Three Excerpts from Recent Issues of *The Corporate Counsel* Dealing with Airplane Use

1. More to Come (excerpt from Jan-Feb 2006 issue of *The Corporate Counsel*)

Because the CD&A will be so critical, we have kept the focus of our comments in this issue to the CD&A. Among the other big picture disclosure fixes we will be addressing shortly (and posting on CompensationStandards.com) are:

The Need for Two Summary Compensation Tables. One table would cover the compensation granted or targeted by the compensation committee during the year. The second table would cover the compensation actually realized (vs. what was projected). Note that the SEC requests comments regarding a two-table SCT approach (at pg 59 of the proposing release). This will enable shareholders to see the compensation picture in the same manner that the directors on the compensation committee should be looking at compensation: both (a) at the time the compensation is set and then (b) assessing after-the-fact what was actually realized (vs. what was projected) and how that should impact future compensation. (Our CompensationStandards Task Force members are currently preparing a model of how this two table approach would look.)

Airplane Perks.. The new perk disclosure guidance from the SEC needs a critical fix so that shareholders can assess the value and usage of airplane perks. As covered in our September-October 2005 issue, the disclosure should focus on the *value to the executive* because it is compensation to the executive. "incremental cost" is not the appropriate measurement approach as it does not address the value to the executive. (It is like saying stock options should not be treated as compensation to the executive because there is no incremental cost to the company if the company does not pay out any cash and is not taxed on the executive’s gains.) Moreover, companies calculate their incremental cost in different ways, so that there is a lack of consistency allowing shareholders to compare and assess. Also, incremental cost does not pick up "deadhead" costs or the value realized when the CEO’s spouse "hitch hikes" on the CEO’s business trip.

The fix here is to provide a consistent "retail cost to the executive" approach—the cost to the individual of chartering a comparable private jet. If the company discloses the total retail value to the executive and provides the hourly rate (which one proxy statement pegged at $7,000 dollars an hour "based on a competitive analysis of comparable leased aircraft") *and* if the disclosure also set forth the hours used by the CEO and his/her invitees, shareholders will have a more accurate, consistent picture of what compensation is being provided.

Just lowering perk reporting thresholds will not address this fundamental problem involving what is often the largest perk a CEO receives. Under the new guidance, it still is not possible to assess the true number a company is attributing to the use of its private jet—and whether it is a low ball number. There has to be open, consistent disclosure so that shareholders (and compensation committees) can add the "real-value to the executive" to his/her total compensation.

2. Perks—Directors (and Shareholders) Are Still Not Being Provided the Full Picture

(excerpt from Sept-Oct 2005 issue of *The Corporate Counsel*)

In our May-June 2004 issue (at pg 7), we stressed the importance of boards receiving all the information about the true value of the perks that a CEO may be receiving. During the past year the heat has gotten greater in this very sensitive area, as more media articles and thoughtful analysis and guidance have honed in on perks. That, in turn, has increased the resolve of regulators and has impacted employee morale and loyalty at given companies.

Most recently, our focus piece this past June (see our May-June 2005 issue) on airplane perks and the May 25th Wall Street Journal article on perks have now provided important information and guidance that every director (not just compensation committee members, because this goes to setting the tone and culture of a company from the top down) at a company that uses a corporate jet should read closely. What is particularly troublesome is that, while some CEOs are treating the company jet as their own personal transportation, some lawyers and company staff are presenting numbers to their boards and preparing perk disclosures for proxy statements (that directors sign off on and are accountable for) that mis-characterize the personal use as business related. Equally troublesome (and also misleading) is that the numbers being disclosed appear to be only a fraction of either (a) the true costs to the company, or (b) the true value to the executive.

Disclosing "The True Value to the Executive"

It seems fundamental that compensation committees, when assessing the total compensation being delivered to the CEO, should be provided with a chart summarizing all CEO perks, including, most importantly, company jet usage by the CEO (and his or her family and friends), which includes the value to the executive if s/he had to pay out-of-pocket to charter a comparable plane. Directors need to factor into the compensation equation the fact that some CEOs view the jet as an important status symbol among peers and place a very high value on their use of the plane. [Indeed, a CEO who uses the jet to commute to and from his home in another state or his vacation home on weekends, or to fly off to play golf at prestigious country clubs, views the jet as a very important component of his/her compensation.]

