

# Meridian Client Update

## SEC Approves NYSE and NASDAQ OMX Rule Changes Relating to Compensation Committee Independence Standards

On January 16, 2013, the Securities and Exchange Commission approved the New York Stock Exchange (NYSE) and NASDAQ OMX (Nasdaq) proposed changes in their respective listing standards relating to compensation committees and their advisers. The effective date of the approved listing standards are set forth below:

- Compensation committee independence standards. Compensation committee members must satisfy certain new independence requirements (see Meridian Client Update dated October 10, 2012) under the revised NYSE and Nasdaq listing standards. For both NYSE- and Nasdaq-listed companies, the new independence requirements become effective the earlier of a company's first annual meeting after January 15, 2014, or October 31, 2014.
- Compensation committee authority with regard to retention of advisers. The revised listing standards require that compensation committees have the authority to retain, oversee and fund advisers. Additionally, the new standards require that compensation committees must consider six independence factors prior to the selection and retention of an adviser (see Meridian Client Update dated October 10, 2012). For both NYSE and Nasdaq listed companies, these new listing standards will become effective on July 1, 2013.
- Modification of compensation committee charter (NYSE-listed companies). Under the revised NYSE listing standards, compensation committee charters of NYSE listed companies must set forth the compensation committee's rights and responsibilities with regard to the retention, oversight, funding and selection of a compensation consultant, independent legal adviser or other adviser. Charters must be revised to comply with this requirement by July 1, 2013.
- Establishment of compensation committee (Nasdaq-listed companies) and compensation committee charter. Under the revised Nasdaq-listing standards, Nasdaq-listed companies will be required to establish a standing compensation committee and the committee will be required to maintain a charter setting forth the committee's authority, including the authority to retain advisers. Standing compensation committees must be established by, and charters must be adopted by, the earlier of a company's first annual meeting after January 15, 2014, or October 31, 2014.

***Meridian Comment.*** These new listing standards should not prove onerous for NYSE- or Nasdaq-listed companies. Standing compensation committees composed of independent directors was already a requirement for NYSE-listed companies and is a common practice among Nasdaq-listed companies. The most significant new listing standard is the requirement that compensation

committees, prior to retaining an adviser, evaluate the independence of the adviser against six specific independence factors. Although this requirement is not effective until July 1, 2013, many public companies have already undertaken such evaluation of their advisers.

## Institutional Shareholder Services Replaces GRId with Governance QuickScore

In 2010, ISS introduced GRId, a new methodology for scoring a public company's governance practices. ISS announced late last week that it is scrapping GRId in favor of a new governance scoring methodology called ISS Governance QuickScore™ effective late February or early March. At that time, Governance QuickScores will begin to appear in ISS proxy research reports.

In a letter to subscribers, ISS has provided the following limited overview of Governance QuickScore:

- “Methodology -- ISS Governance QuickScore uses a quantitatively-driven methodology that looks for correlations between governance factors and key financial metrics, with a secondary policy-based overlay that aligns the qualitative aspect of governance with ISS policy. The methodology is based on best practices across various governance factors, with the number of factors applied varying by region. Details regarding regional factors will be included in a forthcoming technical document.
- Scoring -- Moving away from GRId's color-coded concern levels, ISS Governance QuickScore uses a numeric, decile-based score that indicates a company's rank relative to region. Companies will still be assessed on four independent dimensions: board, compensation/remuneration, shareholder rights and audit, and will also receive an overall Governance QuickScore and assessment. In the latter half of the year, scores relative to industry sector will be introduced.
- Coverage -- Initially, ISS QuickScore coverage will encompass 4,100 companies in 25 markets, including the largest 3000 U.S. companies by market cap, the largest 250 Canadian companies by market cap and UK, Europe, Japan and Asia Pacific companies in the MSCI-EAFE index.”

On January 24, an ISS technical document and related FAQs on Governance QuickScore will be made available for download at [www.issgovernance.com/quickscore](http://www.issgovernance.com/quickscore).

Companies within the QuickScore coverage universe will have access to ISS's free data verification site, beginning Monday January 28, 2013.

**Meridian Comment.** We will be issuing a Client Update summarizing ISS's technical release on Governance QuickScore. It will be interesting to see whether Governance QuickScore gains greater traction in the boardroom than GRId.

## Delaware Supreme Court Upholds Board Decision to Award Non-Deductible Bonuses

In a recent decision, the Delaware Supreme Court rejected shareholder claims that a corporate board has a fiduciary obligation to minimize the corporation's federal tax obligation.

In *Freedman v. Adams*, a shareholder brought derivative claims alleging breaches of fiduciary duty and corporate waste due to the failure of XTO Energy's Board of Directors to structure over \$130 million of executive bonuses from 2004-2007 in a manner that would be deductible under Internal Revenue Code

Section 162(m), which would reduced the company's tax liability by approximately \$40 million. A Delaware Chancery Court rejected the fiduciary breach and waste claims noting the following in its decision:

"Decisions regarding a company's tax policy are not well suited to after-the-fact review by courts and typify an area of corporate decision making best left to management's business judgment, so long as it is exercised in an appropriate fashion. This Court rejects the notion that there is a broadly applicable fiduciary duty to minimize taxes, and, therefore the Plaintiff's argument that the board failed to act despite a duty to minimize taxes is unavailing."

"The Board's decision falls within the line of cases dismissing executive compensation-related waste claims" and that "the size and structure of executive compensation are inherently matters of judgment."

On January 14, 2013, the Delaware Supreme Court upheld the Chancery Court decision with regard to plaintiff's claim of waste (the plaintiff did not appear the lower court's ruling of the fiduciary breach claim). The bar for demonstrating a claim of waste is extraordinarily high. The Court noted that "a claim of waste will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets."

In the XTO Energy case, the Board of Directors intentionally chose *not* to implement a bonus arrangement under which compensation would be deductible under Section 162(m). The Board believed a qualified Section 162(m) plan would constrain the compensation committee in its determination of appropriate bonuses. The Delaware Supreme Court held that, "the decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment. Even if the decision was a poor one for the reasons alleged in *Freedman*, it was not unconscionable or irrational."

***Meridian Comment.* Although only binding in Delaware, the decision by the Delaware Supreme Court in the XTO Energy case will likely have a strong influence on courts in other jurisdictions. Therefore, we may be seeing the end of cases based on a company's failure to minimize tax liability under Code Section 162(m).**

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