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Executive Compensation Disclosures for 2007: Insights – and Key Examples – from the First CD&As

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The 2007 proxy season is well under way, with the public filings to date providing some useful insights into particular issues relating to the disclosure of executive and director compensation. The level of detail varies dramatically between companies. Most disclosures of executive compensation involve a comprehensive Compensation Discussion and Analysis (CD&A), supplementary tables, and explanatory narratives singling out a variety of issues. The challenge has been sorting through them to find solid samples. Some of the ones we have singled out are listed in the topically organized table at the end of this alert. Before turning there, here are some answers to common questions that we are receiving.

POST-2006 ACTIONS TO ENHANCE PAY PRACTICES

In anticipation of 2007 disclosure, many companies are discovering improvements to be made in their practices. As a threshold matter, it is timely to assure that a compensation committee's charter is consistent with the policies disclosed in the CD&A. The announcement of new policies, adopted after 2006, is common – such as policies for granting stock awards and policies for the recapture of executive compensation from those whose fraud or misconduct causes the employer to make a financial restatement. See Poerio and Moran, "They Can't Take It With Them" (National Law Journal, March 12, 2007, copy attached).

CASH BUSES (BONUS v. NON-EQUITY INCENTIVE COMPENSATION)

For Summary Compensation Table purposes, many have struggled with distinguishing between:

- discretionary bonuses, reportable under Column (d) of the Summary Compensation Table, and

- non-equity incentive plan compensation, reportable under Column (g) of the Summary Compensation Table.

Basically, a cash award that meets all three of the following criteria is reportable as non-equity incentive plan compensation: (a) the award is intended to serve as an incentive for performance to occur over a specified period, (b) the outcome with respect to the relevant performance target is substantially uncertain at the time the performance target is established, and (c) the target is communicated to the executive. If any of the three factors does not apply, then the cash award is reportable as a discretionary bonus.

PERQUISITES

Last week, a CNN.com article identified a 23% increase in CEO perk disclosure levels based on a 2006 survey of 100 proxy statement disclosures.¹ Although amounts disclosed for financial purposes are not always the same for tax purposes (personal use of corporate aircraft being a notable example), a proxy statement's disclosure of perquisites should be considered to be admissions for tax audit purposes. Big ticket items such as personal usage of a company's aircraft, home purchase programs, and country club memberships are prime targets for IRS scrutiny.

Thus, companies should be well considered in the disclosure and tax treatment of personal benefits. Benefits characterized as personal usage for SEC purposes should reflect the applicable income inclusion and deduction limitations for tax purposes. See Notice 2005-45, with respect to the tax treatment for the personal use of corporate jets, and Rev. Rul. 2005-74 with respect to home purchase programs.

POST YEAR-END AWARDS

Stock Awards. Stock awards are reported on the Summary Compensation Table and Grants of Plan-Based Awards Table for the fiscal year in which the grant date occurs, even if the grant relates to services in a prior year. When a grant occurs after year-end (e.g., January 2007) for services being performed during the year being disclosed (e.g., 2006), the CD&A for that year (e.g., 2006) should discuss the grant. See the *Grants of Plan-Based Awards Table for Allied Waste Industries, Inc. as an example.*

Cash Awards. In contrast to stock awards, cash awards are reported in the Summary Compensation Table for the fiscal year in which the relevant performance measure is satisfied. Thus, if a grant occurs after year-end (e.g., January 2007) for which the relevant performance measure was satisfied during the year being disclosed (e.g., 2006), then the cash amount is reported for the year being disclosed (e.g., 2006). See the *Grants of Plan-Based Awards Table for The Sherwin-Williams Company and Allied Waste Industries, Inc. as examples.* Note, the amounts paid after the year of disclosure are not reportable again in the fiscal year when the amounts are paid to the named executive

officers (i.e., the amount paid in 2007 and reported in 2006 is not again reported in 2007).

TRACKING STOCK AWARDS ON THE COMPENSATION TABLES

The SEC's expanded disclosure rules require the tracking of a stock option or other stock award from "womb to tomb" (grant to final settlement). The different compensation tables that the SEC requires for this involve a confusing mixture of accounting and tax rules with respect to the timing of awards and the amounts recognized. The Summary Compensation Table and Grants of Plan-Based Awards table reflect a company's accounting expense for these awards.

On the other hand, the Option Exercises and Stock Vested Table reflects income tax recognition rules because it focuses on the in-the-money value for stock options and stock appreciation rights, and the fair market value when vesting occurs for stock award purposes.

