Skadden

Executive Compensation and Benefits Alert

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Continuing Developments in the 2012 Proxy Season

As we continue to monitor developments in the unfolding 2012 proxy season, here are some key themes that have emerged thus far:

What are the overall vote results?

Of the first 180 companies of the Russell 3000 to report the results of say-on-pay proposals, approximately:

- 65 percent have passed with more than 90 percent support;
- 25 percent have passed with between 70.1 percent and 90 percent support;
- 8 percent have passed with between 50 percent and 70 percent support;
- 2 percent (three companies) obtained less than 50 percent support — Actuant and International Game Technology were discussed in our prior mailing and KB Home is discussed below. In a vote result reported after the cutoff date for the calculations above, news reports indicated that Citigroup Inc.'s say-on-pay proposal received 45 percent of votes cast, making it the fourth company (and the largest company) whose say-on-pay proposal has received less than 50 percent support this year.

Thus far, these percentages are not materially different from the full-year results for the 2011 proxy season.

So far, no companies with failed say-on-pay votes in 2011 have failed in 2012. Please note that all percentages in this summary follow the (For/(For + Against + Abstain)) formulation.

What types of factors appear to be causing 2012 say-on-pay proposals to fail?

As noted, based on news reports following its annual meeting, Citigroup Inc. received approximately 45 percent support for its say-on-pay proposal, down from approximately 93 percent last year. ISS, which had issued a "for" recommendation last year, acknowledged in this year's report that the CEO had received only one dollar in base salary for several years and that it was only in 2011 that he had returned to a normal salary structure. However, it issued an "against" recommendation this year, raising the following specific concerns: (a) inadequate disclosure

regarding how incentive compensation was determined by the compensation committee relative to Citigroup's overall performance; (b) the fact that a deferred stock award with a value of $10 million will be based largely on nonfinancial metrics (including regulatory considerations, talent development and an organizational culture focused on responsible finance); (c) the awarding of a two-year cash-based incentive award that vests based on a criterion (cumulative pretax income of $12 billion for the two-year performance period) that ISS does not view as sufficiently challenging; and (d) ISS's view that this level of compensation reflects a pay-for-performance disconnect given Citigroup's stock performance and financial results. ISS also expressed concern regarding the fact that some awards made in 2011 with respect to fiscal 2012 will not be disclosed until 2013, making comparisons with other companies more difficult. Finally, ISS suggested that the adoption of a "hold post-termination" policy for equity awards would better enhance the alignment of interests between executives and shareholders.

KB Home, whose say-on-pay proposal support decreased from 61 percent in 2011 to 46 percent in 2012, received an "against" recommendation from ISS last year, based primarily on the existence of "golden parachute" excise tax gross-up provisions for its executives. While KB Home largely eliminated those provisions following last year's vote, ISS again issued a negative recommendation, focusing this year on what it perceives to be a pay-for-performance disconnect with respect to the most recent one- and three-year periods. ISS noted that there appeared to be substantial discretion with respect to determinations regarding annual bonuses and the vesting of performance-based options. It noted in particular that the options could vest based on the achievement of any one of three performance goals, one of which (relating to customer satisfaction) ISS appeared to view as insufficiently specific and rigorous. In addition, it noted its concern that the CEO's compensation is significantly higher than the next most highly paid executive. Prior to its annual meeting, KB Home filed details regarding the guidelines used in exercising discretion with respect to annual bonuses. ISS indicated that, while this was a significant improvement, it would not be changing its recommendation. It emphasized that, even with this additional information, it was still concerned that performance-based options could vest based on the achievement of only one of three criteria.

What types of factors appear to be causing say-on-pay proposals to receive lower vote percentages in 2012 than they received in 2011?

In one of the higher-profile votes this season, The Walt Disney Company's say-on-pay proposal received a 57 percent approval level this year, as compared to last year's 77 percent approval level (ISS initially recommended an "against" vote in both years, but changed its recommendation last year after Disney eliminated the "golden parachute" excise tax gross-ups that were a key source of concern). ISS noted in its report this year that it perceived there to be a pay-for-performance disconnect at Disney based on one- and three-year total shareholder return relative to ISS-selected peers. Disney responded by indicating that it sets compensation primarily "in relation to the single most appropriate set of peers available: the five major publicly held entertainment companies whose management issues and challenges most closely resemble those of The Walt Disney Company." Disney further noted that an investment made in Disney upon the current CEO's assumption of the role would be significantly more valuable today than an equivalent investment made at that time in those other five companies or in the S&P 500 index. Disney also emphasized that it had provided no upfront grants to the CEO to induce him to extend his tenure when entering into a new employment agreement in 2011, and had structured his compensation so that 90 percent of the potential value of his compensation was in the form of performance-based bonuses, performance-based restricted stock units and options. Finally, Disney indicated that it felt that ISS is understating the performance-based nature of the compensation by treating options as not performance-based, despite the fact that they are of value only if Disney's stock price increases.

Concur Technologies, Inc.'s say-on-pay proposal support decreased from 99 percent in 2011 (when ISS recommended a "for" vote) to 62 percent in 2012 (when ISS recommended an "against" vote). While ISS stated in 2011 that it saw no significant issues of concern in Concur's executive compensation program, this year ISS expressed concern that: (a) total cash

compensation and total compensation were targeted at the 75th percentile and 90th percentile respectively, creating a pay-for-performance disconnect based on both one- and three-year total shareholder return; (b) there is in ISS's view a lack of transparency regarding the methodology used in the earnings per share (EPS) calculations in the bonus program (which differs from EPS calculated based on generally accepted accounting principles (GAAP)); and (c) like the short-term plan, the long-term plan is based on EPS, and also appears to contain shorter-term measurement periods within the plan, such that the plans are too similar and thus do not provide sufficient diversification of compensation risk.

