Emerging Say-on-Pay Trends and Litigation Developments

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday May 13, 2013 at 9:19 am

Editor's Note: The following post comes to us from Regina Olshan, partner in the executive compensation and benefits practice at Skadden, Arps, Slate, Meagher & Flom LLP, and is based on a Skadden alert by Barbara R. Mirza.

Early Lessons from the 2013 Proxy Season

As Skadden monitors the initial weeks of the 2013 proxy season, we are seeing the following preliminary trends:

Vote Results

Of the first 279 companies of the Russell 3000 to report the results of say-on-pay proposals, approximately:

- 72 percent have passed with over 90 percent support;
- 22 percent have passed with between 70.1 percent and 90 percent support;
- 4 percent have passed with between 50 percent and 70 percent support; and
- 2 percent (six companies) obtained less than 50 percent support.

While we are still in the early stages of this proxy season, based on current trends it would appear that companies are receiving somewhat higher levels of support than last year. Please note that all percentages in this summary follow the (For/(For + Against + Abstain)) formulation.

Of the six companies that have obtained less than 50 percent support this year, five passed their most recent vote with approval rates of approximately 68 to 90 percent (the sixth held its first say-on-pay vote this year). All received negative recommendations from Institutional Shareholder Services (ISS).

Factors Causing 'Against' Recommendations from ISS

As with last year, ISS "against" recommendations thus far this proxy season are largely being driven by factors such as:

- a "pay for performance disconnect" (in ISS parlance);
- equity award grants that are time-based rather than performance-based;
- retention or "mega" equity grants or bonuses;
- performance goals that are insufficiently challenging; and
- insufficient shareholder outreach.

In addition, even where current CEO compensation is deemed to be reasonable, several companies have been targeted by ISS with respect to compensation paid to a *departing* chief executive officer, particularly if the termination could potentially be deemed to be a "friendly" one not generally entitling the executive to contractual severance payments (for example, one characterized as a retirement or where the individual remains as chairman). In addition to focusing on severance and equity award treatment, ISS even has raised concerns regarding the pension benefits contractually payable to a departing CEO following decades of service. As such, when a company is attempting to determine the likelihood of an ISS "against" recommendation, it should consider as part of that analysis any payments and benefits being provided to a departing CEO in addition to the compensation being paid to the newly hired CEO.

Factors Causing 'For' Recommendations from ISS

Some companies that received "against" recommendations from ISS in 2012 are receiving "for" recommendations in 2013 and seeing their say-on-pay approval percentages increase significantly (at times by more than 50 percent). The types of actions driving the year-over-year change in recommendation are:

- eliminating excise tax gross-up provisions;
- decreasing CEO pay to reflect lagging company performance;
- increasing the percentage of performance-based equity in the company's incentive programs (particularly if the measures and goals are thoroughly described in the proxy);
- decreasing the percentage at which compensation is benchmarked to the median of the peer group;
- conducting robust shareholder outreach efforts;
- increasing CEO stock ownership requirements;
- instituting a clawback policy; and
- instituting an anti-hedging policy.

In addition, several companies have received an "against" recommendation from ISS in 2013 but then had that recommendation changed to a "for" recommendation by taking the following types of actions immediately following the initial negative recommendation:

- eliminating excise tax gross-up provisions; or
- layering new performance hurdles onto existing awards.

ISS generally has been unmoved by changes that are promised only with respect to future years. A same-year shift in vote recommendation typically is triggered only by actions such as those listed above that are significant, have an immediate impact on current CEO compensation entitlements and are sufficient based on the weight of other factors to shift the balance of ISS opinion.

