

## APPENDIX S

### MERCK'S COMPENSATION AND SECURITIES TRADING POLICIES.

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## APPENDIX S

### MERCK'S COMPENSATION AND SECURITIES TRADING POLICIES.

#### A. Introduction.

This Appendix reviews the components of compensation granted to Merck executives and a select number of non-executives who had a substantial role in the development and marketing of Vioxx and describes the ways in which the success or failure of Vioxx might have affected compensation. It also describes Merck's internal policies and procedures regarding trades in company stock by officers and employees in possession of potentially material non-public information and reviews the trading practices of members of senior management.

#### B. Merck's Compensation Structure for Senior Management.

##### 1. Overview.

The Company divided executive compensation into three parts: (i) salary; (ii) annual bonus; and (iii) the long-term equity award. Although the Compensation and Benefits Committee of the Board of Directors and the Chief Executive Officer had some discretion in setting executive compensation at Merck, the process was largely a formulaic one driven by numeric calculations derived from various Company-wide and Division-level performance assessments as well as by personal performance and the marketplace.

Thus, as explained more fully below, the salary component of executive compensation was set based on the marketplace for comparable positions as well as the executive's personal performance. Similarly, the annual bonus component was

determined based on (i) a “Company Performance Grid” score, a multi-factor assessment of the Company’s performance with reference to various financial and strategic measures, and (ii) a “Division Performance Grid” score, a more granular assessment of each Division’s annual objectives and achievements. Finally, the equity award component was set in light of the market but also took into account various components of the Company Performance Grid as well as the executive’s personal performance.

The success or failure of Vioxx as a product was reflected in several of the underlying metrics assessed in the Company Performance and Division Performance Grids, which were then weighed against several non-financial metrics also assessed in the Grids. Within the financial metric assessments, Vioxx was one of several key franchises upon which Company profitability relied. In light of the formulaic method used to calculate executive compensation, however, Vioxx sales were a factor in the overall Company’s financial success but did not dictate executive compensation.

2. Executive Compensation.

a. Role of the Compensation and Benefits  
Committee of the Board of Directors.

The Compensation and Benefits Committee of the Board of Directors (the “Compensation Committee”), which at all relevant times was comprised of four to five independent outside directors, approved compensation objectives and policies for all Company employees, approved all components of compensation for Merck’s executive officers, and administered the Company’s Executive Incentive Plan, or annual bonus

plan, and Incentive Stock Plan.<sup>1</sup> While Mr. Gilmartin, as Chief Executive Officer, was responsible in first instance for the amounts of compensation for his direct reports (which encompassed members of the Management Committee<sup>2</sup>) in light of Company and Division performance and the market, the Compensation Committee was responsible for the final approval of individual compensation awards for all executive officers.<sup>3</sup>

The Compensation Committee also was responsible for recommending the annual compensation of the Chief Executive Officer (and any executives who also served on the Board of Directors) to the full Board of Directors for approval.<sup>4</sup> The Compensation Committee did not play a direct role in setting the compensation of non-executive officers involved in the development and marketing of Vioxx but was involved in

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<sup>1</sup> See, e.g., 3/16/00 Merck Proxy Statement, at 9-10; Draft minutes of 2/27/01 Compensation and Benefits Committee meeting, MRK-AQD0000501, at 01 (Committee business included, among other things, approving recommendations for base salaries of Management Committee members, Executive Incentive Plan awards, and stock option grants for Plan participants).

<sup>2</sup> The Management Committee was comprised of Mr. Gilmartin and his direct reports, which included executives holding the following positions: (i) President and Co-Presidents, United States Human Health; (ii) President, MRL; (iii) Chief Financial Officer; (iv) Senior Vice President and General Counsel; (v) Senior Vice President, Human Resources; (vi) President, Manufacturing; (vii) President, Human Health Asia Pacific; (viii) President, Worldwide Human Health; (ix) President, Merck Vaccines.

<sup>3</sup> See, e.g., 2/16/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000284, at 84; 2/21/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000306, at 06; 2/20/02 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000331, at 31-32; 2/19/03 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000427, at 27; 2/18/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000511, at 11.

<sup>4</sup> See, e.g., 2/16/00 memorandum from W. Yarno to the Compensation and Benefits Committee, MRK-ASC0000291 (reviewing the base salary, Executive Incentive Plan award and stock option grant for Dr. Scolnick during the time period when Dr. Scolnick served on the Board of Directors); 2/19/03 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000434 (same).

establishing the compensation guidelines used by senior management when determining the compensation of their direct reports.

During the relevant period, the Compensation Committee met approximately four times a year to review and discuss annual compensation for senior management and often had additional meetings to address specific developments or concerns. The Compensation Committee met, for example, several times after the Company's decision to voluntarily withdraw Vioxx from the market to discuss the withdrawal's impact on executive compensation.<sup>5</sup>

According to Merck's 1999 Proxy Statement, the Compensation Committee sought to ensure that:

- “rewards [were] closely linked to Company-wide, division, area, team and individual performance”;
- “the interests of the Company's employees [were] aligned with those of its stockholders through potential stock ownership”; and
- “compensation and benefits [were] set at levels that enable[d] the Company to attract and retain the high-quality employees it needs.”<sup>6</sup>

To remain competitive in the marketplace, the Compensation Committee's stated objective with regard to management compensation was to set:

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<sup>5</sup> See, e.g., Minutes of 10/15/04 Compensation and Benefits Committee meeting, MRK-AQD0000979, at 79; Minutes of 11/23/04 Compensation and Benefits Committee meeting, MRK-AQD0001040, at 40.

<sup>6</sup> 3/16/00 Merck Proxy Statement, at 9; see also 10/9/04 Merck Proxy Statement, at 19.

- base pay targets at the median (50<sup>th</sup> percentile) of leading pharmaceutical companies;
- annual incentives “such that expected payouts will place total cash at the 75th percentile of leading” pharmaceutical companies; and
- total compensation, including stock options, with the potential to be at the high end of the range of pharmaceutical companies, depending on stock performance.<sup>7</sup>

In making its decisions concerning executive compensation, the Compensation Committee relied on information provided by the Company’s Human Resources Department and various outside consulting firms regarding the competitiveness of Merck’s overall compensation plan as compared to the plans of peer pharmaceutical companies.

On an annual basis, the Human Resources Department made presentations to the Compensation Committee regarding the salary, annual bonus and equity components of executive compensation, including data on industry practice in the marketplace.<sup>8</sup> For example, in 2002, the Human Resources department outlined the then-current industry

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<sup>7</sup> 11/26/02 “Executive Compensation and Long-Term Incentive Review” presentation, MRK-ASC0000378, at 83.

<sup>8</sup> Minutes of 10/28/03 Compensation and Benefits Committee meeting, MRK-AQD0000897, at 98. The Human Resources Department relied on external data provided by Towers Perrin. Towers Perrin used the Pharmaceutical Human Resources Association (“PHRA”) Executive Compensation Database to gather executive compensation statistics. The peer group assessed by PHRA differs slightly from the peer group as defined by Merck in its Company Performance assessment. The differences are not significant and do not impact the conclusions drawn herein. Compare 2003 Towers Perrin PHRA Executive Compensation Survey: Merck vs. Selected U.S.-Based Leading Pharmaceutical Companies, MRK-ASC0000523 (surveying Pfizer, Wyeth, Abbott Laboratories, Johnson & Johnson, and Bristol-Myers Squibb in addition to Merck) with 3/20/03 Merck Proxy Statement, at 17 (comparing Merck’s performance to leading healthcare companies, including AstraZeneca, Bristol-Myers Squibb, GlaxoSmithKline, Johnson & Johnson, Eli Lilly, Novartis, Pfizer, Pharmacia, Roche Holding, Schering-Plough, and Wyeth).

practice in long-term incentive packages, providing the Compensation Committee with data indicating that over 80% of large U.S.-based pharmaceutical companies complemented the use of plain-vanilla stock options with other long-term incentive vehicles, such as performance-based or restricted stock programs.<sup>9</sup> In addition, the Human Resources Department also provided the Compensation Committee with marketplace data on the structural components of executive compensation such as the appropriate “level” or pay grade for certain executive (and non-executive) positions and commensurate “target” compensation based on the Company’s peer group and compensation philosophy.<sup>10</sup> After considering information provided by the Human Resources, including from time to time data provided by outside consultants, the Compensation Committee would also set the final pay grades and compensation targets for management.

In 2002, the Compensation Committee engaged Mercer Human Resource Consulting to serve as an independent, outside consultant on issues related to executive compensation. Mr. Peter Chingos\* of Mercer served as the Compensation Committee’s principal outside advisor, provided information and assistance to the Committee on a routine basis and regularly attended Compensation Committee meetings.<sup>11</sup> For example,

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<sup>9</sup> 11/26/02 “Executive Compensation and Long-Term Incentive Review” presentation, MRK-ASC0000378, at 79.

<sup>10</sup> 10/04 “Executive Compensation Review” presentation, MRK-ASC0000532, chart at 37.

<sup>11</sup> See, e.g., Minutes of 5/27/03 Compensation and Benefits Committee meeting, MRK-AQD0000817, at 17; Minutes of 7/22/03 Compensation and Benefits Committee meeting, MRK-AQD0001026, at 26; Minutes of 7/27/04 Compensation and Benefits Committee meeting, MRK-AQD0000973, at 73.

in February 2003, Mr. Chingos\* made a presentation to the Committee outlining the broad market trends for Chief Executive Officer compensation, reviewing compensation paid to peer company Chief Executive Officers and describing the metrics used by competitor companies in setting Chief Executive Officer compensation.<sup>12</sup>

b. Components of executive compensation.

The Compensation Committee was guided in setting levels of compensation by both objective and subjective criteria. The objective criteria, which took into account the Company's overall performance, largely relied on the Company's earnings per share ("EPS") growth as compared to peer pharmaceutical companies. The subjective criteria included such factors as an executive's personal performance as measured by the success of his or her Division. The Compensation Committee had discretion to adjust the bonus pool or an individual bonus award as it deemed appropriate in light of Company performance. For example, in 2000, when the Company's earnings per share increased by 8.3% over the previous year, placing the Company in the 3<sup>rd</sup> quartile compared to its peers,<sup>13</sup> Mr. Gilmartin's total annual cash compensation was just above the 25<sup>th</sup> percentile and his total compensation (equity valued at \$10,102,000) was between the 25<sup>th</sup>

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<sup>12</sup> 2/24/03 presentation by Mercer Human Resource Consulting, "Executive Compensation Review," MRK-ASC0000438-73.

<sup>13</sup> 2001 Merck Performance Summary, MRK-AQD0000571, at 81.

percentile and the median for chief executive officers at comparable U.S.-based pharmaceutical companies.<sup>14</sup>

The subsections below describe the way in which the three components of executive compensation – (i) salary; (ii) annual bonus; and (iii) equity – were determined during the relevant period.

i. Salary.

The Compensation Committee set base salary for executive officers based on a combination of objective and subjective criteria ranging from Company-wide to individual performance for the previous fiscal year. As with annual bonuses (discussed more fully below), base salary was assessed on the basis of operational, strategic, and human resources measures, and was set by comparison to executive officer salaries at peer U.S.-based pharmaceutical companies.<sup>15</sup> In 1999, for example, executive base salaries were determined based on: (i) “a relative comparison between the members of the group to provide internal equity”; (ii) “a comparison to competitive levels”; and (iii) “consideration of additional responsibilities as a result of organizational realignment.”<sup>16</sup> Base salaries were meant to be “competitive [...] against the external market at the 50<sup>th</sup> percentile.”<sup>17</sup>

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<sup>14</sup> 2000 Towers Perrin PPG Executive Compensation Survey (CEO Total Compensation), MRK-ASC0000314; see also 3/30/01 Merck Proxy Statement, at 15-18 (describing CEO cash and equity compensation amounts).

