Frederic W. Cook & Co., Inc.

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August 20, 2010

Evolution of Change-in-Control Practices: 2007 vs. 2010

Research shows us that change-in-control practices are evolving among large US-based companies in response to corporate governance reform pressures from shareholder activist groups. The most significant changes made by companies over the past four years include: reduction of CEO and CFO severance multiples from 3X to 2X; movement from single-trigger equity vesting to double-trigger equity vesting; and elimination of excise tax gross-ups.

Executive Summary

Well constructed change-in-control ("CIC") arrangements are designed to motivate executives to continue to work in the best interests of the company and its shareholders and to mitigate potential anxiety an executive may have regarding his or her future employment due to a CIC. Companies enter into these arrangements to ensure continuity of management during mergers and acquisitions, as a way to attract and retain highly valued executives, and to encourage executives responsible for negotiating potential transactions to do so with independence and objectivity.

The heightened focus on corporate governance reform has drawn attention to CIC arrangements and the costs associated with providing executives with these protections. In addition, shareholder activist groups have brought forth proposals in annual proxy statements seeking to limit payments under CIC severance programs, and Institutional Shareholder Services ("ISS") has designated certain features of CIC arrangements as constituting "problematic pay practices" that may trigger negative vote recommendations on Say on Pay resolutions or withhold vote recommendations on re-election of corporate directors, especially members of the compensation committee (see our Alert Letter dated November 23, 2009).

In light of this activity, we analyzed how companies have revised CIC arrangements by comparing practices in 2007 with practices in 2010. The companies reviewed consisted of the 100 largest companies in the S&P 500 (by market capitalization) as of February 2010. We specifically looked at CIC protections offered to the CEOs and CFOs at these companies, with the CFO presumably representing a general indication of practices for other executive officers.

Of note, there were 23 new CEOs in the 100-company sample over the 4-year period we examined. However, we found that changes in CIC practices instituted by these companies were not correlated to changes in leadership.

We observed the following trends in CIC practices during the past four years:

- Prevalence – The provision of cash severance in CIC-related terminations continues to be majority practice and the source of the severance has been relatively unchanged over the prior four years. Approximately 40% of companies provide their CEOs and CFOs with enhanced cash severance protection in the event of a CIC-related termination (e.g., with a higher multiple than regular severance) under individual arrangements or CIC plans while approximately 30% - 35% provide severance protection through standard, non-CIC-related executive severance or broad-based severance arrangements.

- Multiples – Severance multiples have trended down from 3X to 2X for both CEOs and CFOs. While a 3X multiple continues to be the most prevalent severance multiple for CEOs (61% of companies with cash severance), for CFOs the most prevalent multiple has shifted from 3X to 2X (46% of companies with cash severance).

- Bonus Definition – The use of target bonus in the severance formula is the most prevalent bonus definition for both CEOs and CFOs and has increased in prevalence among the sample companies over the past four years.

- Pension – Enhancements to pensions are a minority practice and have shown a small reduction in prevalence over the past four years – from 25% to approximately 23% of companies.

- Equity Vesting – There has been a significant shift away from single-trigger vesting to double-trigger vesting among the sample companies over the past four years – from 57% / 26% in 2007 to 43% / 39% in 2010. Approximately 18% of companies leave equity vesting acceleration to Committee discretion, which we note under the new financial reform law will require a specific shareholder advisory vote at the time the transaction is approved if the Board chooses to accelerate awards. We suspect that changes in regulatory requirements will reduce the number of companies using a discretionary approach.

- Gross-Ups – The provision of full excise tax gross-ups has declined significantly among the sample companies. The movement is towards full elimination of gross-ups, and the 2010 sample indicates that traditional gross-ups remain in place for only 22% and 17% of the CEOs and CFOs in the study

    - The movement away from excise tax gross-ups is likely to continue. Approximately one-third of the companies that currently provide excise tax gross-ups for their CEOs or CFOs have disclosed that they will not do so for future participants in their CIC programs.

The following pages of this letter discuss these findings in greater detail.

Introduction

Background & Overview

This letter presents a comparison between 2007 and 2010 change-in-control ("CIC") practices for CEOs and CFOs at the 100 largest companies (by market capitalization) in the S&P 500, as of February 2010. The intent of this comparison is to capture changes that companies have made to their CIC practices over the past four years. A complete list of the companies and summary financial data can be found on the last page of this letter.

We compared the proxy disclosure from 2007 with proxy and Form 8-K disclosures in 2010 (filed up to June 30, 2010). We focused on 2007 as the first year in the comparison because it was then that the enhanced proxy disclosure rules providing the data necessary for our research were put into effect.

