

BB REVIEW

Corporate and Securities

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For Further Information

Contact . . .

Steve Yoder
205-226-8791
svoder@balch.com

Mike Waters
205-226-8720
mwaters@balch.com

Suzanne Ashe
205-226-3431
sashe@balch.com

Visit our website
www.balch.com

Address Change . . .

If you no longer wish to receive this update or have an address change, please contact:

Nora Yardley
205-226-3476
nyardley@balch.com

Executive Compensation Disclosures 2005 Proxy Statements

Many of our public company clients are beginning preparation of their proxy statements for their 2005 annual shareholder meetings. This year, disclosures on executive compensation in these proxy statements will be of paramount importance. There are several reasons for this, many related to developments during calendar year 2004.

EXECUTIVE COMPENSATION DEVELOPMENTS IN 2004

- The SEC's Director of Corporate Finance in November 2004 warned those responsible for proxy statement disclosures that the SEC expects disclosure of all compensation whether current or deferred and whether or not called for by a particular table. The SEC has been critical of "boilerplate" disclosure of executive compensation.
- Also in 2004, the IRS began tough new audits of executive compensation programs at Fortune 1000 and other large companies.
- The Delaware courts have been critical of executive compensation in cases such as the shareholder action against Walt Disney Company arising out of the departure of Michael Ovitz and the challenge to the takeover of MONY by AXA.
- The American Jobs Creation Act of 2004, with its directive to the IRS to promulgate extensive new rules on taxation of deferred compensation, evidences a distaste by Congress of executive compensation.
- The FASB's determination that stock options should be expensed will heighten scrutiny of stock options and of the vehicles that are used in substitution for options (such as restricted stock)

- There has been an increase in the number of shareholder proposals in proxy statements challenging executive compensation practices, and proxy voting firms such as ISS have become increasingly stringent in their criteria for recommending approval of compensation plans.
- Sections 302 and 404 of Sarbanes Oxley could impose liability on individuals and companies for failure adequately to disclose executive compensation, on the grounds that the company lacked the necessary financial disclosure controls.

RECOMMENDATIONS FOR PREPARING 2005 PROXY STATEMENTS

- **Compensation Committee Process.** The Compensation Committee of the Board of Directors should be carefully guided through their analysis of executive compensation arrangements so as to ensure that there is a record of real negotiation in the case of agreements with individuals and generally that all parts of the compensation package of the named executives have been thoroughly reviewed and in total are not excessive or unreasonable. The Compensation Committee report that is required to be included in the proxy statement should be written so as to demonstrate the committee's due diligence in carrying out its important duties.
- **Section 162(m) Compliance.** Avoid mere repetition of prior years' boilerplate language about compliance with Section 162(m) of the Internal Revenue Code (this is the section that prohibits deduction of compensation paid to executives in excess of \$1 million that has not been approved by shareholders and is not performance-based).

Visit Our Offices . . .

1901 Sixth Avenue North
Suite 2600
Birmingham, Alabama 35203

1710 Sixth Avenue North
Birmingham, Alabama 35203

2 Dexter Avenue
Montgomery, Alabama 36104

655 Gallatin Street
Huntsville, Alabama 35801

3535 Piedmont Road
14 Piedmont Center
Atlanta, Georgia 30305

1310 Twenty-Fifth Avenue
Gulfport, Mississippi 39501

401 East Capital Street
Suite 200
Jackson, Mississippi 39201

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

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Especially with the IRS audits described above being underway, it would be a very serious problem with the SEC and with plaintiff lawyers if a proxy statement stated, for example, that all executive compensation was designed to comply with Section 162(m) but in fact some compensation had been paid under plans that had not been approved by shareholders.

- **Compensation Table and Footnote Disclosures.** Avoid using the same assumptions as used in prior years as to what must be included in the compensation tables. The SEC has recently provided more guidance on perquisite and other disclosure issues which should cause issuers to err on the side of disclosure. The SEC is generally very critical of complicated disclosures such as those made in footnotes.
- **Deferred Compensation.** With the comments made by the SEC on deferred compensation and with the new IRS rules on this compensation, issuers should carefully review, revise where necessary and make disclosures about these arrangements.
- **Employment Agreements.** If the CEO or other executive named in the proxy statement has an employment agreement with the company, particularly if there is an automatic renewal provision, at a minimum there should be a review of the executive's performance and a review of the appropriateness of the agreement. These reviews should be described in the proxy statement.
- **Change in Control Agreements.** Change in control agreements should be reviewed separately and in the aggregate to make sure that they reflect the "state of the art" and also that they would pass muster under the guidance provided in the February 2004 MONY decision of the Delaware Chancery Court.

FINAL NOTE ON SEPARATE LEGAL COUNSEL

Public companies are well-advised at least to consider whether the Compensation Committee and the CEO should have separate legal counsel from that of the company. Separate counsel will help demonstrate not only the diligence with which executive compensation issues are addressed but also that management is willing to allow some independence into the process.

Balch & Bingham would be pleased to be of assistance to any party involved in the executive compensation review and disclosure process. Please call or email Steve Yoder, Mike Waters or Suzanne Ashe (see contact information on first page) if you would like to discuss these issues further.