<sup>15</sup> 3/16/00 Merck Proxy Statement, at 11.

<sup>16</sup> 2/17/99 memorandum from M. McDonald to Compensation and Benefits Committee, MRK-ASC0000232, at 32; see also 2/16/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000284, at 84; 2/21/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000306, at 06; 2/20/02 memorandum from

Mr. Gilmartin exercised discretion in recommending merit and competitive salary increases for his direct reports.<sup>18</sup> In 2005, for example, Mr. Gilmartin recommended that executives compensated below market should receive a 5-to-10% increase and those compensated at or above market should receive a 3-to-4% increase in base salary, with additional consideration for individual performance.<sup>19</sup>

ii. Annual bonus.

During the relevant period, Merck executives received an annual discretionary bonus out of a bonus pool authorized by the 1996 shareholder-approved Executive Incentive Plan.<sup>20</sup> All Section 16 officers and a select group of other senior management

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W. Yarno to Compensation and Benefits Committee, MRK-ASC0000331, at 31-32; 2/19/03 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000427, at 27; 2/18/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000511, at 11.

<sup>17</sup> See 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000565, at 65; see also 2/21/96 memorandum from R. Gilmartin to Compensation and Benefits Committee, MRK-ASC00000003, at 03 (discussing Mr. Gilmartin's determinations for the base salary, bonuses, and stock options for his direct reports: "On base salaries we consider two sources: general industry information from the HAY Associates Executive Survey and pharmaceutical industry information on our leading healthcare group. A competitive position at the median of the pharmaceutical survey and the 75<sup>th</sup> percentile of HAY would be our benchmark. For total cash (base plus bonus) our competitive position should be at about the 75<sup>th</sup> percentile of the pharmaceutical industry. For total direct compensation (base plus bonus and a hypothetical value of the annual stock option grant) above the 75<sup>th</sup> percentile would be appropriate.").

<sup>18</sup> See, e.g., 2/16/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000284, at 84; 2/21/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000306, at 06; 2/20/02 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000331, at 31-32; 2/19/03 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000427, at 27; 2/18/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000511, at 11.

<sup>19</sup> See 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000565, at 65.

<sup>20</sup> Merck Executive Incentive Plan (As Amended Effective Feb. 27, 1996), <http://sec.gov/Archives/edgar/data/64978/0000950130-96-000896.txt>.

employees were eligible for participation in the Executive Incentive Plan.<sup>21</sup> The Executive Incentive Plan, which was administered by the Compensation Committee, authorized the Committee to set a total bonus pool of no more than 2.5% of the Company's net income (an amount set for tax-related reasons).<sup>22</sup> The Compensation Committee had authority to award less than the full allotment and routinely rewarded bonuses totaling far less than the maximum authorized under the Executive Incentive Plan.<sup>23</sup>

Each year, the actual executive bonus pool was calculated by adding up all participants' salaries and multiplying that sum by a factor determined annually on the basis of Company performance as measured by the Company Performance Grid. Out of

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<sup>21</sup> Merck Executive Incentive Plan (As Amended Effective Feb. 27, 1996), at 1-2, <http://sec.gov/Archives/edgar/data/64978/0000950130-96-000896.txt>; see also 11/17/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-AQD0001031, at 31, 34 (nominating 16 participants for Executive Incentive Plan in 2005); 11/17/99 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000280-81 (recommendation for 17 participants in 2000 Executive Incentive Plan to comprise all Grade 1 employees (12) and other executives who were Section 16 officers (5)); 2/21/01 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000302, at 02-03 (listing Executive Incentive Plan participants for 2001 as approved by Compensation Committee).

<sup>22</sup> Merck Executive Incentive Plan (As Amended Effective Feb. 27, 1996), at 2, <http://sec.gov/Archives/edgar/data/64978/0000950130-96-000896.txt>. Net income was defined by the Executive Incentive Plan as "the amount reported by the Company as consolidated income before extraordinary items and the cumulative effect of accounting changes, adjusted, however, by adding any amount which has been expensed (after taxes) for awards under the Plan in computing such Net Income." *Id.* at 1.

<sup>23</sup> See, e.g., 2/24/04 Compensation and Benefits Committee Annotated Meeting Agenda, MRK-AQD0000944, at 44 ("Company controller confirms that recommended bonuses under [the Executive Incentive Plan] within (i.e., under) the [Executive Incentive Plan] Award Fund that is set for purposes of the IRS's '1\$ million cap.' This relates to the tax deductibility of compensation paid to certain key employees. According to its terms, the [Executive Incentive Plan] formally provides for an Award Fund equal to 2.5% of net income."); 11/17/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-AQD0001029-30 (estimating total Executive Incentive Plan award for 2004 at approximately \$8 million).

that pool, individual executive bonuses were allotted based on factors including Division and individual performance.<sup>24</sup> The two primary factors in the Compensation Committee's calculation of the three components of annual executive bonuses – Company Performance and Division Performance – are described more fully below.

(a) Company-wide performance  
component of executive bonuses.

Company performance was measured annually pursuant to criteria set forth in a Company Performance Grid developed by the Finance Department and approved by the Compensation Committee.<sup>25</sup> The Grid included both quantitative and qualitative factors used to measure the Company's financial success, such as top-line growth and overall profitability as well as strategic performance.<sup>26</sup>

Each component in the Company Performance Grid was assigned a numeric value, which in the period 1997 to 2002 resulted in a maximum score of 100 points.<sup>27</sup> As discussed more fully below, the Finance Department was responsible for calculating the

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<sup>24</sup> 3/16/00 Merck Proxy Statement, at 10.

<sup>25</sup> See, e.g., 2/24/98 Proposed Company Performance Grid for 1998 presentation, MRK-ARJ0000546-53; Minutes of 2/24/98 Compensation and Benefits Committee meeting, MRK-AQD0000232, at 32 (noting that Committee discussed and approved 1998 Grid); Minutes of 2/25/03 Compensation and Benefits Committee meeting, MRK-AQD0000751, at 51 (same for 2003 grid).

<sup>26</sup> See Proposed Company Performance Grid for 2004, MRK-ASC0000505. The Company Performance Grids were also used by the Management Committee to facilitate profit planning as well as developing the annual P&L.

<sup>27</sup> See, e.g., Proposed Company Performance Grid for 1997, MRK-ARJ0000530, at 30; Minutes of 2/25/97 Compensation and Benefits Committee meeting, MRK-AQD0000099, at 99 (noting shift in maximum grid score from 300 points to 100 points); Minutes of 2/25/03 Compensation and Benefits Committee meeting, MRK-AQD0000751, at 51 (noting shift in maximum grid score from 100 points to 120 points).

Company Performance Grid score, which was then subject to the approval of the Compensation Committee. If the final Company Performance Grid score was 90 to 100 points, a score considered “exceptional” or “EX,”<sup>28</sup> a pre-established multiple for the 90 to 100 point range, was used in calculating bonuses. If the final Company Performance Grid score was 80 to 89 points, a score considered “with distinction” or “WD,” the pre-established multiple for that range was used, and so forth.<sup>29</sup>

In 2002, the maximum grid points were increased from 100 to 120,<sup>30</sup> but this change was more cosmetic than substantive. Under the new point allotment, achieving a grid score of 100 was considered “on plan” performance (as opposed to 80 points in previous years).<sup>31</sup> Therefore, 50% of the total available points were still comprised of operational measures, such as earnings per share, sales and return on operating assets. The 2004 Company Performance Grid is reproduced below.<sup>32</sup>

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<sup>28</sup> “Excellent” and “Exceptional” are used interchangeably for the EX rating. See, e.g., 11/20/96 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000063 (EX stands for “Excellent”); 2/19/97 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000073, at 73 (EX stands for “Exceptional”).

<sup>29</sup> See, e.g., Proposed Company Performance Grid for 1996, MRK-ASC0000026, at 26; 11/20/96 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000063 (explaining that RI stands for “Room for Improvement,” HS for “High Merck Standard,” WD for “With Distinction,” and EX for “Excellent”); Executive Incentive Plan Estimated Award Fund for Award Year 2004, MRK-AQD0001030 (showing proposed awards for participants in the Executive Incentive Plan depending on number of points awarded pursuant to the 2004 grid); Minutes of 11/26/96 Compensation and Benefits Committee meeting, MRK-AQD0000037, at 37 (proposed Company rating of “Exceptional” would generate award fund of 106.3% of total reference salaries (\$7,715,400) for those under Executive Incentive Plan).

<sup>30</sup> Proposed Company Performance Grid for 2003, MRK-ASC0000420, at 20.

<sup>31</sup> See Proposed Company Performance Grid for 1996, MRK-ASC0000026, at 26 (80 out of 100 points, or 80%, must be achieved for on plan or “with distinction” performance).

<sup>32</sup> See 2004 Company Performance Grid – Projected Scoring, MRK-AQD0001007.

## 2004 Company Performance Grid – Projected Scoring

	2004 Above Target Performance	2004 Target Performance	Plan Results	Plan Score	Estimated Results	Points Achieved
<b><u>TOP TIER GROWTH COMPANY</u></b>						
<i>Current Year Operating Performance</i>	<u>66</u>	<u>55</u>		<u>53.4</u>		<u>46.5</u>
EPS Growth vs. Healthcare Companies	42	35	Rank 8th	32.2	Rank 9th	30.8
Sales Growth vs. Healthcare Companies	12	10	Rank 8th	9.2	Rank 10th	8.4
Return on Operating Assets	12	10	+2.4% vs 2003	12.0	-2.7% vs 2003	7.3
<b><u>PRESERVING OUR CORE BUSINESS PROFITABILITY</u></b>						
<i>Manufacturing Productivity</i>	<u>12</u>	<u>10</u>	55% of Infl.	<u>7.8</u>	103% of Infl.	<u>12.0</u>
<i>Operational Excellence</i>	<u>6</u>	<u>5</u>		<u>5.0</u>		<u>3.1</u>
<b><u>BUILDING ON THE CORNERSTONE OF RESEARCH</u></b>						
<i>Integrated Scientific Objectives</i>	<u>18</u>	<u>15</u>		<u>15.0</u>		<u>16.4</u>
<i>MRL Planning Model</i>	<u>6</u>	<u>5</u>		<u>5.0</u>		<u>4.7</u>
<b>TOTAL (excluding HR Initiatives)</b>	<b><u>108</u></b>	<b><u>90</u></b>		<b><u>86.2</u></b>		<b><u>82.7</u></b>
<b><u>BUILDING TALENT, ORGANIZATIONAL CAPABILITY AND AN EFFECTIVE WORK ENVIRONMENT</u></b>						
<i>Achievements in Building Talent &amp; Organizational Capability</i>	<u>6</u>	<u>5</u>		<u>5.0</u>		<u>5.8</u>
<i>Improvements in Diversity and Work Environment</i>	<u>6</u>	<u>5</u>		<u>5.0</u>		<u>5.0</u>
<b>TOTAL COMPANY PERFORMANCE</b>	<b><u>120</u></b>	<b><u>100</u></b>		<b><u>96.2</u></b>		<b><u>93.5</u></b>

(i) Components of Company Performance Grid score.

The overwhelming majority of the Company Performance Grid score – 90 of 100 points in the 1997 to 2002 period – was assigned to operating and strategic quantitative measures, as described below.<sup>33</sup>

(A) Operating measures.

