Skadden

Executive Compensation and Benefits Alert

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or your regular Skadden contact.

Stuart N. Alperin
New York
212.735.3920
stuart.alperin@skadden.com

Neil M. Leff
New York
212.735.3269
neil.leff@skadden.com

Regina Olshan
New York
212.735.3963
regina.olshan@skadden.com

Erica Schohn
New York
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
Palo Alto
650.470.4650
joseph.yaffe@skadden.com

Barbara R. Mirza
Los Angeles
213.687.5614
barbara.mirza@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

Two-Thirds of the Way Through the 2012 Proxy Season — Lessons Learned

As we reach the peak of the 2012 proxy filing season, we are continuing to monitor the following developments:

What are the overall vote results?

Of the first 1,656 companies to report the results of say-on-pay proposals, approximately:

- 70 percent have passed with more than 90 percent support;
- 21 percent have passed with between 70 percent and 90 percent support;
- 7 percent have passed with between 50 percent and 70 percent support; and
- 3 percent (45 companies) obtained less than 50 percent support.

While the overall proportions are generally not dissimilar to 2011 results, we have already seen more companies fail their say-on-pay votes this year than in the entire season last year. Four companies have seen failed votes in both 2011 and 2012.

Please note that all percentages in this summary follow the (For/(For + Against + Abstain)) formulation and have been rounded to the nearest percentage.

How have companies responded to lawsuits from the 2011 say-on-pay season?

Last year, a number of companies whose say-on-pay proposals did not receive majority support were the subject of lawsuits, some of which were dismissed and others of which were settled.

Cincinnati Bell Inc. received 30 percent support for its say-on-pay proposal last year, which resulted in a federal court shareholder lawsuit (which was dismissed) and a state shareholder lawsuit (which was settled). In reviewing this year's say-on-pay proposal, Institutional Shareholder Services (ISS) noted that the settlement terms for the state court suit stipulated that the compensation committee would annually rotate off one of its members; the audit committee would oversee periodic audits of the compensation process and alert the compensation committee to any issues that could affect financial performance or incentive awards; the compensation discussion and analysis section of the proxy would be written in easy-to-understand language; and, if shareholders were to vote down the say-on-pay proposal in any future year, the compensation

committee would hire a new compensation consultant to evaluate the program and issue a formal written response within 90 days. ISS noted in its 2012 report that the company engaged in shareholder outreach efforts, undertook a peer group analysis, determined not to pay a discretionary bonus for 2011 and (most importantly in the eyes of ISS) adjusted long-term incentives to be more performance-based, with 50 percent of the chief executive officer's long-term opportunity for the 2012-14 performance period payable in long-term performance units granted based on achievement of performance goals, and the other 50 percent in performance-based options. Following this recommendation from ISS, Cincinnati Bell's say-on-pay proposal for 2012 passed with an approval rate of 89 percent.

After M.D.C. Holdings, Inc. received 33 percent support for its say-on-pay proposal in 2011, a lawsuit was filed against M.D.C. and ultimately settled, with M.D.C. agreeing to take various actions with respect to its executive compensation program during the period from 2012 to 2014. ISS notes in its report for 2012 that M.D.C. is required to have its compensation committee review the compensation philosophy, metrics and amounts in light of prior-year say-on-pay vote(s) before establishing compensation; seek the views of significant institutional shareholders in setting compensation; and include a peer group metric (including at least five public homebuilders selected by the compensation committee) when determining performance measures. While ISS noted that the company had removed single-trigger change-in-control provisions in its pay programs and had raised the change in control acquisition threshold from 20 to 50 percent, and had also disclosed clear metrics for the annual incentive program and attached performance conditions to stock options, ISS expressed concern that the company had not addressed what it viewed as a high-base salary and a lifetime retirement benefit for the CEO. As such, ISS issued an "against" recommendation. M.D.C. issued a supplementary filing that argued strongly against the ISS recommendation, noting that it had responded very specifically to the concerns raised by the 2011 shareholder vote and the related lawsuit. M.D.C. noted, "The Company and its consultant (Pearl Meyer & Partners) engaged in a comprehensive dialogue with ISS personnel regarding modifications to the Company's executive compensation program. In these discussions, ISS never mentioned the retirement benefit, which has been in effect since 2008, nor base compensation which has not been modified for ten years. Although no assurances for a favorable recommendation were made, it was agreed that we would be afforded the opportunity to address any new concerns that might arise before ISS issued its report." The company also noted that there were no comments from any of its shareholders identifying the retirement benefit or base compensation as being an item of concern, and emphasized that the CEO and COO have 40 and 35 years of service with M.D.C., while ISS had provided estimates in its report that were approximately half that. The shareholders of M.D.C. ultimately supported the 2012 say-on-pay proposal with 72 percent support.