The table below provides guidance for the interrelation of the tables with respect to stock options and other stock awards.

	Summary Compensation Table	Grants of Plan-Based Awards Table	Outstanding Equity Awards at FYE Table	Option Exercises and Stock Vested Table
Grant	Report the dollar amount recognized ratably over the service period under FAS 123R.	Report the fair value of the award under FAS 123R.	Report in the applicable column in accordance with the vesting schedule of the award (time or performance vesting).	<u>Options:</u> N/A <u>Stock Awards:</u> Report if immediately vested upon grant.
Prior to Vesting	Report the dollar amount recognized ratably over the service period under FAS 123R.	No consequence for this table.	<u>Options:</u> Report as unexercised, unexercisable (time-vested); or unexercised, unearned (performance-vested). <u>Stock Awards:</u> Report as not vested (time-vested); or unearned, not vested (performance-vested).	No consequence for this table.
Vesting	Report the dollar amount recognized ratably over the service period under FAS 123R.	No consequence for this table.	<u>Options:</u> (Prior to exercise) Report as unexercised, exercisable. <u>Stock Awards:</u> Not reportable; assumed settled.	<u>Option:</u> No consequence for this table. <u>Stock Awards:</u> Report amount recognized for tax purposes.

	Summary Compensation Table	Grants of Plan-Based Awards Table	Outstanding Equity Awards at FYE Table	Option Exercises and Stock Vested Table
Exercise	Disregard, except to the extent a true-up in financial accounting is required to reflect full vesting.	No consequence for this table.	<u>Options</u> : Not reportable because settled. <u>Stock Awards</u> : N/A	<u>Options</u> : Report amount recognized for tax purposes. <u>Stock Awards</u> : N/A
Deferral	Disregard, except to the extent the deferral arrangement results in ongoing financial expense.	No consequence for this table.	<u>Options</u> : N/A <u>Stock Awards</u> : Not reportable; assumed settled upon vesting.	<u>Options</u> : N/A <u>Stock Awards</u> : Report the amount that would have been recognized for tax purposes; provide a footnote quantifying the amount and terms of the deferral.

POST-EMPLOYMENT COMPENSATION

The table below notes a few alternatives by which to report severance and other post-employment pay through different types of tables. Some typical questions that we face are as follows:

- Must the post-employment compensation information include 401(k) and other employer-provided benefits?
 - *Answer*: No disclosure is required for benefits payable under broad-based plans; disclosure is required for special executive level plans and programs (e.g., SERPs, other nonqualified deferred compensation and stock plans).
- Since companies are required to quantify the accelerated vesting of stock options and stock awards, is this estimate based on the FAS 123R rules or another method?
 - *Answer*: With respect to stock options, the value is computed by multiplying the difference between the market value on the last business

day of the last completed fiscal year and the exercise price, by the number of shares subject to accelerated vesting. With respect to stock awards, the value may be computed by multiplying the number of unvested shares by the market value on the last business day of the last completed fiscal year. The unvested stock options and stock awards are set forth in the Outstanding Equity Awards Table. *See the Potential Payments Upon Termination or Change in Control Discussion and Table for the Honeywell International, Inc. as an example.*

CONCLUSION

The thoughtful and complete disclosure of executive and director compensation raises questions whose answers often lie deeply within the SEC disclosure rules and the accompanying release, SEC speeches and the SEC FAQs issued in January 2007. See Paul Hastings Client Alert titled “Proxy Statements 2007: SEC Responds to Executive Compensation Disclosure Issues” (February 2, 2007).²

Please contact any of our attorneys listed below for assistance with implementing the new SEC executive and director compensation rules issued under Item 402 of Rule S-K.