We focused on CFOs as representative of all named executive officers other than the CEO. This simplified the comparison between CEO benefit levels with those for the other named executive officers at the sample companies. Data were collected for the two sample years for the two positions regardless of the incumbent in the position. We found that changes in CIC practices instituted by companies were not correlated to changes in the incumbents.

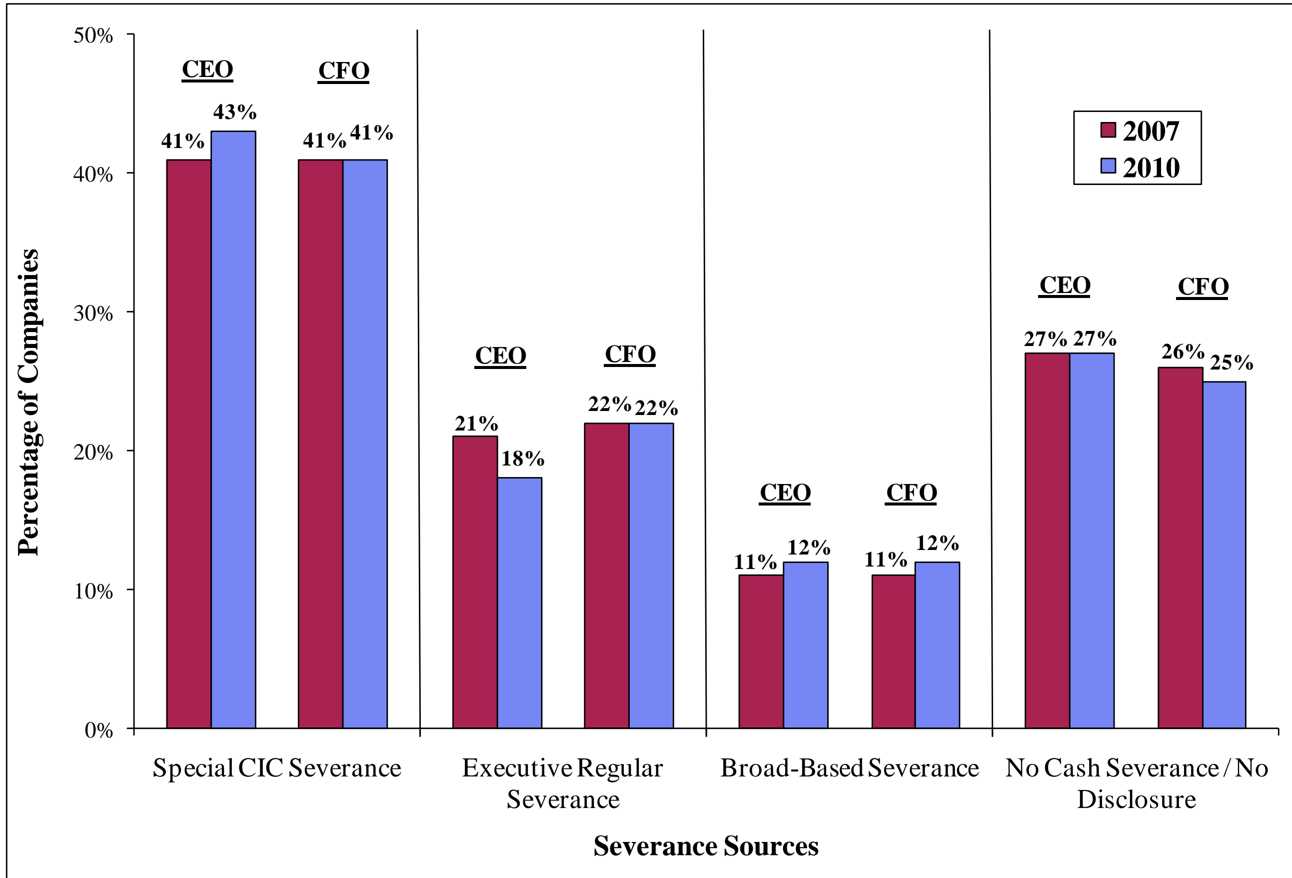
Survey Scope

Analysis of the following CIC arrangements for CEOs and CFOs among the sample companies in 2007 and 2010:

- Cash severance prevalence
- Severance multiple in cash severance formula
- Bonus definition in cash severance formula
- Pension enhancements
- Equity vesting acceleration
- Excise tax gross-up, including any prospective changes disclosed by the sample companies in their 2010 disclosure