The operating measures, worth half of the overall Company Performance Grid score, included: (i) earnings per share growth versus other leading healthcare companies; (ii) sales growth versus other leading healthcare companies; and (iii) return on investment

<sup>33</sup> See, e.g., Proposed Company Performance Grid for 2002, MRK-ASC0000324, at 25 (showing proportionate use of same core measures and outlining differences between 2001 and 2002 grids).

in operating assets.<sup>34</sup> For purposes of the Company Performance Grids, Merck's earnings per share and sales growth metrics were analyzed in comparison to the performance of its competitors.<sup>35</sup>

Of the three operating measures, growth in earnings per share was the most significant metric in the Company Performance Grid, initially assigned a maximum of 30 points out of 100.<sup>36</sup> The emphasis placed on earnings per share reflected the Compensation Committee's view that the Company's performance should be measured based on overall Company profitability and growth as the best drivers of shareholder value.

In February 2004, approximately seven months before the voluntary withdrawal of Vioxx, the Company proposed and the Compensation Committee approved the decision to increase the weight accorded the earnings per share metric from 30 to 35 points in order to further amplify the importance of Company profitability.<sup>37</sup> In 2000, Merck ranked 3<sup>rd</sup> in earnings per share growth versus its peers, resulting in a score of 28

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<sup>34</sup> 1999 Performance Summary, MRK-AQD0000375, at 76, 78; see also 2000 Performance Summary, MRK-AQD0000452, at 54. "Earnings Per Share growth [worth a possible 30 points on the grid] in comparison to analysts' consensus of leading healthcare companies [was] the most significant measure used to evaluate current year operating performance." 2000 Performance Summary, MRK-AQD0000452, at 55, 61-62; Proposed Company Performance Grid for 2000, MRK-ARJ0000845-871. Because the annual summaries key off of the Performance Grid but provide more detail, citations herein are to the 2000 Performance Summary rather than to that year's grid.

<sup>35</sup> Throughout the relevant period, the leading U.S.-based pharmaceutical companies against which Merck's performance was generally measured included (with changes made to reflect mergers or significant corporate occurrences) Abbott Laboratories, AstraZeneca, Bristol-Myers Squibb, Johnson & Johnson, Eli Lilly, GlaxoSmithKline, Pfizer, Pharmacia, Schering-Plough, Wyeth, and Warner Lambert. See generally 3/22/01 Merck Proxy Statement, at 14; 3/9/04 Merck Proxy Statement, at 20.

<sup>36</sup> See Proposed Company Performance Grid for 2002, MRK-ASC0000324, at 28.

<sup>37</sup> See Minutes of 2/24/04 Compensation and Benefits Committee meeting, MRK-AQD0000955, at 55.

out of a possible 30 points.<sup>38</sup> However, in 2004, after the withdrawal of Vioxx, the Company ranked 9<sup>th</sup> in its peer group in earnings per share growth, resulting in a score of 30.8 points out of a possible 35 points.<sup>39</sup>

The second operating measure in the Company Performance Grid, sales growth versus other leading healthcare companies, is the factor most directly linked to the success or failure of a particular product. The sales growth metric accounts for top-line growth without reflecting expenses or other costs. The Company consistently allotted this metric 10 out of the possible 100 points in the Company Performance grid.<sup>40</sup>

The Company Performance Grid for 1999 listed the successful launch of Vioxx, along with volume gains in the sale of Zocor, Prinivil and several other products, as contributing to sales growth.<sup>41</sup> Relative to its peers, the Company estimated that its sales would rank in the top quartile, which translated into a grid score of 9.7 out of 10 for sales growth.<sup>42</sup> The Company gave itself the same score in 2000, noting that “Vioxx, which is exceeding 2000 Plan expectations, is the most significant product driving Sales

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<sup>38</sup> See 2000 Performance Summary, MRK-AQD0000452, at 56, 62; see also Proposed Company Performance Grid for 2002, MRK-ASC0000324, at 28 (explaining ranking system for 2002 grid).

<sup>39</sup> 2004 Company Performance Grid, MRK-AQD0001003, at 08.

<sup>40</sup> See, e.g., 1999 Performance Summary, MRK-AQD0000375, at 78; 2000 Performance Summary, MRK-AQD0000452, at 55; 2001 Performance Summary, MRK-ADQ0000571, at 74; 2002 Performance Summary, MRK-ADQ0000679, at 85; 2003 Performance Summary, MRK-ADQ0000900, at 05; 2004 Company Grid, MRK-AQD0001003, at 07.

<sup>41</sup> “The Human Pharmaceutical Sales growth for 1999 is projected to benefit from a strong performance in the U.S. The successful launch of Vioxx along with volume gains of established major products (*Zocor* and *Prinivil*), contribution from newer products (*Fosamax*, *Cozaar*, *Hyzaar*, *Comvax*, and *Varivax*) and the benefit from the 1998 launches (*Singulair*, *Propecia*, *Maxalt*, *Cosopt* and *Aggrastat*) drove the Sales increase.” 1999 Performance Summary, MRK-AQD0000375, at 81.

<sup>42</sup> 1999 Performance Summary, MRK-AQD0000375, at 79.

growth.”<sup>43</sup> In 2001, five products (including Vioxx) were projected to account for 65% of sales.<sup>44</sup> However, even with healthy sales growth, Merck ranked 8<sup>th</sup> relative to its peers and therefore received a grid score of 7.3 out of 10. In 2002, the Company’s key franchises (which included Vioxx) accounted for 72% of total sales but the Company remained in 8<sup>th</sup> place in sales growth relative to its peers, resulting in a grid score for sales growth of 7.7 out of 10.<sup>45</sup> In 2004, after the withdrawal of Vioxx, the Company ranked 10<sup>th</sup> in sales growth and received a score of 7.3.<sup>46</sup>

The third operating measure reflected in the Company Performance Grid, return on operating assets, measured the Company’s profitability by reviewing annual changes in the Company’s return on operating assets divided by the cost of capital. The Company also allocated to this component 10 points out of the possible 100 in the Company Performance Grid, which effectively gave return on investment the same weight as the sales growth metric.<sup>47</sup>

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<sup>43</sup> 2000 Performance Summary, MRK-AQD0000452, at 58.

<sup>44</sup> “The Human Health Sales growth for 2001 (+12%, excluding a 3 point unfavorable effect from exchange) is projected to benefit from strong worldwide volume growth led by the Company’s key products (*Zocor*, *Vioxx*, *Fosamax*, *Singulair* and *Cozaar/Hyzaar*) which are expected to account for 65% of Human Health Sales, versus 56% in 2000.” 2001 Performance Summary, MRK-AQD0000571, at 77.

<sup>45</sup> 2002 Performance Summary, MRK-AQD0000679, at 85-86, 92.

<sup>46</sup> 2004 Company Performance Grid, MRK-AQD0001003, at 08.

<sup>47</sup> See, e.g., 1999 Performance Summary, MRK-AQD0000375, at 78; 2000 Performance Summary, MRK-AQD0000452, at 55; 2001 Performance Summary, MRK-ADQ0000571, at 74; 2002 Performance Summary, MRK-ADQ0000679, at 85; 2003 Performance Summary, MRK-ADQ0000900, at 05; 2004 Company Grid, MRK-AQD0001003, at 07.

(B) Strategic measures.

The Company consistently allotted 40 points out of 100 possible Company Performance Grid points to strategic measures. While the underlying measures changed based on the Company's focus, they generally reflected the Company's progress with research and development initiatives and strategic initiatives.

The research and development component of this metric –which evaluates MRL's performance – analyzed both the status of products in the pipeline and the Company's overall portfolio development. Throughout the relevant period, the research and development component of the grid was allocated 20 out of 100 possible points.<sup>48</sup> Specifically, MRL was assessed on its: (i) "Objectives for Development," defined as "Accomplishments against planned objectives (completing studies, analyses, clinical programs, approval filings etc.) for target compounds in the development phases of research"; (ii) "Objectives for Basic Research," defined as "Accomplishments against planned objectives for obtaining Safety Assessment candidates for specific classes of compounds in Basic Research"; (iii) "Planning Model Results," defined as "Annual change in the projected portfolio value (risk adjusted NPV of all products, new and inline, being evaluated by the planning model..."; and (iv) "Originated New Product Flow," defined as "new compounds."<sup>49</sup>

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<sup>48</sup> See, e.g., 1999 Performance Summary, MRK-AQD0000374, at 78; 2000 Performance Summary, MRK-AQD0000451, at 55; 2001 Performance Summary, MRK-AQD0000570, at 74; 2002 Performance Summary, MRK-AQD0000679, at 85; 2003 Performance Summary, MRK-AQD0000899, at 05; 2004 Company Grid, MRK-AQD0001003, at 07.

<sup>49</sup> 1998 Proposed Company Performance Grid, MRK-ASC0000105, at 12; 1999 Proposed Company Performance Grid, MRK-ASC0000203, at 10; 2002 Proposed Company Performance Grid,

(C) Other measures.

The 10 remaining points on the Company Performance Grid were “qualitatively evaluated based on Human Resource accomplishments in work environment and individual competencies.”<sup>50</sup> This Human Resource metric assessed the Company’s ability to obtain and retain human capital, diversity initiatives, and Merck’s general work environment,<sup>51</sup> and was filled out by the Human Resources Department.

(ii) Implementation of the Company  
Performance Grid.

At the end of each year, members of the Management Committee prepared a comprehensive summary of Merck’s performance and proposed a Company Performance Grid score. The summary and proposed score were based on information supplied by the Management Committee and were presented to the Compensation and Benefits Committee, typically by Mr. Gilmartin or Chief Financial Officer Judy Lewent, for the Compensation Committee’s approval.<sup>52</sup> As explained above, the total number of points scored on the Company Performance Grid was used to determine the size of that year’s executive bonus pool. The summaries, developed based on input from Management

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MRK-ASC0000324, at 29 (omitting the “Originated New Product Flow” criteria); 2003 Proposed Company Performance Grid, MRK-ASC0000420, at 26 (same); 2004 Proposed Company Performance Grid, MRK-ASC0000505, at 10 (same).

<sup>50</sup> 2000 Performance Summary, MRK-AQD0000451, at 54.

<sup>51</sup> 2004 Company Performance Grid, MRK-AQD0001003, at 08.

<sup>52</sup> See, e.g., Minutes of 11/26/96 Compensation and Benefits Committee meeting, MRK-AQD0000037, at 37; Minutes of 11/23/99 Compensation and Benefits Committee meeting, MRK-AQD0000365 (Ms. Lewent presenting the results).

Committee members regarding their Divisions, were subject to approval by the  
Compensation Committee.

The proposed Performance Grid scores resulting from this process for the years  
2000 to 2004 are set forth below.

Company Performance Grid Scores: 2000-2004

<b>Year</b>	<b>Score</b>	<b>Total Possible Points</b>
2000	90.7 <sup>53</sup>	100
2001	81.2 <sup>54</sup>	100
2002	74.3 <sup>55</sup>	100
2003	85.2 <sup>56</sup>	120
2004	93.5 <sup>57</sup>	120

The Compensation Committee approved the proposed Company Grid score for all  
of the above-mentioned years except 2003, when it reduced the proposed Company Grid  
score by three points based on the performance of MRL after reviewing the MRL  
Division Performance Grid.<sup>58</sup> The decision to lower the score reflected the

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<sup>53</sup> 2000 Performance Summary, MRK-AQD0000451, at 55.

<sup>54</sup> 2001 Performance Summary, MRK-AQD0000570, at 73.

<sup>55</sup> 2002 Performance Summary, MRK-ADQ0000678, at 84.

<sup>56</sup> 2003 Performance Summary, MRK-ADQ0000899, at 05.

<sup>57</sup> 2004 Company Performance Grid, MRK-AQD0001003, at 08.

