

Say on Pay – Early Lessons From the 2012 Proxy Season

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call 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

Joseph M. Yaffe

Palo Alto
650.470.4650
joseph.yaffe@skadden.com

Barbara R. Mirza

Los Angeles
213.687.5614
barbara.mirza@skadden.com

Erica Schohn

New York
212.735.2823
Erica.Schohn@skadden.com

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Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

As we continue to monitor the start of proxy season, here are some key themes of the first weeks:

What are the overall vote results?

Of the first 160 companies of the Russell 3000 to report, approximately:

- 68 percent have passed with over 90 percent support;
- 23 percent have passed with between 70.1 percent and 90 percent support;
- 8 percent have passed with between 50 percent and 70 percent support;
- 1 percent (two companies) had failed — one (Actuant) had no 2011 vote, and the other (International Game Technology) passed in 2011.

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

What caused the failed votes?

For Actuant, Institutional Shareholder Services (ISS) reported on its blog that its concerns related to weak disclosure about incentive plan goals, above-median peer group benchmarking, and adoption of a new supplemental retirement program for executives. ISS has stated that it believes that shareholders also had concerns about a pay-for-performance disconnect due to an increase in total CEO pay while the company posted lagging shareholder returns. It should be noted that the company had issued a 12-point preemptive filing listing all the reasons that it disagreed with the recommendation, including that the Company's own study (commissioned by Towers Watson) indicated no pay-for-performance disconnect; that the ISS equity valuation was 35 percent higher than the Company's valuation (the Glass Lewis valuation was only 9 percent higher) due to ISS's use of the Black-Scholes model rather than the binomial model used by the company; the lack of salary increases in 2009, 2010 and 2011; and the company's view that its supplemental retirement program only serves to bring the named executive officer (NEO) retirement benefits to market levels, among other factors.

For International Game Technology, while the company highlighted in a preemptive filing that Glass Lewis and Egan-Jones recommended a "for" vote, the ISS "against" vote carried the day. Based on the filing, the key concern appears to have been special incentive grants to NEOs of time-based restricted stock units (RSUs) that were made in addition to the regular grant of stock options and time-based RSUs. The company stated that to achieve the goal of long-term retention of senior leadership, it made the determination that it was advisable to grant time-based RSUs with a value equal to approximately 2.5 times the normal annual time-based RSU grant, with full vesting on the third anniversary of the grant date. While it emphasized that these grants were a one-time event related to the fact that it had a new leadership team in a very competitive talent market and wanted to create an incentive for the team to remain in place for three years, the company's vote fell from 82 percent in 2011 to 44 percent in 2012.

What types of compensation changes have contributed to an improved vote percentage?

Beazer Homes USA went from 46 percent to 95 percent after making the following changes after discussions with shareholders: decrease in percentile used to calculate targeted total compensation; increased emphasis on performance-based equity compensation; aggressive bonus plan targets; elimination of gross-ups; reduction in severance multiples; elimination of non-cash severance benefits (such as health and welfare continuation); elimination of evergreen employment agreements; reinstatement of executive and director stock ownership policies; and adoption of a compensation clawback policy.

Jacobs Engineering went from 45 percent to 96 percent after making the following changes following consultation with institutional shareholders: increase in CEO stock ownership guidelines; double trigger vesting of equity on a change in control; adoption of clawback provisions; discontinuance of time-based restricted stock grants; TSR-based vesting for the CEO; and a revamped Compensation Discussion and Analysis section (CD&A) which is intended to describe more clearly the rationale for and operation of the company's programs.

SurModics Inc. went from 59 percent to 92 percent after indicating that none of its agreements now have gross-ups and that no new agreements will contain gross-ups.

Headwaters Inc. went from 53 percent to 77 percent after eliminating gross-ups; conducting a communication and outreach effort with shareholders; extending the minimum performance period for the long-term incentive plan and recalibrating the plan's targets to more closely align with company performance; and implementing a clawback policy. (Note that even without the new SEC clawback rules in effect, the pressure to get a "for" vote from ISS is causing companies to preemptively adopt clawback policies.)

It is interesting to note that Monsanto went from 65 percent to 85 percent without making any significant changes, apparently by engaging in focused dialogue with their 50 largest shareholders who voted "no" in 2011. Their CD&A states that "... a number of these investors informed us the dialogue had enabled them to increase their understanding of our program." In changing its recommendation to "for" this year, ISS emphasized that "the company detailed efforts made in response to low support for its say-on-pay proposal in 2011." Both this fact and the decision by Jacobs Engineering to focus fresh attention on their communication in the CD&A clearly show the importance of (a) making sure that shareholders fully understand the programs they are voting on; and (b) describing in detail any efforts made to engage with shareholders regarding executive compensation programs.

How have companies been responding to 'against' recommendations by ISS and other proxy advisors?

Some companies have responded to the receipt of an "against" recommendation by ISS and other proxy advisors by making preemptive filings that set forth the reasons the company believes that the recommendation is unwarranted. The types of issues addressed in these preemptive company filings include: the relation between pay and performance; peer group composition; the implications of grant timing; valuation issues; and factual errors that the company believes have been made in formulating the recommendation. Thus far, these companies generally still have seen year-over-year decreases in their approval percentage.

One recent filing of note that we are monitoring was made by United Technologies Corporation, which has argued that the ISS analysis is materially flawed for various reasons, including that (a) 12 of their 15 ISS-identified peers are not industrial companies, which the company believes renders

financial performance comparisons meaningless; and (b) eight of their 15 ISS-identified peers had not filed their proxy as of the ISS report, which meant that the Company's 2011 CEO compensation was being compared to 2010 compensation for the majority of the peer group. We will continue to monitor the progress of this and other filings of note.

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.