Prevalence of Cash Severance

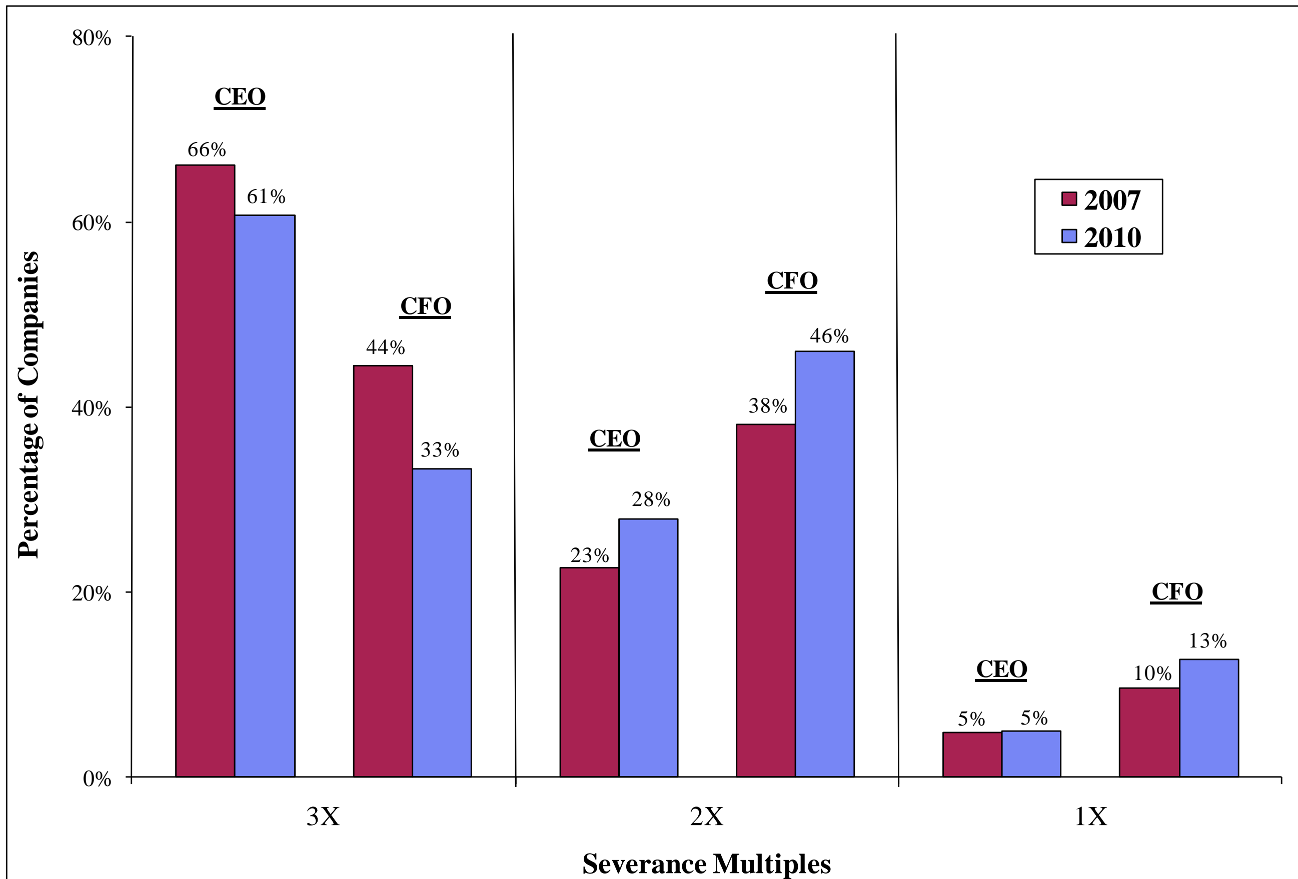
The graph below summarizes the source of cash severance among the sample companies:



Among the sample companies, the provision of cash severance continues to be majority practice and the source of the severance has been relatively unchanged over the prior four years. Approximately 40% of companies provide their CEOs and CFOs cash severance protection on CIC with special CIC severance arrangements (e.g., with a higher multiple than regular severance) under individual contractual arrangements or CIC plans, while approximately 30% - 35% provide severance protection from executive regular severance or broad-based severance programs.