<sup>58</sup> Minutes of 11/28/00 Compensation and Benefits Committee meeting, MRK-AQD0000491, at 91 (approving proposed score); Minutes of 11/27/01 Compensation and Benefits Committee meeting, MRK-AQD0000601, at 01 (same); Minutes of 11/26/02 Compensation and Benefits Committee meeting, MRK-AQD0000666, at 66 (same); Minutes of 11/23/04 Compensation and Benefits Committee meeting, MRK-AQD0001040, at 40 (same); but see Minutes of 11/25/03 Compensation and Benefits Committee meeting, MRK-AQD0000933, at 33 (Compensation Committee reviewed proposed Company grid score of 85 and reduced it by three points to 82 based on performance of MRL after reviewing MRL Performance Grid).

Compensation Committee's desire to emphasize the importance of research and development in the overall grid assessment.

The decision to voluntarily withdraw Vioxx from the market in 2004 was an unprecedented event in Merck history. With regard to compensation, the Compensation Committee and ultimately the entire Board<sup>59</sup> decided that the impact of the withdrawal, which was unforeseen, should be borne primarily by senior management of the Company as opposed employees at the lower levels of management and beyond.<sup>60</sup> The resulting estimated Company Grid score of 93.5 (out of 100 plan points and 120 above target points) reflected the fact that there were no fourth-quarter Vioxx earnings due to the withdrawal, which caused an 11-point reduction in the overall score.<sup>61</sup> The Compensation Committee did not make any upward adjustment to the Company Performance Grid or the earnings per share metric to account for these unprecedented circumstances.<sup>62</sup> As a result, the Executive Incentive Plan bonus pool for 2004 was smaller and a lower proportion of performance share units were awarded.<sup>63</sup> Accordingly,

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<sup>59</sup> 3/9/06 Merck Proxy Statement, at 23, MRK-CIC00095, at 122.

<sup>60</sup> "The general principles agreed to were that higher level employees should feel a greater negative impact than lower level employees and that the integrity of the pay for performance system must be maintained." Minutes of 10/15/04 Compensation and Benefits Committee meeting, MRK-AQD0000979, at 80.

<sup>61</sup> 2004 Company Performance Grid, MRK-AQD0001003, at 08.

<sup>62</sup> 3/10/05 Merck Proxy Statement, at 21-23.

<sup>63</sup> 3/10/05 Merck Proxy Statement, at 21-23; 3/9/06 Merck Proxy Statement, at 22-23, MRK-CIC00095, at 121-22.

Merck executive compensation for 2004 was far below the target compensation level for peer companies.<sup>64</sup>

For the year following the withdrawal of Vioxx, the Company changed the method of calculating the earnings per share and sales growth metrics. Rather than assess itself against its peers, the Company assessed earnings per share and sales growth against its planned performance for that fiscal year.<sup>65</sup> This was done in order to mitigate the effect of the withdrawal on compensation and create employee incentives for performance for the 2005 fiscal year. This change resulted in a 2005 Company Performance Grid score of 107.4 points of a possible 120 points.<sup>66</sup>

(b) Individual performance component and assessment of executive bonuses.

The majority of the members of the Management Committee served as the Presidents of the various Company Divisions. The individual performance component of their bonus was not calculated on the basis of a Personal Performance Grid, but instead, was based on their Division's performance as reflected in the Division Performance Grid score and on the Company Grid score, with each score weighted equally. The resulting

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<sup>64</sup> See 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000565, at 65-66 (stating that the Executive Incentive Plan bonus pool for 2004 was calculated using the 93.5 Company Performance Grid score and that Mr. Gilmartin's recommended individual bonus awards are "below both target levels and levels that would result from the 2004 grid scores (Company/Division) for all Management Committee members."); Minutes of 10/26/04 Compensation and Benefits Committee meeting, MRK-AQD0001000, at 00.

<sup>65</sup> Minutes of 11/22/05 Compensation and Benefits Committee meeting, MRK-AQD0001070, at 70 (stating that 2005 performance grid results "were based on the previously approved change, only for 2005, to compare the financial results versus Plan (not the Leading Healthcare Companies) due to the voluntary withdrawal of Vioxx.").

<sup>66</sup> Minutes of 11/22/05 Compensation and Benefits Committee meeting, MRK-AQD0001070, at 70.

number was then used to determine the percentage of the relevant executive officer's base salary to be given as the annual bonus under the Executive Incentive Plan. Both the Chief Executive Officer and the Compensation Committee, however, had the discretion to alter the bonus amount.<sup>67</sup>

(c) Division performance component of executive bonuses.

As noted above, another factor in determining executive bonuses were Division Performance Grids, which were prepared annually for all Company Divisions (e.g., United States Human Health, Merck Research Laboratories, Public Affairs, etc.) and used in assessing both Division and, in the aggregate, Company-wide performance.<sup>68</sup> Division Performance Grids were used prospectively to set Division achievement goals for the coming year and retrospectively to measure past performance.

During annual Management Committee meetings, each Division's Grid was reviewed by the Chief Executive Officer and members of the Management Committee, which was comprised of the various Division Presidents. Prior to the Management Committee meeting, the Division Grid scores were reviewed and validated by a member of the Finance Department.

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<sup>67</sup> See, e.g., 2/16/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000284, at 84; 2/21/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000306, at 06; 2/20/02 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000331, at 31; 2/19/03 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000427, at 27; 2/18/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000511, at 11.

<sup>68</sup> See, e.g., 2000 USHH Performance Grid, MRK-ARJ0002701-22; 2000 MRL Performance Grid, MRK-ARJ0002922-56.

The MRL Division Grid score was used to determine the 20 points assigned to the research and development portion of the Company Performance Grid.<sup>69</sup> The remaining Division Grid scores, however, were not directly mapped into the Company Performance Grid score (which, as described above, used the earnings per share, sales growth and return on investment in operating assets metrics to measure operating performance) but instead provided a more granular review of the Company's progress.

The majority of the Division Performance Grids, including that for United States Human Health, used a scoring system parallel to that used in the Company Performance Grid, evaluating operating performance (50 plan points), strategic performance (40 plan points), and human resource performance (10 plan points). The Division Grid scores for MRL and United States Human Health for the relevant period are discussed below.

(i) Merck Research Laboratories Division.

The MRL Division Grid was divided among product development objectives, the MRL Planning Model, and Human Resources measures.<sup>70</sup> Product development evaluated research and preclinical product development, early product development, late product development and licensing, and was worth 70 of the 100 plan points. The MRL Planning Model measured the Net Present Value ("NPV") of the Company's new product portfolio and was assigned 10 points. Finally, the Human Resources measure was

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<sup>69</sup> See, e.g., 1999 Performance Summary, MRK-AQD0000374, at 378, 401-03.

<sup>70</sup> 2004 MRL Performance Grid, MRK-ARJ0005284, at 84; 2000 MRL Performance Grid, MRK-ARJ0002921, at 23.

assigned 10 points.<sup>71</sup> The remaining 10 points were divided between the operating expenses versus profit plan metric (2 points), external recognition metric (1 point), and operational excellence metric (7 points).<sup>72</sup> In 2000, though MRL met all of its milestones with regard to the development of Vioxx, as reflected in the portion of MRL's 2000 Grid excerpted below,<sup>73</sup> its overall Grid score was 86.6 out of 100 plan points, reflecting unmet objectives in other therapeutic areas.<sup>74</sup>

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<sup>71</sup> See, e.g., 2004 MRL Performance Grid, MRK-ARJ0005284, at 84.

<sup>72</sup> See, e.g., 2004 MRL Performance Grid, MRK-ARJ0005284, at 84. In 2000, the point allotments were slightly different. Development and basic research were assigned 60 points, the MRL Planning Model was assigned 17 points, and MRL New Product Flow was assigned 10 points. 2000 MRL Performance Grid, MRK-ARJ0002921, at 23.

<sup>73</sup> 2000 MRL Performance Grid, MRK-ARJ0002921, at 26. The 30 points assigned to Vioxx in this portion of the strategic grid does not represent 30 points in the overall MRL Grid allotment. Rather, it was merely a portion of the 40 points (out of 100) assigned to the Development metric.

<sup>74</sup> 2000 MRL Performance Grid, MRK-ARJ0002921, at 21, 26, 27-30.

**RESPIRATORY / ALLERGY / ANTI-INFLAMMATORY**

**VIOXX™ (MK-0966; COX-2 Inhibitor)**

**17.5 / 17.5**

The VIGOR Outcomes data was submitted in the US on 29-June-00. The international submission is targeted for 31-Oct-00 as a Type II variation.

The chronic low back pain (including analgesia) sNDA and EU sIMA is on target for submission in Dec-00.

The CSRs for the pivotal Phase III rheumatoid arthritis studies are on target for completion in Dec-00 to support the RA sWMA release T-1Q01.

Data from the competitive Celebrex dental pain comparison studies were available in Jun-00 as expected; however, the Project Team has decided not to report the data and no publications are planned.

LPOs in the competitive Celebrex OA trials were achieved in Sept-00, and data from the studies will be available in 4Q.

The JNDA for osteoarthritis and dental pain will not be filed in 2000 as originally planned, since the data from the Phase IIb OA bridging study showed no meaningful differences between treatment groups and additional studies are required. The current overall strategy is to file the JNDA for OA, RA, and post-operative dental pain in 2Q02.

Two post-operative dental pain studies were conducted with Tylenol-3 (with codeine). LPOs were achieved in Aug-00. The data, demonstrating that VIOXX significantly reduced moderate to severe acute pain, were presented to the American Pain Society in early Nov-00.

(ii) United States Human Health Division.

In 1998, prior to the launch of Vioxx, United States Human Health's Division Grid score was estimated to be 76.4 out of a possible 100 points. Its operating performance score was estimated as 30 out of 50, representing +7.0% sales growth and +4.2% in operating income, with a strategic performance score of 37 out of 40.<sup>75</sup>

In 1999, however, directly following the launch of Vioxx, United States Human Health's Division Grid score rose to 92.9 out of 100 points. In its Division Performance Grid for that year United States Human Health attributed its performance to "the very successful launch of VIOXX, growth in SINGULAIR coupled with other recently

<sup>75</sup> 1998 USHH Performance Grid, MRK-ARJ0001976, at 977.

launched products, as well as continued growth of ZOCOR, FOSAMAX,  
PRINIVIL/PRINZIDE, and COZAAR/HYZZAR.”<sup>76</sup>

In 2000, after Vioxx was successfully launched and firmly established as a leader in the arthritis and analgesia market, the Division Grid Score for United States Human Health Division rose again to 95.4 out of 100 possible points. In that year, United States Human Health experienced net sales growth of +23 % and +19% growth in operating income, resulting in a score of 50 out of 50 possible points for operating performance.<sup>77</sup> The Division Performance Grid noted that for operating performance, “[United States Human Health] 2000 Sales and [Operating Income] performance are driven by strong Vioxx® sales, along with continued growth of Zocor®, Fosamax®, Singulair®, Cozaar®/Hyzaar®, and Maxalt®.”<sup>78</sup>

With respect to the strategic performance component of the United States Human Health Division Performance Grid, 4 out of 40 points were directly tied to the goal of expanding Vioxx sales.<sup>79</sup> As demonstrated by the portion of the summary reproduced below, the United States Human Health Division Grid identified two relevant goals for

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<sup>76</sup> 1999 USHH Performance Grid, MRK-ARJ0002255, at 257, 261. A memorandum reporting on USHH’s 1999 performance grid noted: “By all indications, the launch of VIOXX® has been Merck’s most successful product to date. VIOXX® has become the third most successful product launch in the pharmaceutical industry.” 10/27/99 memorandum from C. McKines to B. Brown, MRK-AFI0263909, at 09.