As is coming to light now, the one or two or three or four hundred thousand dollars that a company is showing in its proxy statement as the value of a CEO's airplane perk may, in many instances, be several times below the real value to the executive—that is, what it would cost the executive if s/he had to charter a comparable jet. [We note that in one proxy statement, that cost was pegged at $7,000 per hour ("based on a competitive analysis of comparable leased aircraft"), and is the price at which that company reimburses its CEO for the use of his private jet for business purposes.] Also, when a company purchases a new jet that will be used in large part for travel by its CEO, these purchases have not been disclosed or explained in the proxy statement. [It has been suggested to us by a respected colleague that companies should implement a new

disclosure standard: "proportionate cost". If the corporate jet costs the company $10 million per year to own and operate (including the amortization of the jet's purchase price), and 25% of that plane's use is personal use by an executive, that executive's use of the plane should be valued at $2.5 million.]

Those responsible for reviewing or preparing perk disclosures in this year's upcoming proxy statements should be mindful of Alan Beller's warning about perk disclosure: "there are specific items that I fear companies are routinely omitting from their disclosure that should be included. These include the personal use of company planes and similar perks… We also fear that some companies are being overly creative when categorizing other items. I'd suggest that a perk, by any other name, is still a perk… When companies review their disclosure, they should give serious consideration to items that have previously been called business expenses (*e.g.,* housing, security systems, cars etc.) but actually are perks. I don't think it is very difficult to determine whether or not something is a perk. One question to ask that is not dispositive but may be useful is whether it is an expense that is available to employees generally on a non-discretionary basis, like reimbursement for the taxi across town for a meeting, or whether it is a benefit for which only a chosen few are eligible (or selected on a discretionary basis)."

To sum up, the compensation committee should (a) understand the "real value" of all perks, (b) factor their "real value" (not their disclosed cost) into tally sheets and compensation decisions, and (c) disclose their "real value" in the proxy statement to enable shareholders, also, to have all the information necessary to assess the CEO's total compensation.

More Compelling Reasons

Perhaps more fundamental, however, is the resultant impact on employees' morale and behavior (and the public's trust in the system) when they see CEOs taking advantage of perks that they can well afford to pay for like everyone else. We strongly commend to everyone the Intel and Potlatch Corporation disclosures about perks. We would encourage many more compensation committees and CEOs to reexamine their own perk policies and question whether they are justified (*e.g.,* from a cost/benefit, employee relations, shareholder relations perspective) and to provide similar "no perks" language in their proxy statements.

Lastly, no CEO who has worked hard all his or her life to get to the top of the ladder and to be respected by peers and those in the community, as well as the general public, needs to see it all tarnished as Jack Welch has experienced with the disclosure of his airplane and other perk liberties (and as GE felt in an SEC action for its inadequate perk disclosures).

3. Disclosure of Corporate Aircraft Use – 2005 Proxy Season Update

(excerpt from May-June 2005 issue of *The Corporate Counsel*)

Adequacy of Current Disclosures

Although executives' personal benefits, or "perquisites," represent only a small part of their total compensation, perquisites often are viewed by shareholders as a litmus test of an issuer's executive compensation philosophy. Investors today more closely examine whether executive perquisites are being properly valued and disclosed in the summary compensation table, fearing that they have become a significant "stealth" benefit for executives and a hidden cost to an issuer and its shareholders.

Two factors have contributed to inadequate disclosure of executive perquisites: vague and outdated SEC disclosure requirements and the inability of issuers to properly identify and value perquisites. Nowhere is this more apparent than in the treatment of personal use of corporate aircraft, one of the most coveted and costly, but undervalued and inadequately disclosed, perquisites available to executives today.

Review of SEC Disclosure Requirements

S-K Item 402(b)(2)(iii)(C) requires disclosure in the annual meeting proxy statement of any perquisites (as well as any other personal benefits, securities or property) provided to a "named executive officer," as follows:

- Perquisites must be quantified and included in the "Other Annual Compensation" column of the Summary Compensation Table, but only if the aggregate amount exceeds $50,000 or, if less, 10% of the total annual salary and bonus reported for the NEO.

- To the extent that an individual perquisite exceeds 25% of the total perquisites reported for an NEO, the perquisite must be specifically identified by type and amount in a footnote to the table or accompanying narrative.

- Perquisites must be calculated based on the "aggregate incremental cost" to the issuer.