Severance Multiple

CIC cash severance formulas are typically expressed as a multiple of salary and bonus. The graph below summarizes the prevalence of severance multiples among the sample companies that provided their CEOs and CFOs with cash severance protection. Note that the graph summarizes the most prevalent multiples; a few companies provided multiples other than those illustrated below (e.g., 5X, 2.5X, etc.):



The graph above illustrates a trend of severance multiple reduction from 3X to 2X for both CEOs and CFOs over the prior four years. While a 3X multiple continues to be the most prevalent severance multiple for CEOs, for CFOs the most prevalent multiple has shifted from 3X to 2X.

Severance Bonus Definition

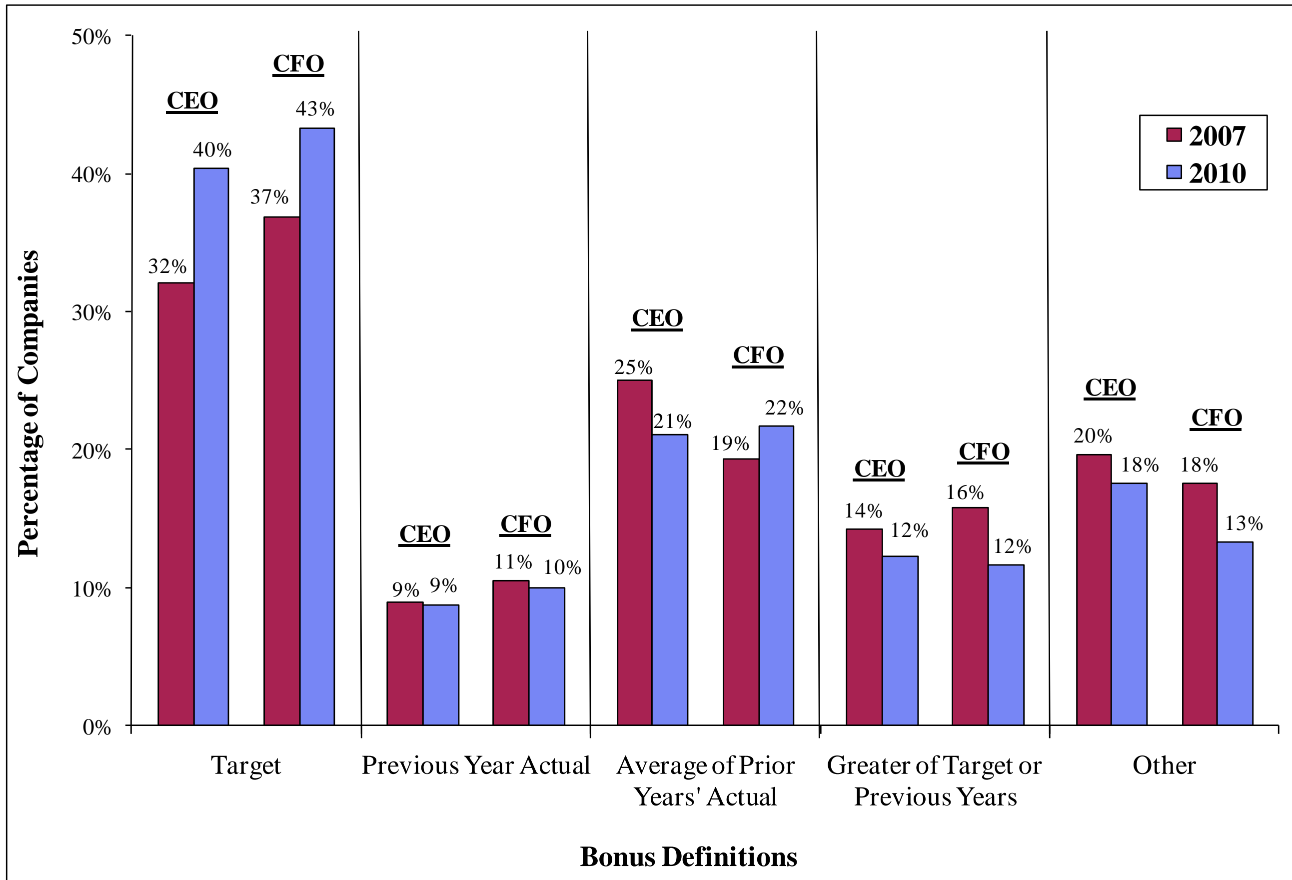
Bonus in the CIC cash severance formula can be defined in a number of different ways, including but not limited to, the following:

Target – executive receives the target bonus for the year of termination

Average – executive receives the average bonus paid over a prior number of years (e.g., three years)

Greater of – executive receives the greater of two or more criteria, usually the target bonus in the year of termination or the average bonus over a prior number of years