<sup>77</sup> 2000 USHH Performance Grid, MRK-ARJ0002701, at 03.

<sup>78</sup> 2000 USHH Performance Grid, MRK-ARJ0002701, at 01-01.

<sup>79</sup> 2000 USHH Performance Grid, MRK-ARJ0002701, at 03-04. In 2001, one point was deducted from the USHH Performance Grid on account of the Company’s receipt of the September 17, 2001 Warning Letter discussed in detail in Appendix G. 2001 USHH Performance Grid, MRK-ARJ0003154, at 55-56.

the year 2000: (i) surpassing Celebrex in national prescription share in the Coxib market by May 2000 (while continuing to grow Vioxx share in the arthritis and analgesia market); and (ii) achieving 13.3% of the national monthly arthritis and analgesia prescription share by the end of September 2000. The first goal was not met, while the second goal was achieved. Therefore, two of four potential points tied to the franchise for the grid were awarded.<sup>80</sup>

## STRATEGIC PERFORMANCE

### FIVE KEY FRANCHISES (Total Points: 14)

- **GROW VIOXX®** - Surpass Celebrex NRx share in the COXIB market by end of May 2000, while continuing to grow Vioxx® share in the A&A market.

Specific Measures

- (a) Surpass NRx share in COXIB market by the end of May 2000 (monthly Rx data).

	<u>&lt;RI</u>	<u>RI</u>	<u>HS</u>	<u>WD</u>	<u>EX</u>
Timing	>8/00	8/00	7/00	6/00	5/00
Points	<1.4	1.4	1.6	1.8	2.0

Result: As of November 15, Vioxx® has not achieved 50% of the NRx share in the Coxib market (0 points).

- (b) Achieve monthly NRx exit share of 13.3% in the A&A market by the end of September 2000.

	<u>&lt;RI</u>	<u>RI</u>	<u>HS</u>	<u>WD</u>	<u>EX</u>
NRx Market Share (%)	<11.3%	11.3%	12.3%	13.3%	>13.3%
Points	<1.4	1.4	1.6	1.8	2.0

Result: NRx A&A share for Vioxx® in September was 16.5% (2.0 points)

<sup>80</sup> 2000 USHH Performance Grid, MRK-ARJ0002701, at 04. "Excellent" and "Exceptional" are used interchangeably for the EX rating. See, e.g., 11/20/96 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000063 (EX stands for "Excellent"); 2/19/97 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000073, at 73 (EX stands for "Exceptional"). RI stands for "Room for Improvement," HS for "High Merck Standard," and WD for "With Distinction." See Proposed Company Performance Grid for 1996, MRK-ASC0000026, at 26; 11/20/96 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000063.

The strategic performance measure also assigned four points to the Company's success in growing and defending Zocor's market share and a total of six points for its success in growing and defending the market share of a number of other key products, including Fosamax, Singulair, and Cozaar/Hyzaar.<sup>81</sup>

In 2004, after Vioxx was withdrawn from the market, the United States Human Health Division scored 85.3 out of 100 plan points and 120 total points on its Division Performance Grid.<sup>82</sup> The United States Human Health Division projected 12% growth in Operating Income for 2004, "adjusted for the effects of the Vioxx® withdrawal and delay in Arcoxia® launch versus Plan growth of 21%. As a result, Operating Performance is scored at 34.3 out of 50 Plan points or 69%."<sup>83</sup> United States Human Health proposed a score of 40 out of 40 for strategic measures.<sup>84</sup>

iii. Equity.

During the marketing and development of Vioxx, the third component of executive compensation took the form of equity grants. Throughout, executives were granted stock options, and later were given restricted stock and performance share units. As discussed below, executive officers were encouraged to hold Merck common stock.

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<sup>81</sup> 2000 USHH Performance Grid, MRK-ARJ0002701, at 04-06.

<sup>82</sup> 2004 USHH Performance Grid, MRK-ARJ0004854, at 54, 56.

<sup>83</sup> 2004 USHH Performance Grid, MRK-ARJ0004854, at 54.

<sup>84</sup> 2004 USHH Performance Grid, MRK-ARJ0004854, at 54.

A series of shareholder-approved Incentive Stock Plans administered by the Compensation Committee governed Merck's equity incentive program.<sup>85</sup> The Incentive Stock Plans administered by the Compensation Committee also governed non-executive officer equity awards; therefore, the general tenets described below apply to all eligible employees. To the extent that certain programs were targeted solely at non-executive officer employees, they will be discussed in Section B.4.c of this Appendix. The use of stock options, performance share units and restricted share units, as well as Merck's policy of encouraging executives to hold Merck common stock, are described below.

(a) Stock options.

Stock options were required to have an exercise price equal to the fair market value of Merck stock on the date the option was granted.<sup>86</sup> Prior to 2002, annual and quarterly grants vested on a "cliff" basis (all at once) after five years. As of January 1, 2002, following a review of industry practice and a survey of employee preferences, the Compensation Committee modified the schedule so that granted options vested in equal installments on the first through third anniversaries of the grant. Stock options generally remained outstanding for ten years.<sup>87</sup>

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<sup>85</sup> See, e.g., 2001 Incentive Stock Plan (Form 10-Q filed on 8/10/00), at 01. Regular full-time and part-time employees, not merely executives, were eligible for participation in the Incentive Stock Plan. Id.; see also 1996 Incentive Stock Plan (Form 10-Q filed on 8/10/95), at 1.

<sup>86</sup> See, e.g., 2003 Incentive Stock Plan (Form 10-Q filed 8/13/03), at 3; 2001 Incentive Stock Plan (Form 10-Q filed on 8/10/00), at 2; 1996 Incentive Stock Plan (Form 10-Q filed on 8/10/95), at 2.

<sup>87</sup> Minutes of 10/23/01 Compensation and Benefits Committee meeting, MRK-AQD0000562, at 62.

(b) Performance share and restricted share units.

In 2003, the Compensation Committee approved, beginning in 2004, the substitution of performance share units and restricted stock units for a portion of stock options granted to senior management pursuant to the Company's long-term incentive compensation program.<sup>88</sup> In so doing, the Committee noted "a strong continuing trend among large U.S. companies to reduce stock options and increase other stock-based incentives such as performance shares and [restricted stock units]."<sup>89</sup>

A performance share unit was in effect a promise to grant a recipient one share of Merck common stock at a future date if certain pre-established performance goals were attained by that date. At the beginning of a three-year performance period, each recipient was allocated a specific number of "target" performance units. At the end of three years, the recipient would receive a number of shares of Merck stock equal to zero to 200% of the number of target units, depending on whether pre-specified Company performance criteria had been met as measured by earnings per share growth relative to Merck's peer healthcare companies over the relevant three years.<sup>90</sup>

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<sup>88</sup> 3/9/04 Merck Proxy Statement, at 21; see also 10/03 presentation, "Executive Compensation Review," MRK-ASC0000480, at 84 ("In July 2003, the Committee approved a two-vehicle LTI program comprising 75% stock options and 25% PSUs, based on value (under which 3 stock options = 1PSU).")

<sup>89</sup> Minutes of 11/25/03 Compensation and Benefits Committee meeting, MRK-AQD0000933, at 34.

<sup>90</sup> Minutes of 5/27/03 Compensation and Benefits Committee meeting, MRK-AQD0000817; 2/24/04 Merck's Long-Term Incentive Program: Aligning Company Performance and Senior Management Rewards, MRK-ARY0000089-90; Performance Share Unit Terms for Annual Grant Under the Merck & Co., Inc. 2004 Incentive Stock Plan, MRK-ARY0000093, at 93.

A restricted stock unit was a share of Merck stock that was conditionally granted to an employee but could be forfeited back to Merck if the recipient did not remain employed by the Company for a specified number of years (generally three). Unlike performance share units, payout (in the form of Merck unrestricted shares) depended solely on continued service and not on Company performance.<sup>91</sup>

(c) Allocation of various types of equity grants.

From 2004 forward, Merck's policy was to allocate long-term incentive grants among the three vehicles described above. "Based on value, 50% of the grant will continue to be in stock options, 25% will be in performance share units and 25% will be in restricted stock units."<sup>92</sup> In 2005, the Company began a Long-Term Incentive Election Program, which permitted all covered employees, including executives, to elect between different proportions of stock options and restricted share units. However, any employees eligible for performance share units were required to apportion 25% of their

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<sup>91</sup> 3/10/05 Merck Proxy Statement, at 21; 2/24/04 Merck's Long-Term Incentive Program: Aligning Company Performance and Senior Management Rewards, MRK-ARY0000089-90; Restricted Stock Unit Terms for Annual Grant Under the Merck & Co., Inc. 2004 Incentive Stock Plan, MRK-ARY0000092.

<sup>92</sup> 2/18/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000511, at 12.

equity awards to performance shares.<sup>93</sup> In 2005, the Company used a ratio of three stock options to one performance share unit.<sup>94</sup>

In order to retain key talent, in 2004, Merck began the Leader Shares Program, which awarded restricted stock units to select employees on the basis of their “leadership potential and future contributions in achieving critical business goals and objectives.”<sup>95</sup> According to a memorandum summarizing the highlights of the Leader Shares Program, “Only employees identified as high potential/promotable during the annual Succession Planning process [were] eligible for award consideration.”<sup>96</sup> Leader Shares awards were determined as a percentage of base salary and were converted into restricted stock units based on the average of the high and low stock price on the day of the grant. Awards vested on a three-year cliff basis.<sup>97</sup>

In 2004, Leader Share grants were awarded to approximately 50 employees.<sup>98</sup> In 2005, however, after the withdrawal of Vioxx, the Leader Shares Program was expanded

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<sup>93</sup> 3/9/06 Merck Proxy Statement, at 22, MRK-CIC000095, at 121; see also Minutes of 7/27/04 Compensation and Benefits Committee Meeting, MRK-AQD0000973, at 74 (“The Committee then considered ... the provision of choice so that employees in Grades 3 to 5 may ‘elect’ between LTI grants comprising of 100% stock options or a combination of stock options (75%) and restricted stock units (25%). Employees in Grades 1 and 2 would have a similar choice, except that at least 25% of their LTI grant (based on value) would be in performance share units.”).

<sup>94</sup> 3/10/05 Merck Proxy Statement, at 22. In 2006, the ratio was four options to one unit. 3/9/06 Merck Proxy Statement, at 23, MRK-CIC000095, at 122.

<sup>95</sup> Highlights of Leader Shares Program, MRK-ASJ0000003; Instructions for Completing the 2004 Leader Shares Program, MRK-ASJ0000004.

<sup>96</sup> Highlights of Leader Shares Program, MRK-ASJ0000003.

<sup>97</sup> Highlights of Leader Shares Program, MRK-ASJ0000003.

<sup>98</sup> As of March 2004, 25 employees are listed as receiving Leader Shares, including Dr. Kim who received the highest award of 15,000 shares. See List of grants of shares, MRK-ASI0000001.

and awards were given to approximately 300 employees, six of whom were executive officers<sup>99</sup>, to assist with retention efforts after withdrawal.<sup>100</sup> According to a memorandum from Management to the Compensation Committee, individual Leader Share awards for executives in 2005 were calculated based on employee “criticality to the future leadership of the Company and retention needs. Most critical = value based on 200% of annual base salary. Highly critical = value based on 150% of annual base salary.”<sup>101</sup>

After the withdrawal of Vioxx, the Company maintained its philosophy that grants for executives should be set at target levels commensurate with other executives in the healthcare field.<sup>102</sup> However, due to the depressed stock prices, the dollar value of executive equity awards for 2004 was far below market levels.<sup>103</sup>

In the year following the withdrawal, the Company’s decision to measure Company performance and earnings per share growth against planned targets as opposed

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<sup>99</sup> See Executive Incentive Plan, 2004 Plan Year Bonus Awards / 2005 Long-Term Incentive Grants, MRK-ASC0000568 (listing P. Kim, B. Shears, M. Avedon, R. Clark, K. Fraizer, M. McGlynn).