Tax Rules Address Value, Not Cost

Because the SEC's rules do not provide any guidance for calculating the aggregate incremental cost of perquisites, many issuers have resorted to the federal income tax rules for assistance. The current IRS rules for imputing income to executives for personal use of corporate aircraft have their genesis in 1985 legislation that rescinded one year-old legislation requiring employees that took a company car home at night to maintain a detailed log of business and personal use. [Slipped in, via the committee report on the bill, was a directive that the IRS stop valuing personal use of corporate aircraft by executives at the rates companies paid or would be required to pay to charter a comparable flight and to instead apply a much lower value—nowadays, often less than the cost of a coach ticket on a commercial flight. We commend to our readers an excellent account of how this happened—and what the true costs are—in David Cay Johnston's chapter on "Plane Perks" in his book, *Perfectly Legal*, which we have posted on CompensationStandards.com, with permission from the publisher.]

Generally, the current tax rules stipulate that personal use of corporate aircraft is to be treated as a taxable fringe benefit, except to the extent the executive reimburses the issuer. Where an issuer has a security program that requires its executives to use corporate aircraft (*e.g.*, for executives in high-risk locations) and meets IRS guidelines, the amount includible in income is reduced.

The tax rules offer one straightforward general rule and two complicated alternative approaches for calculating the value of a personal flight. Under the general rule, the taxable value of a flight is equal to the cost of chartering the same or a comparable aircraft for the same or a comparable flight in an arms-length transaction. Under a more widely-used alternative rule, a flight's taxable value is based on the current per-mile Standard Industry Fare Level ("SIFL") rate established by the Department of Transportation, increased by two items—an aircraft multiple and a terminal charge.

Although SIFL is supposed to approximate the value of a coach or first-class fare, SIFL rates currently are substantially below commercial airfares. (A recent *Wall Street Journal article* reported that a 2,000-mile round-trip flight on a Gulfstream V would cost $43,000 to charter, but its value would be calculated at only $1,500 using SIFL and at an incremental cost of only $11,000. And, if the company has a qualifying security plan in place, the SIFL rate may be only $750!) [Under a third approach, the so-called "seating capacity" rule, the value of a flight taken by an executive who is not flying primarily on company business is zero (and therefore is excludable from the executive's income) if at least half of the aircraft's regular passenger seating capacity is occupied by employees flying primarily on company business. Also affecting the amounts imputed to executives for tax purposes is the American Jobs Creation Act of 2004, which became effective in January and which prohibits (in Code Section 274(e)) companies from deducting more than they impute as income to an executive. (On May 27, the IRS issued interim guidance for calculating the deductible cost of personal use of corporate aircraft, effective for costs incurred after June 30, 2005. The guidelines establish the persons whose personal use is subject to the deductibility limit and the costs attributable to personal use, which include both fixed and variable costs. See IRS Notice 2005-45.)]

Calculating Aggregate Incremental Cost

The Staff has stated that issuers should not use SIFL for valuing personal use of corporate aircraft for purposes of S-K Item 402, because SIFL does not reflect the aggregate incremental cost to the issuer. (This year's Starwood Hotels & Resort and J.P. Morgan Chase proxy disclosures demonstrate the disparity between SIFL and incremental cost. The Starwood CEO's personal use of the corporate jet was disclosed, using SIFL, as $208,000 in 2002 and 2003, but when Starwood recalculated those amounts this year to reflect incremental cost, the amount jumped to $653,000. The J.P. Morgan CEO's personal use was restated from $31,000 in 2003 under SIFL to $182,000 using incremental cost.) There appears to be no consensus, however, on what "cost" entails. Although there is no requirement that an issuer disclose its methodology for calculating incremental cost, our discussions with practitioners and our review of dozens of proxy statements revealed the following themes.

