



Compensation Committee The Importance of Process

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1. What is a Director's Fiduciary Duty of Care?
 - a. Florida law (Fla. Stat. §607.0803)
 - i. Director must discharge his or her duties as a director, including his or her duties as a member of a committee:
 - A. in good faith;
 - B. with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
 - C. in a manner he or she reasonably believes to be in the best interests of the corporation.
 - ii. In discharging their duties, directors may rely on information, opinions, reports or statements (including financial statements) if prepared or presented by (x) officers or employees of the corporation reasonably believed to be reliable and competent in the matters presented; (y) legal counsel, public accountants and other persons as to matters the director reasonably believes to be within the person's professional or expert competence; and (z) other Board committees if he reasonably believes the Committee merits confidence.

2. What is the Fiduciary Duty of Loyalty?
 - a. Officers and directors cannot use their position of trust and confidence to further their private interests
 - b. Undivided and unselfish loyalty to the corporation
 - c. There can be no conflict between duty to the corporation and self-interest

3. Can directors be indemnified for breaches of fiduciary duties?

- Generally yes
- Indemnification is not permitted for
 - breach of duty of loyalty
 - acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law
 - any transaction from which the director derived an improper personal benefit

4. What is the business judgment rule?
- a. It is presumption, in most states, that directors have acted “on an informed basis and in the honest belief that the action taken was in the best interests of the company [and its shareholders].” *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
 - b. Presumption applies if there is no evidence of fraud, bad faith, or self-dealing.
 - c. If presumption applies, board’s decision will be upheld if it can be “attributed to any rational business purpose.” *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
 - d. Courts typically look at the process the directors followed in making their decisions to demonstrate that the business judgment rule should apply.

5. Adopt a Charter to describe the Committee's duties and responsibilities.
 - a. NYSE Listing Requirements require Charter
 - b. NASDAQ Listing Standards do not (but best practices still require it)
 - c. Charter should address such things as the purpose of the Committee, its composition (including procedures for the appointment and replacement of members), frequency of meetings, and duties and responsibilities).

6. Develop a philosophical framework within which the Committee will make its decisions – NACD Blue Ribbon Commission on Executive Compensation (2003) recommends the following 5 fundamental principles
 - a. Independence
 - b. Fairness (tested both internally and externally)
 - c. Linkage to performance
 - d. Long-term value for shareholders
 - e. Transparency – full and clear disclosure

7. Compensation of Committee

- a. Ensure that compensation committee members are fully independent
- b. Select members that are qualified
 - i. Choose individuals who show evidence of diligence, understanding, and courage
 - ii. Strive for professional diversity
 - A. Desirable to have at least one current or former CEO
 - B. Also desirable to have person with strong financial background

8. Educate the Committee

- a. Company goals and objectives (as set by management and the Board)
 - i. Compensation strategy should incentivize actions that will accomplish those goals and objectives
- b. What are peer companies doing
 - i. External fairness of compensation
 - ii. Ability to recruit and retain

- c. Financial accounting, tax and legal implications of compensation being awarded
 - i. Financial accounting rules are changing, and compensation committee needs to take a fresh look at its compensation programs in light of those changes
 - A. Stock options are no longer afforded financial accounting advantage
 - B. Performance based compensation no longer results in variable accounting treatment
 - C. How do you maximize incentive, and minimize financial cost and dilution.
 - ii. Section 162(m) (\$1,000,000) deduction limitation), 409A (new deferred compensation rules), 280G (excess golden parachute payments) rules
 - iii. SEC disclosure, reporting and other requirements.

9. Develop and control the process for considering and approving executive compensation
 - a. Exercise reasonable control over the calendar
 - i. Schedule meetings at regular intervals (typically quarterly), including regular “executive sessions”
 - ii. Require information to be considered at meetings to be provided sufficiently in advance of meetings so that members can review and digest information
 - iii. Consider significant corporate actions over at least 2 meetings

- b. Obtain independent expert advice
 - i. Committee should hire independent compensation consultant
 - ii. Consider retaining independent legal counsel for certain matters (e.g. negotiation of CEO Employment Agreement)
- c. Don't make decisions in a vacuum
 - i. Tally sheets can provide complete picture of total compensation package (and impact of changes in one compensatory element upon total package)
 - ii. Internal fairness and analysis

iii. External fairness analysis

- A. Consider, but don't be slave to, surveys
- B. Make sure peer groups are appropriate
- C. Be careful of the Lake Wobegon syndrome (all of our executives are above average); and the inflationary spiral it creates
- D. Focus on total compensation package (companies put different emphasis on cash and equity compensation)

10. Be transparent

a. SEC requirements

- i. Alan Beller, former Director of the SEC's Division of Corporate Finance, in his October 20, 2004 speech at an NASPP conference, reminded everyone that the current rules require:

“Clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers...and directors...by any person for all services rendered in all capacities to the registrant and its subsidiaries, unless otherwise specified.”

- ii. Recent actions by SEC against Tyson Foods and General Electric

- b. State law duty of candor
- c. New rules should help alleviate tension with management (who may prefer less disclosure).