<sup>100</sup> Approximately 190 of these grants were accelerated from January 2005 to November 2004.

<sup>101</sup> See 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000565, at 66. Awards to non-executive employees were based on smaller percentages of base salary. See, e.g., 11/22/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-AUA0009965, at 65.

<sup>102</sup> See 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000565, at 65.

<sup>103</sup> 3/10/05 Merck Proxy Statement, at 22; 3/9/06 Merck Proxy Statement, at 22-23, MRK-CIC00095, at 121-22; see also Management Committee Compensation Summary, MRK-ASC0000569, at 69 (showing, for example, that Dr. Peter Kim’s 2005 compensation, including long-term incentive awards, was 36% below the 75th percentile of total compensation given for his position at peer pharmaceutical companies) (attached to 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000565).

to peer companies (as described above) mitigated the effect of the withdrawal on the number of performance shares awarded<sup>104</sup> but could not mitigate the effect of the lower stock prices.

(d) Executives' Stock Holdings.

According to Merck's March 9, 2004 Proxy Statement, the Chief Executive Officer and executives were encouraged to "hold Merck Common Stock in an amount representing a multiple of base salary. For the Chief Executive Officer, the multiple is ten; for the other executive officers, the multiple is five."<sup>105</sup> The number of shares of direct Merck common stock held by Mr. Gilmartin, Mr. Anstice, Dr. Scolnick, and Dr. Kim, at three points during the relevant period, are set forth below.

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<sup>104</sup> Minutes of 11/22/05 Compensation and Benefits Committee meeting, MRK-AQD0001070, at 70.

<sup>105</sup> 3/9/04 Merck Proxy Statement, at 21.

Summary of Direct Holdings of Merck Common Stock

Executive Officer	As of 12/99	As of 12/00	As of 12/03
Mr. Gilmartin	34,305 <sup>106</sup>	34,305 <sup>107</sup>	34,305 <sup>108</sup>
Mr. Anstice	42,526 <sup>109</sup>	110,831.5156 <sup>110</sup>	114,977 <sup>111</sup>
Dr. Scolnick	246,580 <sup>112</sup>	246,580 <sup>113</sup>	N/A <sup>114</sup>
Dr. Kim	N/A	N/A	426 <sup>115</sup>

3. Compensation of the Chief Executive Officer.

Mr. Gilmartin's compensation as Chief Executive Officer was governed by the same general principles and plans described above, although it was assessed separately by the Compensation Committee for the approval of the full Board and reported annually in Merck's proxy statements. For each year between 1996 and 2004, Mr. Gilmartin's annual compensation included salary, bonus, and an award of stock options, all of which

<sup>106</sup> 12/99 Annual Statement of Changes in Beneficial Ownership of R. Gilmartin, MRK-ATA0000009. Mr. Gilmartin also held 10,305.5190 in dividend reinvestment. See id.

<sup>107</sup> 12/19/00 Ownership Summary Report of R. Gilmartin, MRK-ATA0000030. Mr. Gilmartin also held 10,435.4480 in dividend reinvestment, and 155,570 in indirect common stock by a family limited partnership, or FLP. See id.

<sup>108</sup> 12/31/03 Ownership Summary Report of R. Gilmartin, MRK-ATA0000048. Mr. Gilmartin also held 11,256.3350 in dividend reinvestment, and 155,570 in indirect common stock by a family limited partnership, or FLP. See id.

<sup>109</sup> 12/20/99 Ownership Summary Report of D. Anstice, MRK-ATA0000002. Mr. Anstice also held 4,598.1520 in dividend reinvestment. See id.

<sup>110</sup> 12/19/00 Ownership Summary Report of D. Anstice, MRK-ATA0000023. Mr. Anstice also held 3,389.7180 in dividend reinvestment. See id.

<sup>111</sup> 12/31/03 Ownership Summary Report of D. Anstice, MRK-ATA0000041.

<sup>112</sup> 12/20/99 Ownership Summary Report of E. Scolnick, MRK-ATA0000018.

<sup>113</sup> 12/19/00 Ownership Summary Report of E. Scolnick, MRK-ATA0000038.

<sup>114</sup> Dr. Scolnick was no longer a Section 16 Officer as of December 31, 2002. See Direct and Indirect Holdings of Each Section 16 Officer on 12/31/99, 12/31/00, and 12/31/03, MRK-ATA0000001.

<sup>115</sup> 12/31/03 Ownership Summary Report of P. Kim, MRK-ATA0000050.

were approved by the Compensation Committee, taking into account compensation of Chief Executive Officers at peer healthcare companies.<sup>116</sup> In 2004, when Merck incorporated performance share units into its compensation scheme, Mr. Gilmartin's equity compensation began to comprise both "stock options and [performance share units], thereby making his stock-based compensation entirely dependent on the long-term appreciation of the Company's stock price and on Company performance."<sup>117</sup>

According to the proxy statements of the Company and members of its Peer Group, as well as "CEO Total Compensation" studies performed by Towers Perrin, Mr. Gilmartin's base salary, total annual cash compensation (based on the prior year's bonus) and total compensation (with equity awards as valued by Towers Perrin) for the years 1996 to 2004 ranked as follows:

- 1996: base salary was at the median, total annual cash compensation was above the median, and total compensation (including equity valued at \$4,935,216) was at approximately the 70<sup>th</sup> percentile.<sup>118</sup>

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<sup>116</sup> See, e.g., Minutes of 2/25/03 Compensation and Benefits Committee meeting, MRK-AQD0000820, at 21; Minutes of 2/24/04 Compensation and Benefits Committee meeting, MRK-AQD0000955, at 56; see also 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-AQD0001060, at 60 (requesting approval of Mr. Gilmartin's compensation); 2004 Towers Perrin PHRA Executive Compensation Survey, MRK-AQD0001064, at 64 (chart comparing Chief Executive Officer compensation at Merck versus peer firms) (attached to 2/16/05 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-AQD0001060); Minutes of 10/28/97 Compensation and Benefits Committee meeting, MRK-AQD0000180, at 80 ("Committee reviewed compensation survey information on the competitiveness of the CEO and the twenty highest paid executives in the Company compared to nine U.S.-owned major pharmaceutical companies.").

<sup>117</sup> 3/10/05 Merck Proxy Statement, at 21.

<sup>118</sup> CEO Total Compensation Summary, MRK-ASC0000071 (attached to 2/19/97 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000068); see also 3/17/97 Merck Proxy Statement, at 11-14.

- 1997: base salary was below the median, total annual cash compensation was above the median, and total compensation (including equity valued at \$6,957,328) was at approximately the 70<sup>th</sup> percentile.<sup>119</sup>
- 1998: base salary was below the median, total annual cash compensation was above the median, and total compensation (including equity valued at \$6,640,000) was at approximately the 30<sup>th</sup> percentile.<sup>120</sup>
- 1999: base salary was below the 25<sup>th</sup> percentile, total annual cash compensation was below the 25<sup>th</sup> percentile, and total compensation (including equity valued at \$10,300,000) was between the 25<sup>th</sup> percentile and the median.<sup>121</sup>
- 2000: base salary was below the 25<sup>th</sup> percentile, total annual cash compensation was between the 25<sup>th</sup> percentile and the median, and total compensation (including equity valued at \$10,102,000) was between the 25<sup>th</sup> percentile and the median.<sup>122</sup>
- 2001: base salary was between the 25<sup>th</sup> percentile and the median, total annual cash compensation was between the 25<sup>th</sup> percentile and the median, and total compensation (including equity valued at \$15,480,000) was between the 25<sup>th</sup> percentile and the median.<sup>123</sup>

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<sup>119</sup> CEO Total Compensation Summary, MRK-ASC0000126 (attached to 2/18/98 memorandum from D. Smith to Compensation and Benefits Committee, MRK-ASC0000123); see also 3/19/98 Merck Proxy Statement, at 11-14.

<sup>120</sup> CEO Total Compensation Summary, MRK-ASC0000239 (attached to 2/17/99 memorandum from M. McDonald to Compensation and Benefits Committee, MRK-ASC0000236); see also 3/18/99 Merck Proxy Statement, at 11-14.

<sup>121</sup> CEO Total Compensation Summary, MRK-ASC0000295 (attached to 2/16/00 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000292); see also 3/16/00 Merck Proxy Statement, at 12-15.

<sup>122</sup> CEO Total Compensation Summary, MRK-ASC0000314 (attached to 2/21/01 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000311); see also 3/22/01 Merck Proxy Statement, at 15-18.

<sup>123</sup> CEO Total Compensation Summary, MRK-ASC0000342 (attached to 2/20/02 memorandum from W. Yarno to Compensation and Benefits Committee, MRK-ASC0000339); see also 3/21/02 Merck Proxy Statement, at 17-19.

- 2002: base salary was between the median and the 75<sup>th</sup> percentile, total annual cash compensation was between the 25<sup>th</sup> percentile and the median, and total compensation (including equity valued at \$12,661,000) was between the 25<sup>th</sup> percentile and the median.<sup>124</sup>
- 2003: base salary was above the 75<sup>th</sup> percentile, total annual cash compensation was above the 75<sup>th</sup> percentile, and total compensation (including equity valued at \$9,242,000) was between the 25<sup>th</sup> percentile and the median.<sup>125</sup>
- 2004: base salary was above the 75<sup>th</sup> percentile, total annual cash compensation was below the 25<sup>th</sup> percentile, and total compensation (equity valued at \$6,904,000) was below the 25<sup>th</sup> percentile.<sup>126</sup>

For purposes of the above rankings, Towers Perrin valued options using a valuation methodology commonly known as “Black-Scholes.” While this methodology is useful for comparing equity grants made by different companies, the actual value of a stock option depends on the way in which the market moves between the date of the grant and the date of exercise. If the stock price drops and stays below the option exercise price (as happened at Merck when Vioxx was withdrawn from the market), then such options are valueless.

In 2003, Mr. Gilmartin, along with the Human Resources Department, began preparing annual Chief Executive Officer Personal Performance Grids that were

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<sup>124</sup> CEO Total Compensation Summary, MRK-ASC0000437 (attached to 2/19/03 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000435); see also 3/20/03 Merck Proxy Statement, at 18-21.

<sup>125</sup> CEO Total Compensation Summary, MRK-ASC0000523 (attached to 2/18/04 memorandum from M. Avedon to Compensation and Benefits Committee, MRK-ASC0000521); see also 3/09/04 Merck Proxy Statement, at 22-24.

<sup>126</sup> 10/04 presentation, “Executive Compensation Review,” MRK-ASC0000532, at 44; see also 3/10/05 Merck Proxy Statement, at 24-26.

approved by the Compensation Committee.<sup>127</sup> Mr. Gilmartin assessed himself on “Operating Performance,” “Strategic Performance,” and “Human Resource Management,” which closely mimicked the factors set out in the Company’s Performance Grid metric.<sup>128</sup> The grids were used by the Compensation Committee when setting Chief Executive Officer compensation.

4. Compensation of Non-Executive Employees Integral to the Development and Marketing of Vioxx.

Like executive officers, many of the people integral to the development and marketing of Vioxx (e.g., Drs. Reicin, Gertz, and Dixon) received annual compensation in three parts: (i) salary; (ii) bonus; and (iii) equity. Compensation award decisions for non-executive officers were even more regimented and formulaic than award decisions for executive officers.