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

Penn Virginia Corporation received 39 percent support for its say-on-pay proposal in 2011 when ISS issued an "against" recommendation, but that support increased to 87 percent in 2012 following a "for" recommendation from ISS. Following the 2011 vote, Penn Virginia engaged in shareholder outreach efforts to determine the causes of concern and hired a new compensation consultant to recommend appropriate changes, including replacing much of its time-vesting equity awards with performance-based awards, decreasing the previous peer median benchmarking practice to the 25th percentile, limiting the aggregate maximum amount of cash bonuses, converting its qualitative-based cash bonus to a program consisting partly of quantitative measures, and reducing compensation to better reflect company size and recent performance. Penn Virginia also appointed a new CFO in December 2010 and a new CEO in May 2011. While ISS observed in its 2012 report that shareholder returns performed significantly below index and industry peers over the most recent one-, three- and five-year periods, it also acknowledged that the strong outreach efforts and significant changes in compensation represented a commitment toward a stronger pay-for-performance linkage at the company. As such, ISS indicated that it believed that there was no pay-for-performance misalignment and recommended a vote "for" the 2012 say-on-pay proposal.

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

Chiquita Brands International, Inc.'s say-on-pay proposal support decreased from 85 percent in 2011 (when it received a "for" recommendation from ISS) to 20 percent in 2012, when it received an "against" recommendation. ISS stated that it believes that there is a pay-for-performance disconnect, particularly given that this was the second consecutive year of negative one-, three- and five-year measurements of total shareholder return (TSR). The report stated that ISS analysis indicates that the CEO's annual base salary and target bonus opportunity appear to be high compared to both ISS's and Chiquita's peer groups; there is a lack of disclosure for the 2011– 13 performance cycle of the long-term performance plan, such that shareholders cannot assess the rigor of the goals; and Chiquita includes multiple "aspirational peers" (*i.e.*, companies with more than double Chiquita's revenues) in its peer group selection, which ISS feels may have a "ratcheting effect" on executive pay. The Company issued a supplemental filing saying that the structure and design of its program have not changed since 2011, when ISS issued a "for" recommendation, and that the strong approval received for the 2011 say-on-pay proposal indicated to Chiquita that its programs were appropriate. It further stressed that its "policy of disclosing general metrics upfront and specific numerical performance goals once performance periods have been completed is consistent with the best interests of our shareholders, because prospective disclosure of those specific metrics would be useful to our competitors and competitively harmful to Chiquita". Chiquita indicated that its peer group represents the group of companies with which it competes for executive talent (whereas the ISS group included a retail grocer and a conglomerate, among other companies viewed as nonpeers by Chiquita) and that the Chiquita-determined peer group had remained unchanged between the time that ISS issued its 2011 "for" recommendation and the time it issued its 2012 "against" recommendation. The filing also emphasized that, even though this had been Chiquita's third consecutive year of profitability, incentive payouts had been reduced or eliminated based on the financial measures relevant under Chiquita's compensation plans, such that "realized pay" was less than the original pay opportunity.

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

It is common for companies to engage in dialogue with ISS prior to, and following, the issuance of the ISS recommendations. Although this dialogue has not generally resulted in ISS changing its recommendation (absent affirmative changes in the company's compensation practices directed at the reason for the negative recommendation, such as eliminating gross-ups), it has been our experience that, with persistence, companies have had some success ensuring that ISS includes additional information in the report regarding the company's positive pay practices and steps taken since the prior say-on-pay vote to address shareholder concerns. The inclusion of these positive statements in the ISS report, together with outreach shareholders, appears to have tipped the scales for some companies, resulting in say-on-pay proposals being approved when they might not have been approved without such efforts.

In addition, companies have responded to a negative recommendation by issuing supplementary filings (as noted above in the examples of M.D.C. and Chiquita) in an attempt to convince their shareholders not to follow the ISS recommendation. Links to our prior mailings are at the bottom of this memorandum, and the themes described in those memorandums continue to deepen as the proxy season continues. We would note the following additional nuances that we have seen in recent weeks:

- Companies continue to urge shareholders to focus on realizable pay as compared with the full value of awards. In one case a grant was made and forfeited in the same calendar year, resulting in zero realizable pay, but ISS included the full value of the award in calculations of the CEO's pay, which the company argued was misguided.

- There have been several cases of companies asking their shareholders to focus on measures that are more relevant than TSR in judging the company's performance, such as safety, quality, low volatility and dividends, and to focus on performance over a longer period of time.

- Various companies have expressed frustration that ISS has not acknowledged the unique circumstances of CEO transitions, when an outgoing CEO might be paid a retention amount at a time when it is unclear how long a search for his or her successor will take, and a new CEO could be awarded sign-on and make-whole awards as part of the recruiting process.

- We have also seen concerns expressed relating to other instances of perceived ISS insensitivity to context, such as a company that was criticized for using narrow performance criteria when the use of other criteria would have caused a default under the company's main credit agreement, which the company argued would have been far more damaging to shareholders.

- Finally, there continues to be a strong current of discontent running through the supplemental filings regarding ISS's formulaic peer group selection process against which relative performance and compensation are determined. It has been argued, for example, that the process disfavors younger growth companies by discounting market capitalization and overemphasizing revenue, and that it disregards the complexities and unique characteristics of franchise businesses. However, the main theme running through the peer group discussions in the supplemental filings is a strong sense of frustration over being grouped with "peers" in completely unrelated industries, with company reactions to the ISS peer groups in supplemental filings using language such as "deeply flawed," "arbitrary," "inexplicable," "not at all relevant," "clearly erroneous" and a "persistent failure."

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 fourth in a series. For our prior say-on-pay alerts, please see Say-on-Pay — Early Lessons From the 2012 Proxy Season; Continuing Developments in the 2012 Proxy Season; and Additional Updates on the 2012 Proxy Season.