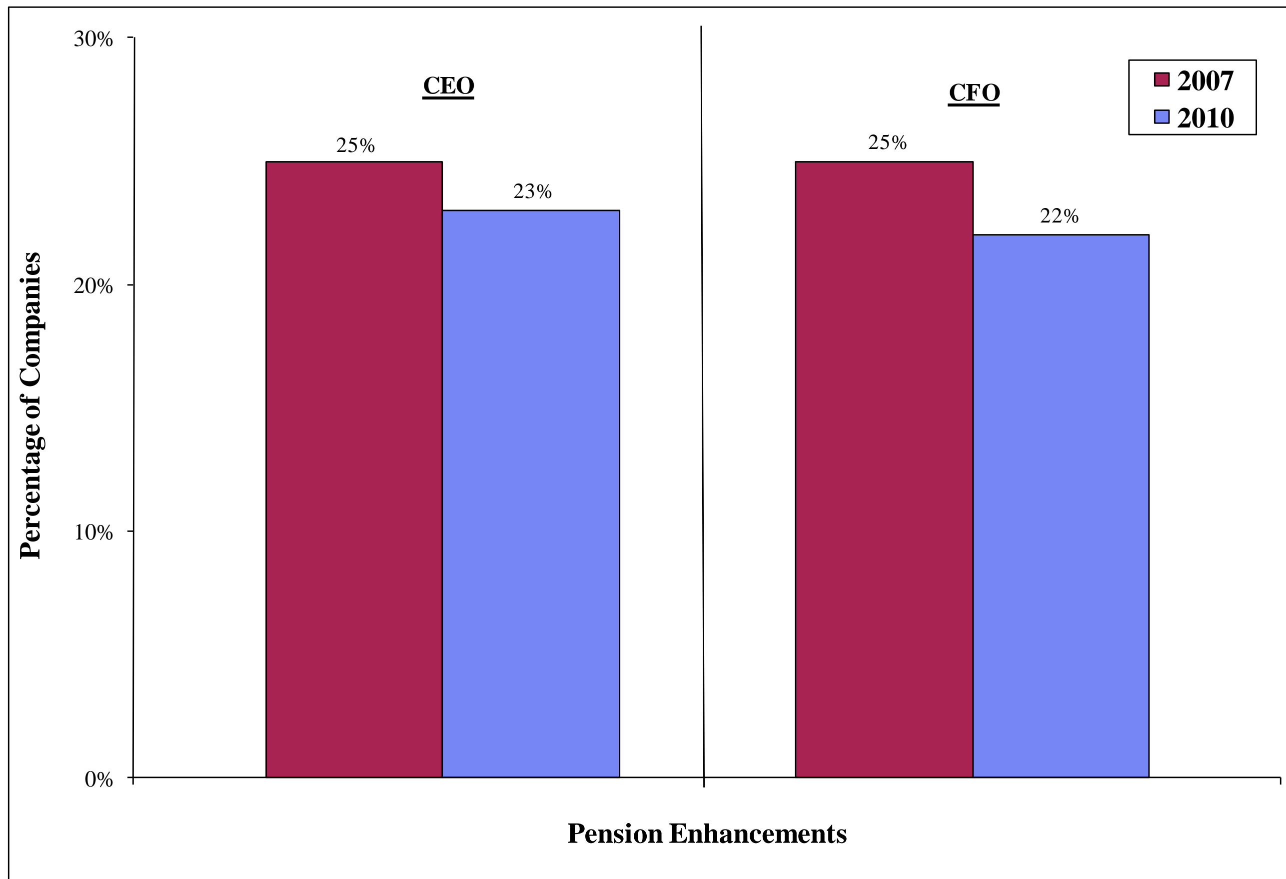
The graph below summarizes the most prevalent severance bonus definitions among the sample companies who provide their CEOs and CFOs with severance protection:



As can be seen above, target bonus continues to be the most prevalent bonus definition for both CEOs and CFOs and has increased in prevalence among the sample companies over the past four years.

Pension Enhancement

The table below summarizes the prevalence of pension enhancements on CIC termination among the sample companies:



Pension enhancements continue to be a minority practice and show a small reduction in prevalence over the past four years. Pension enhancements are inconsistent with emerging best practice due to the sensitivity of the size of additional benefits relative to cash severance. Note that under ISS' policies a pension enhancement could result in a withhold vote recommendation for members of the compensation committee if such an enhancement results in service credit for years not worked.