At the end of each year, the Human Resources Department circulated to all members of the Management Committee a Total Compensation Management packet.<sup>129</sup> The packet outlined the compensation philosophy for non-executive management, which was to provide competitive and performance-based pay, reward plan-year performance

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<sup>127</sup> See, e.g., Minutes of 2/24/04 Compensation and Benefits Committee meeting, MRK-AQD0000955, at 55-56; Raymond V. Gilmartin 2003 Personal Performance Grid, MRK-AQD0000819, at 19; Raymond V. Gilmartin 2004 Personal Performance Grid, MRK-AQD0001061, at 61.

<sup>128</sup> Raymond V. Gilmartin 2003 Personal Performance Grid, MRK-AQD0000819, at 19; 2003 Performance Summary, MRK-AQD0000900, at 04-05.

<sup>129</sup> See, e.g., 12/18/98 memorandum from Corporate Compensation Team to Distribution, “Total Compensation Management,” MRK-AUF0000001-23; 12/15/00 memorandum from Corporate Compensation Team to Distribution, “Total Compensation Management,” MRK-AUF0000057-93; 12/14/04 memorandum from L. Stevens to Distribution List, “2004/05 Total Compensation Management (TCM),” MRK-AUF0000375-446.

through the annual bonus award, and encourage employees to understand shareholder value through the granting of stock options.<sup>130</sup> The packet contained pre-determined ranges for salary and equity awards for each level of non-executive employee.<sup>131</sup> Generally, the Company's goal was for base pay, total cash and total compensation to reach the 75<sup>th</sup> percentile of leading pharmaceutical companies.<sup>132</sup>

The process of setting non-executive salary, bonus and equity compensation is discussed below.

a. Salary.

As members of the Management Committee, Division Presidents – including Dr. Scolnick, Dr. Kim, and Mr. Anstice – were responsible for setting the compensation of their direct reports within the guidelines set forth in the Total Compensation Management packet. Base salaries were determined according to employee grade or level, with merit increases apportioned out of a merit increase budget approved by the Management Committee on an annual basis. For example, in 1999, the Management

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<sup>130</sup> See, e.g., 12/18/98 memorandum from Corporate Compensation Team to Distribution, "Total Compensation Management," MRK-AUF0000001, at 05.

<sup>131</sup> See, e.g., 12/20/02 memorandum from Corporate Compensation Team to Distribution List, "Total Compensation Management," MRK-AUF0000134, at 186-201; 12/14/04 memorandum from L. Stevens to Distribution List, "2004/05 Total Compensation Management (TCM)," MRK-AUF0000375, at 383.

<sup>132</sup> See 12/15/00 memorandum from Corporate Compensation Team to Distribution, "Total Compensation Management," MRK-AUF0000057, at 69; 10/03 presentation, "Executive Compensation Review," MRK-ASC0000480, at 82.

Committee approved a 4.5% merit increase to the salary budgets for all Divisions.<sup>133</sup> In 2004, the Committee approved a 3.75% increase.<sup>134</sup>

b. Annual bonus.

Annual bonuses for non-union, non-executive employees were administered under Merck's Annual Incentive Plan.<sup>135</sup> The aggregate Annual Incentive Plan pool for all of the Company's Divisions was determined by means of a bottom-up calculation reflecting the total number of eligible employees multiplied by the Company's Performance Grid score and each Division's Performance Grid score.<sup>136</sup> The Company Performance Grid score and Division Performance Grid scores were weighed equally in the calculation.<sup>137</sup> The Annual Incentive Plan pool was then allocated among the Divisions based on the number of eligible employees in each Division and each Division's Grid score.

Individual bonuses were determined by the Division President after reviewing the employee's Personal Performance Grid, pay grade or level, and the relevant Division's

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<sup>133</sup> 12/18/98 memorandum from Corporate Compensation Team to Distribution, "Total Compensation Management," MRK-AUF0000001, at 05.

<sup>134</sup> 12/14/04 memorandum from L. Stevens to Distribution List, "2004/05 Total Compensation Management (TCM)," MRK-AUF0000375, at 84.

<sup>135</sup> See Annual Incentive Plan (Effective January 1, 1994), MRK-ARJ0000006, at 07; see also Annual Incentive Plan (Amended and Restated as of May 23, 2005), MRK-ARJ0000010, at 11.

<sup>136</sup> For example, in 2000, if both the Company and Division received a score of "WD" (with distinction) or better, annual incentive plan funding would be set at 100%, whereas if the Division received a score of "WD" or better but the Company did not, the bonus pool was set at 92.5%. 12/15/00 memorandum from Corporate Compensation Team to Distribution, "Total Compensation Management," MRK-AUF0000057, at 59.

<sup>137</sup> 12/15/00 memorandum from Corporate Compensation Team to Distribution, "Total Compensation Management," MRK-AUF0000057, at 59.

overall performance. Each employee had a target bonus amount based on a fixed percentage of his or her base salary,<sup>138</sup> and the Division President had the discretion to award up to that amount after reviewing the employee's performance. The Compensation Committee was not directly involved in determining individual non-executive compensation, and Mr. Gilmartin's role was limited to reviewing allocation of the overall Division Bonus pool.

An employee's Personal Performance Grid assessed several factors. An example of one such factor is his or her involvement on Company teams, such as Arthritis and Analgesia World Business Strategy Team, which was responsible for creating consensus on strategy concerning Vioxx product development.<sup>139</sup> This factor assessed an employee's strategic performance rather than the Division's financial performance.<sup>140</sup> For example, in 2004, after the decision to withdraw Vioxx from the market, core Arthritis and Analgesia World Business Strategy Team members were assessed on how effectively they provided "strategic input and tactical participation throughout all 4 phases of the withdrawal," which involved, among other tasks, assuring that physicians and patients were aware of determinations and outcome of the APPROVe Trial.<sup>141</sup>

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<sup>138</sup> See, e.g., 2000/2001 Total Compensation Management, MRK-AUF0000057, at 90.

<sup>139</sup> See 12/3/04 memorandum from R.T. Bissett to D. Anstice et al., MRK-ASF0000626, at 26 ("The final WBST rating will impact the AIP for team members by adjusting up or down that portion of their AIP related to WBST performance (generally 5-15% of the PPG for team members).").

<sup>140</sup> Dr. Alice S. Reicin 2003 Personal Performance Grid, MRK-AAD0800069, at 71 (Dr. Reicin reported to Dr. Barry Gertz).

<sup>141</sup> 2004 Arthritis and Analgesia Performance Grid, MRK-ASF0000641, at 43.

Other factors also played a role. For example, in 2003, Dr. Reicin, Executive Director of MRL Clinical Sciences Immunology and Analgesia, who reported to Dr. Gertz, was assessed on her work with several immunology and analgesia products. Of the 100 points on her Personal Performance Grids, her participation in the WBST team was allotted 15 points. Dr. Reicin was also reviewed on whether she was successful in performing her tasks to aid in Vioxx regulatory initiatives (30 possible points), providing clinical input on new chemical entities (10 possible points), facilitating the Vioxx clinical program (5 possible points), and others.<sup>142</sup>

The Company sought to mitigate the effect of the Vioxx withdrawal on non-executive officers' compensation by adjusting the Division Grid scores to annualize Vioxx-related sales for the first three quarters for the entire year. While this adjustment reduced the impact of the withdrawal, it did not eliminate it, as the overall Annual Incentive Plan pool was based 50% on the Company Grid score and 50% on Division Grid scores.<sup>143</sup>

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<sup>142</sup> Dr. Alice S. Reicin 2003 Personal Performance Grid, MRK-AAD0800069, at 71 (Dr. Reicin reported to Dr. Barry Gertz).

<sup>143</sup> Minutes of 10/15/04 Compensation and Benefits Committee meeting, MRK-AQD0000979, at 79-80. The Sales Incentive Plan ("SIP"), the bonus pool used to pay salespeople, was normalized so that the earnings for the first three quarters were extrapolated for the fourth quarter so as not to penalize salespeople for the Company's decision to withdraw. Minutes of 10/15/04 Compensation and Benefits Committee meeting, MRK-AQD0000979, at 79-80.

c. Equity compensation.

The shareholder-approved Incentive Stock Plans administered by the Compensation Committee also governed non-executive officer equity awards.<sup>144</sup> The Company used fixed-share guidelines to determine stock option allocations and granted options to eligible non-executive officers as well as executive officers.<sup>145</sup> Equity awards to non-executive officers who were eligible to receive stock options, performance share units, and restricted share units, were determined by Division Presidents with the help of the Human Resources Department.<sup>146</sup>

Throughout the relevant period, the Company also used the “Key Research and Development Options” Program, which provided stock options to key non-executive members of MRL.<sup>147</sup> The Program granted stock options to employees “deemed essential in the development of a Developing Product.”<sup>148</sup> Recommendations were only permitted after a product was approved for Safety Assessment by the Research

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<sup>144</sup> See, e.g., 2001 Incentive Stock Plan (Form 10-Q filed on 8/10/00), at 1. Regular full-time and part-time employees, not merely executives, were eligible for participation in the Incentive Stock Plan. Id.; see also 1996 Incentive Stock Plan (Form 10-Q filed on 8/10/95), at 1.

<sup>145</sup> See, e.g., 12/18/98 memorandum from Corporate Compensation Team to Distribution, “Total Compensation Management,” MRK-AUF0000001, at 03; 12/15/00 memorandum from Corporate Compensation Team to Distribution, “Total Compensation Management,” MRK-AUF0000057, at 91.

<sup>146</sup> See, e.g., 12/18/98 memorandum from Corporate Compensation Team to Distribution, “Total Compensation Management,” MRK-AUF0000001-23; 12/15/00 memorandum from Corporate Compensation Team to Distribution, “Total Compensation Management,” MRK-AUF0000057.

<sup>147</sup> 2004 Incentive Stock Plan, Rules and Regulations for Key Research and Development Program, MRK-AUB0000001-07. The program generally excluded executives except under “‘special circumstances’ as determined by the President-MRL.” Id. at 01.

<sup>148</sup> 2004 Incentive Stock Plan, Rules and Regulations for Key Research and Development Program, MRK-AUB0000001, at 02.

Management Committee.<sup>149</sup> A percentage of the options vested upon the occurrence of certain scientific milestones in the basic research or development of a particular product.<sup>150</sup>

The Company also granted stock options on a quarterly basis in smaller amounts to certain employees for special recognition under the Quarterly Stock Option Grant Program. These grants were far smaller than the annual grant and infrequently used for executive officers.

C. Merck's Securities Trading Policies.

As detailed above, Merck's senior management and, to a lesser extent, its other employees, received shares of Company stock and stock options as part of their compensation. Federal law imposes strict restrictions on securities trading by corporate "insiders," especially the senior managers of public companies. At the heart of these restrictions is the prohibition against open market trades by corporate insiders in possession of material nonpublic information. To promote compliance with these regulations, Merck implemented a series of internal policies. This section discusses the legal obligations and Company policies applicable to both senior management and to all

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<sup>149</sup> 2004 Incentive Stock Plan, Rules and Regulations for Key Research and Development Program, MRK-AUB0000001, at 02.

<sup>150</sup> For example, in the area of basic research, an employee would receive 10% of the grant after the Research Management Committee's decision to allocate an "MK number" to the product and begin Phase IIb trials, 15% of the grant vested one month after the Committee's decision to begin Phase III trials, 25% one month after the Committee's decision to file a New Drug Application, and 50% one month after the registration of the product. The program also provided a reduction in the shares allocated if there was a delay in the regulatory approval of the product. 2004 Incentive Stock Plan, Rules and Regulations for Key Research and Development Program, MRK-AUB0000001, at 03, 06.

of the Company's insiders and assesses the trading practices of the Company's senior management.

