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Compensation Committee Roundtable

Thursday, November 17, 2011
12:30 p.m. – 1:45 p.m.

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Compensation Committee Roundtable

November 17, 2011

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Compensation Committee Roundtable

Moderators:

- *Jessica S. Lochmann Allen* – Partner, Foley & Lardner LLP
- *Steven W. Vazquez* – Partner, Foley & Lardner LLP

Panelists:

- *Michael S. Kesner* – Principal, Human Capital, Deloitte 2Consulting LLP
- *Patrick McGurn* – Special Counsel, Institutional Shareholder Services
- *Georgia R. Nelson* – PTI Resources, LLC
- *Mark C. Williamson* – Chairman, Putnam Roby Williamson Communications

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Say on Pay

Say on Pay – 2011 Proxy Season Results

- The vast majority of companies received majority shareholder support for their "say on pay" votes
- For the frequency of future "say on pay" votes, shareholders favored annual say on pay votes by a wide margin
- Withhold vote campaigns against compensation committee members decreased in 2011 compared to 2010
- There was a correlation between failed "say on pay" votes and negative vote recommendations from proxy advisory services
- Leading factors contributing to failed "say on pay" votes in 2011 included:
  - A perceived disconnect between pay and performance.
  - The presence of disfavored pay practices
- "Say on golden parachute" votes relatively rare

Say on Pay – Consequences of a Failed Vote

- The consequences of a failed "say on pay" vote include the following:
  - Although all companies will be required to address the "say on pay" vote and any responsive actions in CD&A, this disclosure will take on greater importance for companies with failed "say on pay" votes
  - The potential that proxy advisory services will be more likely to recommend withholding votes from compensation committee members
  - The potential for litigation

Institutional Shareholder Services (ISS) Update

- 2011-2012 Policy Survey Findings on U.S. Compensation Practices:
  - Pay levels relative to peers and a company performance's trend are relevant for both investor and issuer respondents when determining pay for performance alignment
  - Discretionary annual bonus awards can sometimes be problematic - investor and issuer respondents agree
  - Investor and issuer respondents diverge on opposition levels to a say-on-pay vote that should trigger a board response to improve pay practices
  - Less appetite from investor respondents in taking into account positive factors to mitigate cost of an equity plan
  - "Single-trigger" equity vesting in the context of equity plans elicits differing views from issuer and investor respondents

Institutional Shareholder Services (ISS) Update

- November: Will release final updates to Policies
- October: Released draft updates to Policies:
  - Proposal is to base voting recommendations on compensation committee members and the current year say-on-pay proposal on a case-by-case basis if the company's prior year say-on-pay proposal received "significant opposition" from the votes cast
    - Case-by-case analysis would take into account several factors, including an evaluation of the company's outreach efforts to major institutional investors, the company's response to the issues that influenced the prior year's vote, the meaningfulness and comprehensiveness of the company's disclosure and ISS's analysis of other compensation actions of the company
    - Higher level of scrutiny would be placed on companies where the say-on-pay proposal received the support of less than 50% of votes cast
    - Comment sought as to whether a support level of less than 70% should warrant an explicit response from the company to address concerns.

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Institutional Shareholder Services (ISS) Update

- October Release of Draft Updates to Policies (continued):
  - Proposed new methodology for evaluating a company's executive pay practices
  - Focus on reflecting the principle of pay-for performance
  - ISS's existing approach is to identify underperforming companies in terms of one- and three-year shareholder returns among a peer group, and then provide a qualitative analysis of other factors
  - Proposed approach would continue to feature a quantitative analysis, followed as applicable by a further qualitative analysis

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Institutional Shareholder Services (ISS) Update

- October Release of Draft Updates to Policies (continued):
  - The proposed quantitative analysis would have two features: one focusing on relative alignment of pay-for-performance and one focused on absolute alignment
    - The relative alignment analysis would evaluate companies within groups of 14-24 peers, selected on the basis of market capitalization, revenue (or assets for financial firms) and other factors
      - Would evaluate degree of alignment between the company's shareholder returns and CEO pay over one-year and three-year periods (with the three-year analysis given a 60% weight, and the one-year analysis a 40% weight)
    - The relative analysis would also consider the multiple of the CEO's total pay relative to the peer group median

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Institutional Shareholder Services (ISS) Update

- October Release of Draft Updates to Policies (continued):
  - Proposed "absolute alignment" analysis would consider alignment between the trend in the CEO's pay and the company's shareholder returns over a five-year period
    - The relative alignment and absolute alignment "may be" weighted 50/50 in the quantitative analysis
  - If the quantitative analysis demonstrates "weak" alignment, then ISS would use a further qualitative review to determine a final vote recommendation
  - The qualitative review would take into account a broad range of factors, including the use of performance-based awards, performance goals, peer group benchmarking and financial performance

Pay for Performance

- What Does "Pay for Performance Really Mean in Practice?
  - How to measure pay?
    - "Real" or "realizable" pay versus Summary Compensation Table
    - Relative – selection of peers
  - How to measure performance?
    - Total shareholder return
    - Financial measures used for incentive compensation
    - Other measures
    - Relative – selection of peers