Equity Vesting

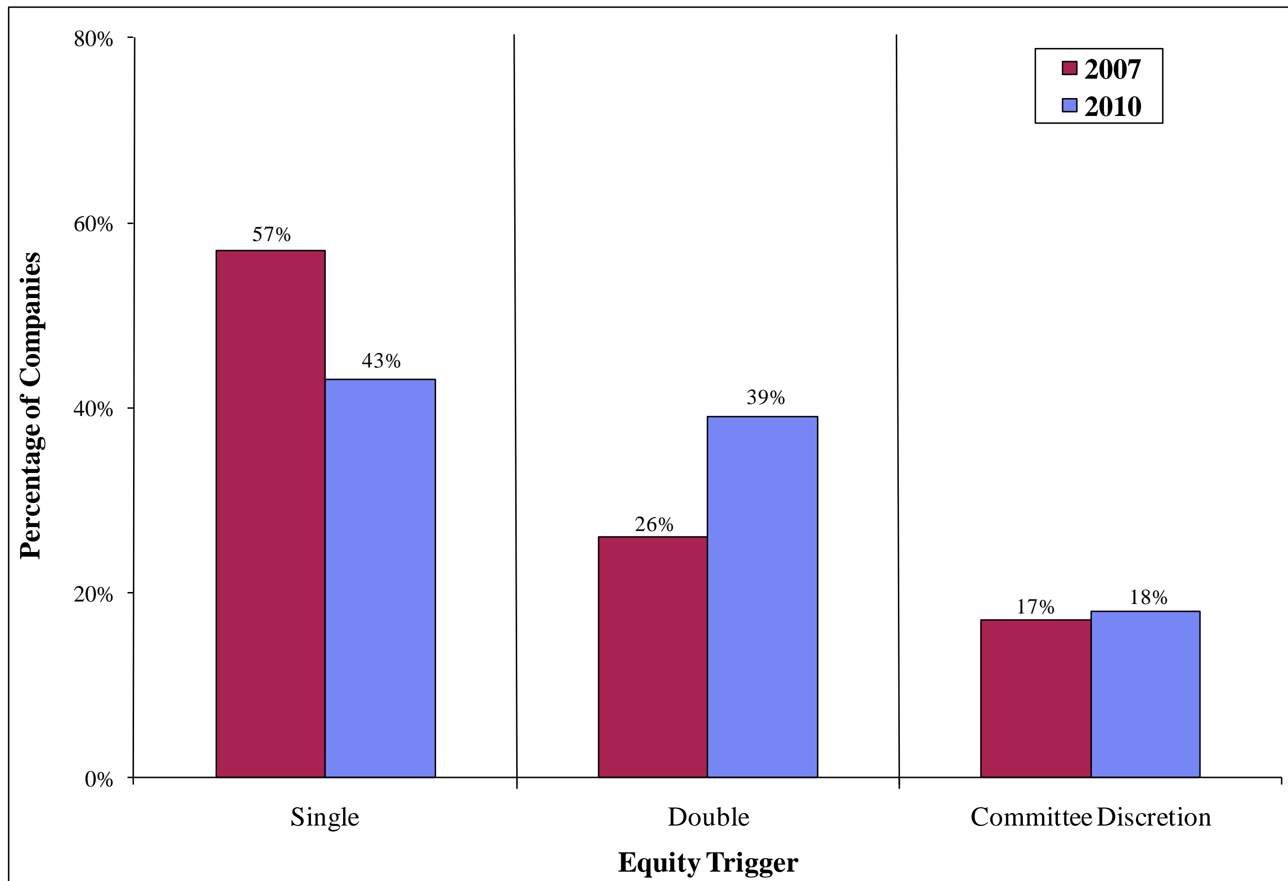
Equity vesting acceleration can be designed as either a single-trigger or double-trigger event:

Single-Trigger – equity vesting acceleration occurs upon the occurrence of a CIC. The individual does not need to be terminated to receive the equity vesting acceleration.

Double-Trigger – equity vesting acceleration occurs upon both the occurrence of a CIC ("first trigger") and a qualifying termination of the individual's employment with the company ("second trigger") within the CIC protection period (the period following the CIC in which the individual is entitled to receive special severance payments if employment is terminated by the company without

cause and, if applicable, by the individual for "good reason"). Thus, the individual must actually lose his or her job to receive equity vesting acceleration.

The graph below summarizes the prevalence of equity vesting triggers among the sample companies:



There has been a significant shift away from single-trigger vesting to double-trigger vesting among the sample companies over the past four years. Single-trigger vesting remains slightly more prevalent, but is no longer majority practice.

