerations into account, as well, in making decisions on executive compensation.

As of the date of this writing, concerns over excess executive compensation have reached a new level. While substantive legal restrictions concerning executive compensation - as opposed to disclosure requirements and tax rules on deductibility of such compensation - remain a creature of state law, there have been efforts to reign in excessive executive compensation through other means, including proposed federal legislation.[2.1]

http://www.pbookshop.com

[1] Older Cases on Reasonableness of Executive Compensation

Some older cases recognized a cause of action for "excessive compensation" or similarly styled claims under state corporate law. In some of these cases, the court

---

[1] The SROs are the registered national securities exchanges (the largest of which are the New York Stock Exchange (the "NYSE") and the American Stock Exchange (the "AMEX")) and the National Association of Securities Dealers (the "NASD"), which owns and operates the NASD Automated Quotation system (the "NASDAQ"). The SROs are subject to oversight by the SEC, which is required to approve the SROs' rules. *See* 17 U.S.C. § 78s(g)(1) (2000).

[2] The SEC's proxy statement disclosure requirements relating to executive compensation can be found in Regulation S-K Items 402 and 407, 17 CFR §§ 229.402, 229.407. *See* A.A. Sommer, Jr. (Gen. Ed.), Federal Securities Exchange Act of 1934 § 4.03[5][b] for discussion of Regulation S-K Item 402.

[2.1] H. R. 4291, the "Protection Against Executive Compensation Abuse Act," introduced in the 109th Congress, would require public companies to submit detailed executive compensation plans for shareholder approval at each annual meeting of shareholders and would require separate shareholder approval for executive compensation that is "based on or otherwise relate[s] to" an acquisition, merger, consolidation or other disposition submitted to shareholders for approval.

0004 [ST: 16-1] [ED: 16-5] [REL: 3] Composed: Thu May 17 13:20:18 EDT 2007
XPP 7.3C.1 Patch #3 SC_63962 llp 066 [PW=500pt PD=684pt TW=360pt TD=548pt]
VER: [SC_63962-Local:14 Jul 06 14:11][MX-SECNDARY: 18 Apr 07 15:24][TT-: 30 Aug 06 13:14 loc=usa unit=ch0016] 0

simply substituted its own judgment for that of the board of directors or even stockholders in deciding that challenged compensation was "excessive" or disproportionate to the value conferred on the corporation.

For example, in *Winkelman v. General Motors Corp.*,[3] the plaintiffs alleged that "the defendants, beginning in 1918 and continuing to date, have been participants in a fraudulent scheme or conspiracy to loot General Motors Corporation of its assets through the payment of illegal bonuses and extra compensation."[4] Disinterested directors (who never received any bonuses or "extra compensation" under the plans in question, but who had approved the challenged payments) moved for summary judgment.[5]

Despite the fact that the moving directors were independent (and were not recipients of the challenged bonus awards), and giving nodding recognition to the business judgment rule, the court nonetheless held that whether the awards the defendants had approved were reasonable and proportional to the value of the services that the recipients provided to the corporation could not be determined as a matter of law:

> The main cause of complaint, for which there is some basis, is that the bonuses allotted to certain of the executives, who were also members of the Board of Directors, when added to their salaries as such executives, resulted in excessive compensation in certain years. The record contains nothing specific as to the extent and nature of their services, but it may be assumed that the duties incident to the important offices they held were such as required all the time of men of great ability.
>
> The directors undoubtedly possessed a certain discretion in apportioning the bonus among the executives. The establishment of the various bonus plans, with the approval of the stockholders, assumed that the officers and directors charged with the duty of administering the plans would exercise a proper discretion. . . . The Finance Committee of the Board of Directors, of which the three moving defendants were at times members, considered and reported on such bonus allotments as were recommended for executives who were also members of the Board of Directors. . . .
>
> The three moving defendants stress the fact that they did not themselves receive any part of the bonus in any year. There is no presumption of actual or constructive fraud that arises solely from the amount of compensation paid to an officer of a corporation. However, the compensation may be so large under the circumstances involved in a particular case as to constitute spoliation or waste of corporate property, in which instance an investigation in equity is warranted. . . .

http://www.pbookshop.com

---

[3] Winkelman v. General Motors Corp., 39 F. Supp. 826 (S.D.N.Y. 1940).

[4] *Winkelman*, 39 F. Supp. at 827.

[5] *Winkelman*, 39 F. Supp. at 830.