Many issuers interpret “aggregate incremental cost” to mean just the direct operating costs of a flight (*i.e.*, the costs incurred in making a particular flight). Thus, where the aircraft is company-owned and used primarily for business-related travel, direct and indirect fixed expenses (*i.e.*, expenses that do not change based on usage, such as pilots’ and other employees’ salaries, purchase costs of the aircraft, and non-trip-related hangar expenses) are excluded from the disclosable cost. (Query what costs should be included where a CEO uses the corporate jet in such a manner that an additional pilot is hired.) Variable expenses, in contrast (*i.e.*, expenses directly or indirectly attributable to a flight), are included in the disclosable cost. Variable expenses may include the following:

- hangar and tie-down costs away from the aircraft’s home base;
- landing fees, airport taxes, and similar assessments;
- flight planning and weather contract services;
- crew travel expenses (including food, lodging, and ground transportation);
- in-flight food and beverage;
- insurance obtained for the specific flight;
- aircraft fuel (fuel, oil, lubricants, and other additives) per hour of flight;
- aircraft accrual expenses per hour of flight;
- maintenance, parts, and external labor (inspections and repairs) per hour of flight;
- customs, foreign permit, and similar fees directly related to the flight; and
- passenger ground transportation and trip-related maintenance.

[The proxy statements we reviewed did not provide enough information for us to determine whether issuers are including all attributable variable costs in their calculation of costs. Additionally, we noticed that the dollar amounts disclosed by various issuers vary wildly, suggesting (in addition to differential use of corporate aircraft) a disparate method of calculating the costs.]

Where family members or guests accompany an NEO on a flight, again there is little uniformity in how issuers calculate the disclosable amount, with some using aggregate incremental cost and others using the value of the benefit received. Aggregate incremental cost would include only those costs directly attributable to the additional passengers (such as in-flight food and beverage and any additional weight-related charges), and that is all the SEC’s rules currently require. We think, however, that the value of a seat on a comparable charter (and not the cost of a first class seat on a commercial flight) is a more appropriate amount to attribute to the NEO for disclosure

purposes. [From a compensation standpoint, the compensation *to the NEO* and his/her family in the above example would be greater—and is the number shareholders are entitled to see and assess in the proxy statement.]

Impact of Security Concerns

Since the 9/11 terrorist attacks, many issuers have adopted policies requiring their CEO (and, in some instances, other senior executives) to use corporate aircraft for all business and personal travel, for security reasons. Because issuers treat security-related use as a business expense, many have assumed that it is not a disclosable perquisite. The Staff has said emphatically, however, that security is not an adequate basis for re-characterizing an otherwise disclosable perquisite as a non-disclosable business expense. [We wonder if the security findings of some companies are not just a ruse for a lower value perquisite or a "no perquisite" treatment. As the *WSJ* article suggested, at least some of the companies that say they require executives to use corporate aircraft for personal travel for "security reasons" don't seem to be likely targets of criminal activity.]

Because of the rampant non-compliance with the disclosure rules, Johnson & Johnson felt the need to point out, in its 2005 proxy statement, that any perquisite comparisons with its peers is not "apples to apples" because "many other peer corporations require their chairman and certain other executive officers to use company aircraft for personal as well as business travel. As a result, at those corporations, personal use of company aircraft by the chairman and those other executive officers is not treated as a perquisite or personal benefit and the costs associated with such personal use of company aircraft are not reported in the proxy statement. The Company has not required the chairman and other executive officers to use corporate aircraft for personal travel. Mr. Weldon is taxed on the imputed income attributable to personal use of company aircraft and does not receive tax assistance from the Company with respect to these amounts."

Other "Personal Use" Scenarios. In addition to "security concerns" as a justification for non-disclosure, we suspect that aircraft perquisites often go undisclosed because they are not properly characterized as involving "personal use." Alan Beller, in his October 20, 2004 speech at our Executive Compensation conference, seemed to share this concern, stating that: "We also fear that some companies are being overly creative when categorizing other items. I'd suggest that a perk, by any other name, is still a perk, and therefore must be considered for disclosure. When companies review their disclosure, they should give serious consideration to items that have previously been called business expenses (*e.g.*, housing, security systems, cars, etc.) but actually are perks. I don't think it is very difficult to determine whether or not something is a perk. One question to ask that is not dispositive but may be useful is whether it is an expense that is available to employees generally on a non-discretionary basis, like reimbursement for the taxi across town for a meeting, or whether it is a benefit for which only a chosen few are eligible (or selected on a discretionary basis). The valuation of perks also should be carefully examined. We have seen disclosure of large tax gross ups for perks that are themselves not disclosed, and this obviously raises questions. I also remind you that the appropriate

measure of value is the aggregate incremental cost to the company, not the tax value of the benefit."

Under this standard, an NEO's commute on the corporate aircraft to his family's residence several states away would be considered a perquisite. (For example, TXU's proxy statement disclosed that its CEO received $560,982 for commuting on corporate aircraft.) If issuers were to disclose the value *to the NEO* of chartering a comparable private jet, we suspect the amounts would be much larger.