Single-trigger vesting is generally viewed as inconsistent with investor preferences and has become an important corporate governance issue. Double-trigger vesting is recommended by ISS as an example of a "good pay practice". ISS has also mentioned in its reports that in the near future it may recommend against stock plans that have single-trigger vesting.

Excise Tax Gross-Up

Under Section 4999 of the Internal Revenue Code, an excise tax must be paid by an individual if total "parachute payments" made in connection with a CIC exceed the safe harbor limit, which is $1.00 less than 3X the individual's "base amount." Base amount is defined as the average W-2 compensation from the company for the five years preceding the year in which the CIC occurs. The excise tax to the individual is equal to 20% of all "parachute payments" in excess of 1X the "base amount" and the company loses the corresponding tax deduction for this "excess parachute payment".

Companies address the excise tax issue in one of the following ways:

Provide full tax gross-up – company pays the individual's excise and related income taxes in an effort to offset the excise tax and keep the individual whole. Note that these payments are deemed "excess parachute payments" as well, which requires the company to gross-up the gross-up payment. In so doing, the company provides the individual with payments such that the individual receives on an after-tax basis an amount equal to the amount the individual would have received in the absence of the imposition of the excise taxes.

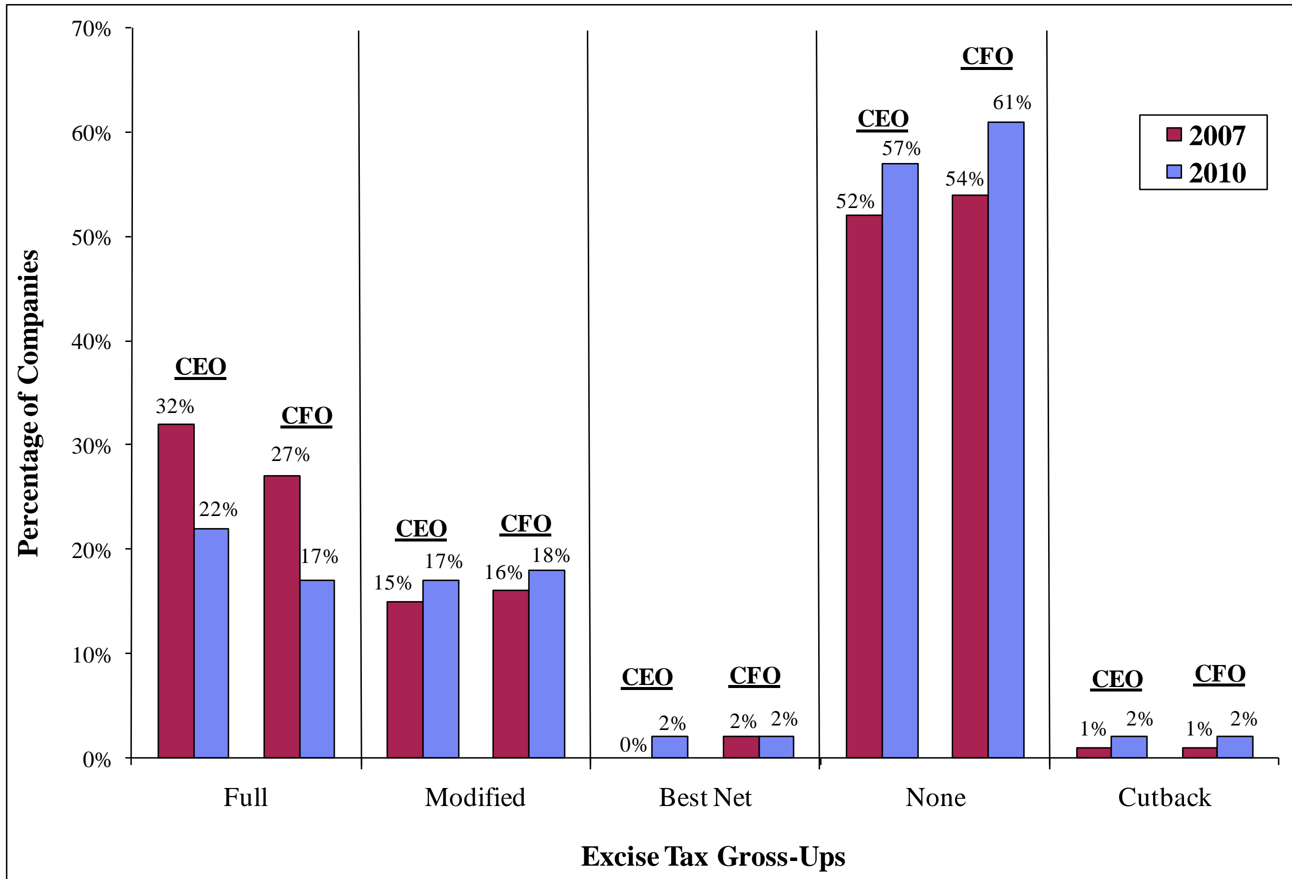
Provide modified tax gross-up – company pays the excise tax only if the payments exceed the safe harbor by a certain amount (e.g., 110% or $50,000). If not, payments are cut back to the safe harbor.