1. Federal Insider Trading Regulations.

Federal law imposes criminal and civil liability for "insider trading." Generally speaking, insider trading refers to the purchase and sale on the open market of a company's equity securities by a person who is in possession of material nonpublic information about the company or its securities.<sup>151</sup> The purpose of the rule against insider trading is to prevent corporate insiders from profiting at the expense of other market participants who have an informational disadvantage.

The senior-most officers and directors of public companies – those people most likely to have access to inside information – are subject to strict trading regulations under federal law. These officers and directors, commonly known as "Section 16 officers and directors," must (i) report any trades of their company's securities to the Securities and Exchange Commission ("SEC"), the federal agency charged with enforcing insider trading laws, and (ii) refrain from both purchasing and selling their company's equity securities on the open market within a single six-month period.<sup>152</sup> These requirements, respectively, (i) facilitate enforcement of the rule against insider trading by providing for regulatory oversight, and (ii) make it more difficult for these insiders to profitably trade on material nonpublic information.

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<sup>151</sup> 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5; *Dirks v. SEC*, 463 U.S. 646, 654 (1983) ("[A]n insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes 'secret profits.'" (citation omitted).

<sup>152</sup> 15 U.S.C. § 78p.

2. Merck's Policies.

Merck took several steps to promote compliance with these regulations.<sup>153</sup> These steps included: (i) restricting trading in Merck securities by the Company's Section 16 officers and directors to four pre-set window periods annually; (ii) adopting a broad corporate policy against insider trading; and (iii) restricting trading in Merck securities on an ad-hoc basis when insiders possess potentially material nonpublic information. Each of these policies is described more fully below.

a. Policies applicable to Section 16 officers and directors.

In light of the special rules applicable to Section 16 officers and directors, Merck adopted stringent internal policies governing their trading activity. Beginning in April 1999, just prior to the launch of Vioxx, the Company instituted a policy that restricted certain trading activity by Section 16 officers and directors to pre-established "window periods."<sup>154</sup> These periods were set to begin three days after the Company released quarterly earnings and last for ten trading days thereafter.<sup>155</sup> The trading activities limited to window periods included "purchases and sales of stock, 'cashless' stock option

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<sup>153</sup> Our mandate was to investigate the conduct of the Company's senior management. Although this group of people is slightly broader than the Company's Section 16 officers and directors, the latter category encompasses the majority of former. As such, our investigation of stock trading policies and practices focused more closely on the Company's Section 16 officers and directors. This group included, among others, all directors of the Company, the Chief Executive Officer of the Company, the president of the Company, and all vice presidents in charge of major operating Divisions. 17 C.F.R. § 240.16a-1(f). In general, it includes any officer with a "policy-making" function. Id.

<sup>154</sup> 3/5/99 memorandum from M. McDonald to Section 16 Officers, MK-STK0000500; 3/5/99 memorandum from M. McDonald to Merck Board of Directors, MK-STK0000501.

<sup>155</sup> 3/5/99 memorandum from M. McDonald to Section 16 Officers, MK-STK0000500; 3/5/99 memorandum from M. McDonald to Merck Board of Directors, MK-STK0000501.

exercises,<sup>156</sup> and Deferral Plan and Employee Savings and Security Plan reallocations.”<sup>157</sup>

Essentially, the policy limited all open-market transactions by Section 16 officers and directors to these window periods. The policy explicitly exempted certain types of non-market transactions, including gifts of Merck common stock.<sup>158</sup>

Even during window periods, Company policy, consistent with federal law, prohibited Section 16 officers and directors (and all other employees) from engaging in open-market trading while in possession of potentially material nonpublic information.<sup>159</sup> This policy overlapped with the Company’s generally applicable policies described below. Thus, there were times that the Company expressly prohibited Section 16 officers and directors from trading, notwithstanding the fact that the trading window was open. In order to help ensure compliance with this policy, the Company required Section 16 officers and directors to advise the Office of the Secretary before engaging in any transactions involving Merck securities.<sup>160</sup>

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<sup>156</sup> A “cashless” stock option exercise is an exercise in which a certain portion of the underlying shares is sold in order to raise the money necessary to pay the option price as well as any taxes and other expenses associated with the transaction. According to Ms. Colbert, the Company’s policy did not limit the exercise of options for cash to the window periods because these transactions did not involve open market transactions.

<sup>157</sup> 3/5/99 memorandum from M. McDonald to Section 16 Officers, MK-STK0000500; see 3/5/99 memorandum from M. McDonald to Merck Board of Directors, MK-STK0000501.

<sup>158</sup> 3/5/99 memorandum from M. McDonald to Section 16 Officers, MK-STK0000500; 3/5/99 memorandum from M. McDonald to Merck Board of Directors, MK-STK0000501.

<sup>159</sup> 3/5/99 memorandum from M. McDonald to Section 16 Officers, MK-STK0000500; 3/5/99 memorandum from M. McDonald to Merck Board of Directors, MK-STK0000501.

<sup>160</sup> 3/5/99 memorandum from M. McDonald to Section 16 Officers, MK-STK0000500; 3/5/99 memorandum from M. McDonald to Merck Board of Directors, MK-STK0000501.

The Merck policies applicable to Section 16 officers and directors promoted compliance with federal law in two respects. First, and most significantly, limiting open-market transactions to window periods minimized the potential for trading on the basis of nonpublic information. All of the window periods followed the Company's disclosure of earnings information, which typically entailed the disclosure of previously undisclosed information concerning the Company. Thus, relative to other time periods, it was less likely that these officers and directors would possess material nonpublic information.

Second, limiting certain trading activity to window periods helped to ensure timely reporting of transactions by these officers and directors. Confining trading activity to these times enabled the Company to efficiently provide resources to Section 16 officers and directors to assist them with completing the required forms.<sup>161</sup>

b. Policy 30.

Policy 30 of the Merck Corporate Policies ("Policy 30"), which was applicable to all employees of the Company, summarized and adopted the federal insider trading regulations and requires all area heads to ensure communication of the policy to their subordinates.<sup>162</sup> According to Ms. Celia Colbert, Secretary of the Company, this policy was available on Merck's intranet as well as circulated annually along with other important Company policies. Ms. Colbert stated that employees were required to

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<sup>161</sup> Although it appears that Merck's Section 16 officers and directors generally complied with all filing requirements, as required by federal regulations, the Company has disclosed in its proxy statements several instances in which its officers and directors failed to comply with these requirements. See 3/16/00 Merck Proxy Statement, at 29; 3/9/04 Merck Proxy Statement, at 41. All of these transactions were ultimately reported, though late, using the standard forms.

<sup>162</sup> Corporate Policy 30: Insider Trading, MRK-ASB0000001, at 01.

acknowledge their understanding of all policies. The policy went beyond the letter of the law by requiring employees to abstain from trading until the beginning of the second full trading day after public disclosure of material nonpublic information in their possession.<sup>163</sup> Policy 30 also urged employees who believe they may be in possession of material nonpublic information to consult with the Office of the General Counsel prior to exercising stock options or stock appreciation rights.<sup>164</sup>

c. Particular trading restrictions.

In addition to restricting trading by Section 16 officers and directors to window periods and adopting a policy for its employees that prohibited insider trading, the Company also (i) routinely issued memoranda to employees, corporate officers, and directors who were in possession of potentially material nonpublic information prohibiting them from trading in Company securities (“trading restriction memoranda”), and (ii) through its General Counsel, routinely asked individuals who might possess inside information not to trade. If issued during a Section 16 trading window, trading restriction memoranda or verbal instructions not to trade would override the window and prevent Section 16 officers and directors from trading.

The Company issued trading restriction memoranda when members of the Legal Department determined that an identifiable group of insiders possessed potentially material nonpublic information. Members of the Legal Department could learn of the existence of such information in several ways. Company lawyers participated directly in

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<sup>163</sup> Corporate Policy 30: Insider Trading, MRK-ASB0000001, at 02.

<sup>164</sup> Corporate Policy 30: Insider Trading, MRK-ASB0000001, at 02.

corporate transactions and sat on cross-functional committees and could learn of the existence of potentially material nonpublic information through these activities. In addition, Company employees sometimes informed the Legal Department of the existence of such information on their own initiative.

Once members of the Legal Department learned of potentially material information, the information was evaluated to assess whether it might be viewed as material under prevailing legal standards. Subsequently, Mr. Frazier, Ms. Colbert, and/or Mr. Filderman, a company lawyer, would reach a final determination as to whether a trading restriction memorandum should be issued. If they believed a trading restriction was warranted, then one of them would issue the memorandum to all employees, corporate officers, and directors whom they understood to possess this information. It appears that occasionally recipients of these memoranda would identify other individuals who possessed the same information, but did not receive a memorandum upon its initial distribution.<sup>165</sup> On these occasions, the memorandum would be forwarded to these additional individuals in order to notify them of the restriction and direct them not to trade.

Throughout the time that Vioxx was marketed, from about May 1999 through September 2004, the Company issued a number of Vioxx-related trading restriction memoranda. These restrictions were occasioned by, among other events, the unblinding of data from clinical trials, regulatory submissions, and unannounced regulatory action,

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<sup>165</sup> See, e.g., 2/6/04 email from J. Wainwright to C. Colbert, MRK-ASE0000019; 2/6/04 email from R. Schober to C. Colbert, MRK-ASE0000020.

such as the approval of a drug or a change in labelling. For example, on April 9, 2002, Ms. Colbert issued a memorandum concerning the FDA's decision regarding changes to the Vioxx product label based on data from the VIGOR Trial.<sup>166</sup> As is typical of the trading restriction memoranda generally, this memorandum requested that the recipients keep the information confidential and stated:

In addition, as a recipient of material, nonpublic information you will be subject to trading restrictions in Merck securities. We ask that you not trade in Merck securities (including the exercise of stock options) until the commencement of the second full trading day after public announcement.<sup>167</sup>

Some trading restriction memoranda did not define the restricted period, but rather imposed an indefinite trading restriction until the issuance of a subsequent memorandum lifting the restriction.

In addition to these written trading restriction memoranda, Mr. Frazier occasionally issued verbal requests to specific individuals not to trade in Merck securities based on his judgment that they possessed nonpublic information that might be viewed as material. To Mr. Frazier's knowledge, the individuals to whom he made these informal requests – who were often members of the Management Committee – always complied.

### 3. Assessment of Trading Activity by Senior Management.

In the course of our investigation, we reviewed the trading records of Merck's Section 16 officers and directors that had been filed, in accordance with federal

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<sup>166</sup> 4/9/02 memorandum from C. Colbert to Distribution, MRK-ADG0008249.

<sup>167</sup> 4/9/02 memorandum from C. Colbert to Distribution, MRK-ADG0008249.

regulations, with the SEC for the period during which the Company marketed Vioxx. These documents reflected all trading activity in Merck stock of approximately 50 members of the Company's senior management. Of the hundreds of reports we reviewed, only a very small percentage reflected open-market purchases or sales of Company stock. With one exception – a small acquisition of fewer than 90 shares<sup>168</sup> – it appears that all of these transactions took place during a pre-established window period. Although we did not have access to a complete record of the times that the Company's windows were "closed" pursuant to trading restriction memoranda, none of these open market transactions took place during a restriction period of which we were aware. No evidence in the record suggests that any member of Merck's senior management violated the prohibition on insider trading by trading on the open market while in possession of material nonpublic information concerning Vioxx.

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<sup>168</sup> According to Ms. Colbert, this transaction occurred at the beginning of the director's tenure and was performed, without his knowledge, by one of his financial advisors. Once the director learned of the transaction, he promptly informed the Company, which assisted him in reporting the transaction to the SEC as required by federal regulations.