Similarly, TransDigm Group Inc decreased from 98 percent to 54 percent after ISS changed from a 2011 recommendation of "for" (with no significant issues of concern) to a 2012 recommendation of "against." ISS acknowledged that the company ranked first within the peer group in terms of both one- and three-year total shareholder return, and that shareholder returns greatly exceeded index and industry peers over the immediately preceding one-, three- and five-year periods. However, ISS noted that (a) a "golden parachute" excise tax gross-up was provided in an agreement finalized in the past fiscal year; (b) while amending the CEO's employment agreement and outstanding stock option agreements, TransDigm retained the gross-up provisions in those agreements; and (c) while the size of the CEO's pay is primarily due to a large grant of performance-based options in fiscal 2011, the award contains a number of carry-forward and carry-back adjustments that in the view of ISS make it difficult for shareholders to judge the rigor of the performance conditions.

While these votes undoubtedly reflect a complex variety of factors, the magnitude of the decreases provides some indication of the impact of ISS recommendations.

What factors appear to be causing say-on-pay proposals to receive higher vote percentages in 2012 than they received in 2011?

Shuffle Master, Inc. increased from 44 percent in 2011 to 86 percent in 2012. ISS had issued an "against" recommendation in 2011 based on the fact that Shuffle Master entered into an employment agreement with its executive vice president and chief operating officer that included a modified single-trigger provision (i.e., a provision permitting the executive to terminate employment following a change in control and receive certain benefits). ISS switched its recommendation to "for" in 2012 due to the removal of this provision.

How have companies been responding this year to 'against' recommendations by ISS and other proxy advisers?

In one particular filing of note, after ISS issued an "against" recommendation this year with respect to Photronics, Inc. (due to what it perceived as a lack of response to the 57 percent approval level last year), Photronics issued a filing describing its communications with its shareholders on topics including executive compensation, and in particular on the existing "golden parachute" excise tax gross-up provisions in employment agreements. Photronics also issued an additional filing stating that, following this year's ISS recommendation, these excise tax gross-up provisions were eliminated and no additional gross-up provisions would be included in the future. This disclosure caused ISS to reverse its position and issue a "for" recommendation (the other filings reviewed for this mailing did not result in such a reversal). Its say-on-pay approval level this year following that change was 89 percent. This experience emphasizes the importance of companies not only engaging with their shareholders, but also describing those outreach efforts in detail in the proxy. It also suggests that responses to ISS that unambiguously accept its recommendations and indicate strong, clear corrective actions can potentially result in a changed recommendation.

Most other pre-emptive filings made by companies whose say-on-pay proposals received "against" recommendations addressed what the companies in question saw as flaws in the ISS methodology. Certain clear themes are emerging in these filings:

- Many companies have significant concerns regarding ISS's peer group determination, with several companies raising specific issues with its methodology, including: (a) choosing "peers" based on revenues instead of market capitalization; (b) including "peers" with which the company does not actually compete for talent due to geographic distance; and (c) including "peers" from industries perceived by the company as unrelated.
- Companies that have changed CEOs recently have expressed concern that, in determining whether there is a pay-for-performance disconnect, ISS is not limiting its review only to performance under the current CEO but rather is also taking into account performance under the prior CEO, leading to inappropriate recommendations. Conversely, companies with long-term CEOs have suggested that their lengths of tenure are not being considered and that their CEO's pay is being inappropriately compared with the pay of less-experienced CEOs.
- An issue that is disproportionately affecting early filers is that comparisons of peer group compensation are being made using different years, with early filer 2011 compensation being compared against peer group compensation from 2010 (due to those peer group members not yet having filed compensation data for 2011).
- Many pre-emptive filings have raised the point that it is incorrect for ISS to treat stock options as not being performance-based given that they only provide value if the company's stock price increases. Companies also have noted that there can be significant discrepancies between the GAAP-based option valuations used by companies in proxy reporting under SEC rules as compared with the larger values generated by the methodology used by ISS, and several have expressed particular concern regarding what they view as incorrect volatility estimates.
- Finally, some companies have expressed in pre-emptive filings that they believe that the periods during which ISS measures performance are too short, and/or too focused on total shareholder return at the expense of other measurements such as operating performance.

Despite these pre-emptive filings, the companies in question have still seen year-over-year decreases in say-on-pay approval percentages ranging from mild to significant. To take just one example, as we noted in our last mailing, United Technologies Corporation argued that the ISS analysis is materially flawed for various reasons, including that: (a) 12 of its 15 ISS-identified peers are not industrial companies, which they believe renders financial performance comparisons meaningless (the ISS peer group included Apple, Microsoft and UPS); and (b) eight of its 15 ISS-identified peers had not filed their proxy as of the ISS report, which meant that United Technologies' 2011 CEO compensation was being compared to 2010 compensation for the majority of the peer group. Nevertheless, its say-on-pay approval percentage fell from 97 percent in 2011 (when ISS had recommended "for") to 60 percent in 2012 following this year's negative recommendation.

As the events of this second say-on-pay season unfold, we will continue to keep you up to date regarding items of interest and developing themes. If you have any questions regarding your proxy disclosure or your executive compensation plans and programs, please do not hesitate to contact us.

This "Say on Pay" update is the second in a series. For our prior say-on-pay alert, please click here.