Provide best-net payment – company cuts back payments to the safe harbor limit only if the individual would receive a greater after-tax benefit than if the excise tax were paid by the individual on the excess parachute payments.

Provide no tax gross-up – executive to pay excise tax if payments exceed the safe harbor.

Limit payments to safe harbor ("cutback") – company cuts back payments to the safe harbor limit so that no excise tax is imposed on the individual under any circumstance.

The graph below summarizes the prevalence of excise tax gross-ups among the sample companies:



As can be seen above, the provision of full excise tax gross-ups has declined significantly in prevalence among the sample companies over the past four years. Companies have moved towards providing no gross-ups, which continues to be majority practice for both CEOs and CFOs.

The movement away from excise tax gross-ups is going to continue in the future. Approximately one-third of the companies that currently provide excise tax gross-ups for their CEOs or CFOs have disclosed that new participants in their CIC programs will not have this feature.

Note that providing an excise tax gross-up (including a modified gross-up) is on ISS' list of "problematic pay practices" for new or materially amended agreements. Under their policy, ISS will likely recommend to shareholders that votes be withheld from (or be voted against) compensation committee members (and potentially the entire board of directors) if new or materially amended agreements include any type of excise tax gross-up.

Conclusion:

We anticipate the trends highlighted in this survey to continue in response to investor concerns, ISS policies and non-binding votes on "golden parachutes" required in the say-on-pay legislation recently signed into law and effective in 2011.

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This letter was authored by DJ Shetty and Stephan Bosshard, with research assistance from Eric Winikoff and Silvana Nuzzo. Jeffrey Kanter provided oversight to the review. Questions and/or comments should be directed to Mr. Shetty in our New York office at djshetty@fwcook.com or (212) 299-3716, or to Mr. Bosshard in our New York office at sdbosshard@fwcook.com or (212) 299-3720. This letter and other published materials are available on our website, www.fwcook.com.

Companies in Research Sample

3M	ConocoPhillips	Hewlett-Packard	Pfizer
Abbott Laboratories	Corning	Home Depot	Phillip Morris International
Altria Group	Costco Wholesale	Honeywell International	PNC Financial Services
Amazon.com	CVS Caremark	IBM	Procter & Gamble
American Express	Dell	Intel	Prudential Financial
Amgen	Devon Energy	Johnson & Johnson	Qualcomm
Anadarko Petroleum	DIRECTV	JPMorgan Chase	Schlumberger
Apache	Dow Chemical	Kimberly-Clark	Southern
Apple	DuPont	Kraft Foods	Target
AT&T	eBay	Lockheed Martin	Texas Instruments
Bank of America	Eli Lilly	Lowe's	Time Warner
Bank of New York Mellon	EMC	Mastercard	Travelers
Baxter International	Emerson Electric	McDonald's	Union Pacific
Berkshire Hathaway	Exelon	Medco Heatlh Solutions	United Parcel Service
Boeing	Express Scripts	Medtronic	United Technologies
Bristol-Myers Squibb	Exxon Mobil	Merck	UnitedHealth Group
Carnival	FedEx	MetLife	US Bancorp
Caterpillar	Ford Motor	Microsoft	Verizon Communications
Celgene	Freeport-McMoRan	Monsanto	Visa
Chevron	General Dynamics	Morgan Stanley	Walgreen
Cisco Systems	General Electric	News Corp	Wal-Mart Stores
Citigroup	Gilead Sciences	Nike	Walt Disney
Coca-Cola	Goldman Sachs Group	Occidental Petroleum	WellPoint
Colgate-Palmolive	Google	Oracle	Wells Fargo
Comcast	Halliburton	PepsiCo	XTO Energy

Summary Financial Data of Research Sample

	FYE Revenues ($ Millions)	Market Capitalization as of 6/30/10 ($ Millions)	FYE Net Income ($ Millions)
75th Percentile	$61,401	$80,681	$5,080
Average	48,942	64,681	4,090
Median	30,594	39,215	2,671
25th Percentile	16,577	27,429	1,720