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Exhibit A

Notable Proxy Statement Disclosures

Disclosure Item	Observation	Sample Proxy Statements
Accounting and Tax Implications	Although many companies limit their CD&A's discussion of accounting and tax to Code 162(m) effects, those of a few companies cover the implications of FAS 123R, certain aircraft and other entertainment expenditures per Code 274, golden parachutes under Code 280G, and new Code 409A regarding deferred compensation and severance.	<ul style="list-style-type: none"> Allied Waste Industries, Inc. (FAS 123R; and Code 409A and 280G implications) Ameriprise Financial, Inc. (Code 274(a) aircraft deduction limitations, FAS 123R) Schlumberger N.V. (Schlumberger Limited) (FAS 123R) Sun Trust Banks, Inc. (Code 280G and 409A)
All Other Compensation Table (Perquisites)	Many companies itemize perquisites through a supplemental disclosure table related to the "All Other Compensation" column of the Summary Compensation Table.	<ul style="list-style-type: none"> General Electric Company (provides sub-tables listing the executives in rows and benefits in columns) Schlumberger N.V. (Schlumberger Limited) (provides a separate table for each executive) The Sherwin-Williams Company (provides sub-tables listing benefits in rows and the executives in columns)
Claw-back Policies	Many companies disclose policies for recouping awards in the case of financial restatements due to an executive's misconduct.	<ul style="list-style-type: none"> Merck & Co., Inc. Schlumberger N.V. (Schlumberger Limited)
Director Compensation – Extra Tables	Although the disclosure of director compensation merely requires one table, some companies provide a supplemental table for a more detailed discussion.	<ul style="list-style-type: none"> Eli Lilly and Company (provides an outstanding equity awards table) Motorola, Inc. (provides supplemental tables tracking deferred stock units and other stock awards granted to directors)
Director Compensation Table – Placement in the Proxy Statement	In many proxy statements, the Director Compensation Table precedes the CD&A, and is placed among the board of directors/ corporate governance matters section of the proxy statement.	<ul style="list-style-type: none"> Ameriprise Financial, Inc. Eli Lilly and Company McDermott International, Inc. Motorola, Inc. Synnex Corporation The Sherwin-Williams Company Waddell & Reed Financial Inc.
Executive Ownership Guidelines	Many companies provide concise discussions related to the guidelines established for target levels of share ownership.	<ul style="list-style-type: none"> Merck & Co., Inc. Schlumberger N.V. (Schlumberger Limited) United Western Bancorp
Grant-making Policies for Stock Awards	Although the SEC requires disclosure of grant-making procedures and practices relating to stock awards, some companies have been more thorough than others.	<ul style="list-style-type: none"> Merck & Co., Inc. (specified dates for grants; no backloading or springloading discussion; and developing policy to eliminate "off cycle" grants) Schlumberger N.V. (Schlumberger Limited) (provides a detailed discussion on its stock option granting process)
Peer Group and Benchmarking	Some companies provide extraordinary detail about the benchmark peer group comparisons that are used to establish points of reference for the NEOs' compensation.	<ul style="list-style-type: none"> Allied Waste Industries, Inc. (lists companies in its industry peer group and revenue peer group) Ameriprise Financial, Inc. (the company has a mix of three business segments; listed a peer group of companies in each business segment)

Disclosure Item	Observation	Sample Proxy Statements
		<ul style="list-style-type: none"> Applied Materials, Inc. (provides a list of companies in the same industry and similar size which competes for executive talent) United Western Bancorp, Inc. (provides a peer group table that lists financial results of comparable companies) Wilmington Trust Corporation (provides a separate peer group discussion for various elements of compensation) Wm. Wrigley Jr. Company (provides an extensive list of peer group companies)
Performance Targets and Confidentiality	The disclosure of the formula or other metrics for performance-based bonuses varies significantly between proxy statements. Some companies discuss the general measures applied to determine bonuses without disclosing the actual target levels themselves, while other companies make clear identifications.	<ul style="list-style-type: none"> Berkshire Hathaway (identifies no formula; merely subjective decisions) Eli Lilly and Company (identifies the performance measures and related targets) General Electric Company (identifies financial and strategic goals related to cash bonus of CEO; but provides that goals are set at levels that reflected the "internal, confidential business plan" with respect to its long-term performance awards)
Post Year-End Actions	A few companies discuss post-2006 policy changes.	<ul style="list-style-type: none"> Allied Waste Industries, Inc. (disclosing an incentive plan adopted in 2007) Sun Trust Banks, Inc. (disclosing 2007 changes to the executive compensation program)
Potential Post-Employment Payments	Some companies provide a single comprehensive table; while other companies use a multi-table approach (one for each executive).	<ul style="list-style-type: none"> Single Table Electronic Data Systems Corporation Eli Lilly and Company Synnex Corporation The Sherwin-Williams Company Waddell & Reed Financial, Inc. Multi-Table Good Year Tire & Rubber Company McDermott International, Inc. Motorola, Inc. Wm. Wrigley Jr. Company

¹ "The Big Reveal: SEC Rules Unmask CEO Perks" (<http://www.cnnmoney.com>, March 16, 2007).

² See <http://www.paulhastings.com/publicationDetail.aspx?publicationId=641>.