Trends in Supplemental Filings

- Fewer Complaints Regarding Peer Groups: Last year we noted a clear, early trend of companies issuing supplemental proxy filings expressing disagreement with the recommendations issued by shareholder advisory firms such as ISS and Glass Lewis, particularly with respect to the peer groups that those firms were using for purposes of compensation comparisons. Following the 2012 proxy season, the advisory firms indicated that they would be making changes to the methodology by which they determined peer groups, and that they anticipated that this would result in advisory firm

peer groups and company peer groups becoming more aligned. While we are still in the early weeks of the proxy season, we are seeing a definite reduction in the number of supplemental proxy filings that take issue with advisory firm peer group composition.

- Other Types of Filings: We are continuing to see some early supplemental proxy filings (albeit fewer of them than last year) that focus on the following types of issues:
  - concern that the 2012 compensation of early filers is being compared with the 2011 compensation of their peers, due solely to the fact that those peers have later annual meeting dates and have not yet filed proxies with respect to 2012 compensation;
  - the fact that ISS is not taking into account a chief executive officer's long tenure when comparing compensation with shorter-tenured peer group CEOs;
  - the inclusion by ISS of the full grant date value of equity compensation in its year of grant rather than focusing on the value that is likely to be realized from the award; and
  - alleged factual and calculation errors by ISS.

The Latest on the Proxy Litigation Front

As noted in Skadden's prior mailing on the subject (see Executive Compensation and Benefits Alert: Annual Meeting Litigation – How to Prepare), there has been a recent wave of lawsuits alleging breaches of fiduciary duties by management and directors in connection with compensation-related decisions. These lawsuits involve generic allegations of inadequate proxy disclosure with respect to compensation-related proxy proposals (typically say-on-pay proposals and proposals to increase the number of shares reserved under equity compensation plans) and seek to enjoin the company's annual meeting until supplemental disclosures are made. More than 20 such cases were filed in 2012, and the plaintiffs' law firm predominantly initiating these suits announced that it is "investigating" over 60 additional companies. Some companies concerned about potential disruption to their annual meetings have been willing to settle these claims, while others have chosen to litigate.

In one promising recent development, in *Paul Noble vs. AAR Corp, et al.*, a shareholder plaintiff's lawsuit seeking to enjoin AAR Corp's say-on-pay vote was dismissed. The suit had alleged that the company failed to disclose certain information in its proxy with respect to compensation decisions, including how the compensation committee chose its compensation consultant for 2012, why it changed compensation consultants in 2013, the reasons behind peer group changes and even information regarding the compensation paid at peer group companies. The U.S. District Court for the Northern District of Illinois found that the only required disclosures are those required under the Dodd-Frank Act and Regulation S-K, and indicated that the plaintiff had not been able to point to any law requiring corporations to disclose more information than that required by federal disclosure requirements. The court noted that the plaintiffs could not simply manufacture additional disclosure requirements, particularly in light of the business judgment deference accorded to directors. Finally, the court stated that the plaintiff had not demonstrated any harm to shareholder interests, as required by a direct suit (as opposed to a derivative suit on behalf of the corporation). Time will tell whether this case is the beginning of a trend with respect to how proxy disclosure lawsuits will be handled, and we will continue to monitor and report on developments in that regard.

Finally, companies also should be mindful of a "third wave" of lawsuits that has been rising in early 2013. This new wave does not seek to enjoin a shareholder vote but rather to challenge compensation decisions that have already been made. These cases often involve failures to meet the requirements of Section 162(m) of the Internal Revenue Code, for example by granting awards in excess of the plan's stated per-person limits or by failing to get reapproval

of performance goals every five years. Other lawsuits allege that awards have been granted in excess of the overall number of reserved shares under the plan (or under the company's articles of incorporation), or that executives have sold company shares in a manner that brings them out of compliance with company share ownership policies. While it is too early to tell how successful these claims will be, we strongly encourage companies to monitor their equity award granting processes carefully and ensure that in-house and outside counsel are afforded an opportunity to review executive compensation actions.

As the events of this third say-on-pay season unfold, and as litigation developments continue to evolve, we will be keeping 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.

0 Comments

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