

# Executive Compensation and Benefits Alert

July 23, 2013

If you have any questions regarding the matters discussed in this memorandum, please contact any of the attorneys listed on page 4, or call your regular Skadden contact.

## Skadden's Proxy Watch: Latest 2013 Say-on-Pay Trends and a Proxy Litigation Update

As the 2013 proxy season heads into its final weeks, we are continuing to monitor say-on-pay vote results and supplemental filing trends, as well as the most recent waves of proxy-related litigation, and have the following observations:

### Vote Results

Of the first 1,971 companies of the Russell 3000 to report the results of say-on-pay proposals, approximately:

- 73 percent have passed with more than 90 percent support;
- 18 percent have passed with between 70.1 percent and 90 percent support;
- 6 percent have passed with between 50 percent and 70 percent support; and
- 3 percent (55 companies) obtained less than 50 percent support.

While the proportions are not substantially different as compared to last year's results, companies do appear to be receiving slightly higher levels of support, with companies with the lowest levels of support seeing particularly large year-over-year increases. Of the companies for which we have 2013 results, more than 80 percent that had failed votes in 2012 have passed in 2013, while more than 80 percent that have failed votes this year passed in 2012, underscoring the importance of consistent focus on these issues. Please note that all percentages in this summary follow the (for/(for + against + abstain) formulation.

### Factors Influencing ISS Recommendations

As noted in the most recent [Proxy Watch mailing](#), ISS "against" recommendations this proxy season continue to be driven by factors such as:

- a "pay for performance disconnect" (as determined based on ISS methodology);
- an emphasis on time-based equity award grants rather than performance-based grants;
- retention bonuses and "mega" equity grants;
- performance goals deemed by ISS to be insufficiently challenging;
- insufficient shareholder outreach and/or outreach in which the compensation committee is not directly involved; and
- termination and severance payments to an outgoing CEO, particularly in the case of a "friendly" termination (such as a termination characterized as a retirement or where the individual remains on the board).

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In addition, ISS has focused on the following items this proxy season:

- “make-whole” payments and grants to a new CEO to decrease the money “left on the table” by the individual in leaving the prior employer;
- severance payments, which could (based on ISS calculations) result in the multiple of compensation being greater than three; and
- bonuses which are not solely determined by a formula based on achievement of pre-specified performance criteria.

### **Trends in Supplemental Filings**

- *Peer Group Issues:* Following the 2012 proxy season, each of ISS and Glass Lewis indicated that it would be making changes to the methodology by which it determined peer groups. It was anticipated that this would result in advisory firm peer groups and company peer groups becoming more aligned. The initial wave of supplementary filings by companies in response to negative ISS recommendations did contain fewer complaints about peer group methodology. However, as the season has evolved, there has been a slight uptick in companies’ supplemental filings addressing peer group concerns. Criticisms include:
  - the use of revenue to choose peers when other measures (such as market capitalization) would be more relevant, at times resulting in peer groups in which not a single peer was in the same market capitalization range;
  - excluding peers in the company’s geographical area, when that is the area within which the company competes for talent (and/or not taking into account that the geographical area in question has an unusually high cost of living);
  - inclusion of many companies not in the subject company’s industry (although this particular complaint has been less common than in last year’s proxy season); and
  - differences between the peer groups constructed by ISS and Glass Lewis, with several companies indicating that they preferred the peer group constructed by Glass Lewis.
- *Other Issues:* The following additional issues have been raised in supplemental filings during the 2013 season:
  - A number of companies alleged that the shareholder advisory firms had made mistakes of fact regarding the terms and parameters of compensation arrangements, particularly in the case of incentive compensation plans. While each situation has its own unique characteristics and context, the fact that this issue was raised by multiple companies is a reminder that when drafting proxy disclosure with respect to complex arrangements, it is critical to be exceptionally clear and to have the disclosure carefully reviewed by multiple parties to check for overall comprehensibility. The use of charts and graphics also can be useful in this regard. It also is important to review carefully the advisory firms’ descriptions of the company’s compensation arrangements for factual accuracy.
  - As with last year’s supplemental filings, companies continued to express frustration that ISS does not consider stock options to be “performance-based compensation” (absent a performance-based vesting schedule), despite the fact that no value can be received with respect to a stock option unless the stock price increases.
  - Some companies defended their use of bonus awards that were not completely formulaic, noting that at times it is reasonable and/or more

appropriate to permit the compensation committee to adjust bonuses in ways that are sensitive to factors which cannot be adequately captured in a formula.

- It was noted in at least one filing that ISS policy changes caused previously acceptable practices (such as the entering into of pre-IPO excise tax gross-ups with a limited term) to transform into unacceptable practices, thus generating a negative recommendation that could not have been anticipated at the time the compensation arrangements were entered into.
- Finally, at least one company expressed concern about pension value “increases” based almost entirely on interest rate changes being treated as a true increase in pay. While it may not affect the ultimate view of advisory firms as to the characterization of the increase, companies should consider explaining these types of “artificial” increases with clarity and specificity in public disclosures.

### **Future Disclosure Obligations**

While we are now in our third season of “say on pay,” other compensation-related requirements set forth in the Dodd-Frank Act have not yet been the subject of proposed regulations by the Securities and Exchange Commission (SEC) and the anticipated timeline has been repeatedly pushed forward. Among the most controversial rules is the requirement that companies disclose CEO compensation as a multiple of median worker pay. This rule has raised serious concerns in the corporate community regarding the complexity of the related data collection, how compensation will be defined, whether international employees will be included and if the ratio will in fact be useful information for investors. While there have been press reports in recent days suggesting that the proposed regulation could be released for comment by the end of August, we have not yet heard anything definitive from the SEC. Skadden will continue to monitor this and other Dodd-Frank rulemaking and will provide insights in future client mailings as the regulations become available.

### **Proxy Litigation Update**

As noted in Skadden’s January 2013 [mailing](#) on the subject, in 2012 and early 2013 there was a wave of lawsuits alleging breaches of fiduciary duties by management and directors in connection with compensation-related decisions. These lawsuits involved 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 sought to enjoin the company’s annual meeting until supplemental disclosures were made. While “investigations” have continued to be announced by law firms specializing in this type of litigation, in recent months there has been a slowdown in reported litigation activity arising from those investigative efforts. We will continue to monitor developments closely.

As we discussed in our most recent [mailing](#), there is a “third wave” of lawsuits that does not seek to enjoin a shareholder vote, but rather to challenge compensation decisions which have already been made. These cases often involve claims that a company has failed 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 re-approval of performance goals every five years. In the last two months at least one company that had exceeded the per-person limit in its equity award plan decided to void the grant in question and then sought shareholder approval for an increase in the annual per-person limit under the plan, postponing the annual meeting to provide additional time for the proposed increase to be considered (and ultimately approved) by shareholders. Similar rescissions of grants by companies occurred in late 2012 and the first weeks of 2013, which in many cases are thought to have been made in response to threats of litigation. As companies prepare for their next round of equity grants,

we would encourage them to monitor any equity grant activity carefully and to involve internal counsel and equity specialists, as well as external advisers, to maintain compliance with all relevant laws and the terms of the company's plans and arrangements.

As the events of this third say-on-pay season wind down, we will be keeping you up to date regarding lessons learned and items to keep in mind with respect to the preparation of next year's proxy, a process which for many companies will begin in just a few months. We will also be monitoring the various types of proxy litigation and will bring you updates and insights as the newest waves of litigation evolve. If you have any questions regarding your proxy disclosure or your executive compensation plans and programs, please do not hesitate to contact us.

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