Full Disclosure… to the Compensation Committee, Too

The SEC's action against Tyson Foods for misleading disclosure of perquisites and other benefits to its former CEO (Lit. Rel. No. 19208, April 28, 2005) highlights the disturbing problem of the ill-informed compensation committee. In addition to failing to adequately disclose perquisites, Tyson was charged with failing to maintain adequate internal controls for providing $1.5 million in personal benefits to its CEO that, in the SEC's view, were not appropriately authorized by either the compensation committee or the board of directors. Although the compensation committee knew (i) that the CEO received "travel and entertainment" benefits in the form of personal use of corporate aircraft and homes, and (ii) the dollar amount of the annual perquisites, the internal controls violation apparently was based on the compensation committee's failure to determine the details of the benefits being provided to the CEO. For example, the compensation committee did not know the corporate jet was often used by family members and friends of the CEO, without the CEO on board.

The SEC is clearly signaling a growing impatience with "stealth" compensation and failure to disclose perquisites, even to the compensation committee. Issuers may want to revisit the nature and amount of information provided to their compensation committee members regarding NEO perquisites, both to assure compliance with the disclosure requirements and to avoid internal controls violations.

The Future of Aircraft Perquisite Disclosure

This proxy season, some issuers are heeding the call for enhanced disclosure of personal aircraft use. Pfizer, Eli Lilly, Electronic Data Systems and others have included detailed descriptions of their aircraft use policies and valuation methodologies in their proxy statements. But many other issuers have not yet heeded the call. We would like to see more issuers disclose their specific methodology used to calculate the aggregate incremental cost of the aircraft use, which would enable shareholders to put the disclosure into context and better understand issuers' perquisite policies. As the investor community's resentment of well-compensated CEOs who "nickel-and-dime" issuers grows, we may well see an increase of the type disclosure that was in this year's Intel proxy statement: "Intel seeks to maintain an egalitarian culture in its facilities and operations. Intel's officers are not entitled to operate under different standards than other employees. … Company-provided air travel for Intel's officers is for business purposes only: Intel's company-owned aircraft each hold approximately 40 passengers and are

used in regularly scheduled shuttle routes between Intel's major U.S. facility locations, and Intel's use of non-commercial aircraft on a time-share or rental basis is limited to appropriate business-only travel."

Disclosing True Costs—And Value to the NEO

As is so well laid out in David Cay Johnston's book, the true cost to the issuer and the real value to the NEO appear to be understated, both to compensation committees and to shareholders. As reported in the *WSJ,* the amount that a company would have to pay to charter a comparable jet (and the amount that a CEO who owns his/her own jet charges the company for business use of the aircraft) are often three or four times greater than the aggregate incremental cost actually disclosed). This discrepancy has come to the attention of the SEC Staff, as Alan Beller has stated that they are studying whether market rate or incremental cost is the best measure for perk value.

Although currently not required for proxy disclosure purposes, the compensation committee needs to know the true cost and value of *all* compensation delivered to its CEO and other NEOs. We would like to see issuers provide to their boards of directors both the incremental cost of perquisites to the issuer and the compensation (*i.e.*, the real value) provided to the NEO. And, we would like to see *both* disclosures set forth in the proxy statement, as they are material to shareholders in assessing the value to the NEO of the total compensation received by the NEO. [We note that this is consistent with the SEC's positions now in other compensation related areas, such as the obligation to file "material" compensation agreements, where the Staff has moved from a material to the issuer standard to a material to the shareholders standard.]

A Word of Caution. Lastly, our readers should take note that when Tyson first announced the SEC investigation in a press release on August 16, 2004, it stated that "the Staff may recommend administrative action against two Tyson employees, neither of which are executive officers, for allegedly causing the violations." Although it now appears that the employees escaped SEC action, the Division of Enforcement is on record as focusing on "gatekeepers." See former SEC Enforcement Director Stephen Cutler's speech at UCLA on September 20, 2004 and the discussion of the *Flowserve* proceeding in our March-April 2005 issue at pg 7. Given the Staff's current frustrations with lawyers who are still "hiding the ball" in the misbelief that their clients are the executives and not the shareholders, we would not be surprised to see an SEC action soon brought against lawyers and others responsible for drafting incomplete or misleading perquisites disclosures.