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Pay for Performance

- How should "pay for performance" be presented to shareholders (CD&A)?
  - Use of charts or other graphics
  - Location in proxy statement
  - Establishing workable precedent
  - SEC requirements:
    - GAAP presentation or reconciliation
    - Not materially misleading (balance)
  - Effect of Dodd-Frank required pay for performance disclosure

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Responses to Year One of Say on Pay

- Trends in executive compensation as a result of say on pay
  - Changes in substantive pay practices in response to the vote, the preparation for the vote (eliminating poor pay practices like perquisites, gross-ups, excessive severance)?
- At what percentage of "no" votes is responsive action required?
- If there is a negative say on pay vote, what response is required to avoid a withhold vote recommendation for comp committee members?
- Responses to say on pay vote will need to be disclosed in 2012 CD&A

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Say on Pay Litigation

- Despite the disclaimer of new or enhanced fiduciary duties arising from advisory "say on pay" votes, several companies are now facing state law shareholder derivative lawsuits following failed "say on pay" votes
  - At least ten companies are facing derivative suits (and in many instances, more than one such suit), and plaintiffs' class action/derivative firms have announced investigations of additional companies that suffered failed "say on pay" votes
  - The early results have been mixed
    - KeyCorp: Settled a suit based on the failure of a say on pay vote required by the TARP, agreeing to changes to its compensation practices and procedures and a payment of $1.75 million to the plaintiffs' law firms
    - Beazer: In August 2011, the defendants in Teamsters Local 237 v. Beazer succeeded in having the say on pay suit against them dismissed
    - Cincinnati Bell: By contrast, this suit recently survived a motion to dismiss
- Are there specific actions companies can be taking to minimize their risk of say on pay litigation (other than seeking a positive vote outcome)?

Preparing for Year Two of Say on Pay

- Generally speaking, how should companies be preparing for the second year of say on pay?
  - Preparation of 2012 CD&A and say on pay proposal
    - Streamline
    - Plain English
    - Sequence should reflect priority of information
    - Start early
  - Analyze vote from first year
    - Which shareholders voted "no" and why
    - Proxy solicitor analysis
  - Determine whether to include a "say on golden parachutes" vote
  - Reach out to constituents

Constituent Engagement

- How should companies be engaging with shareholders on say on pay issues?
  - Timing: prior to proxy season
  - Methods:
    - Surveys
    - Group meetings
    - One-on-one meetings
    - Conference calls
    - E-Forums
    - Additional soliciting material
  - Designation of compensation "spokesperson"
- How and when should companies be engaging with ISS on say on pay issues?

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Other Dodd-Frank Compensation-Related Provisions

Compensation Committee Independence

- Dodd-Frank Act required SEC to issue rules concerning exchange listing standards that would require heightened independence requirements for compensation committee members
- SEC proposed rules in early 2011 that would require listing standards requiring each compensation committee member to be "independent."
- Independence would be defined by the exchanges considering:
  - Sources of compensation of the director, including any consulting, advisory or other compensatory fee paid by the company to the director
  - Whether the director is affiliated with the company or any of its subsidiaries or their affiliates.
- SEC plans for adoption of listing standards in November – December 2011

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Compensation Committee Independence

- Are companies currently taking action to better ensure their committee members will remain "independent" under a heightened independence standard?
- Do companies expect any problems with committee composition when the final rules and listing standards become effective?

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Committee Advisor Independence

- Dodd-Frank Act required SEC to issue rules concerning exchange listing standards that would require compensation committees to consider independence of advisors and to have the authority to hire advisors
- SEC has proposed rules calling for listing standards mandating:
  - Compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (collectively, the "compensation advisers"), and must be directly responsible for appointing, compensating and providing oversight of the work of the compensation adviser
  - Company must provide appropriate funding (as determined by the compensation committee) for payment of reasonable compensation to compensation advisers

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Committee Advisor Independence

- SEC proposed rules on compensation committee advisors also would mandate listing standards requiring:
  - Compensation committees must consider certain independence criteria prior to hiring compensation advisers, including the following factors: (1) the provision of other services to the company by the firm employing the compensation adviser; (2) the amount of fees received from the company by the company employing the compensation adviser, as a percentage of that firm's total revenue; (3) the policies and procedures adopted by the firm employing the compensation adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the compensation adviser with a member of the compensation committee; and (5) the compensation adviser's ownership of the company's stock
- SEC has also proposed rules requiring proxy statement disclosure of advisor conflicts of interest and how they were addressed
- SEC plans for adoption of listing standards and disclosure rules in November – December 2011

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Committee Advisor Independence

- What are compensation consultants advising companies to do in light of the requirement?
- What actions are companies taking to ensure future independence?

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Clawbacks

- Dodd-Frank Act required the SEC to issue rules directing exchanges to prohibit the listing of issuers that do not develop and implement policies providing:
  - For disclosure of the issuer's policy regarding any incentive-based compensation that is based on financial information required to be reported under the securities laws; and
  - That, if the issuer is required to prepare an accounting restatement due to its material noncompliance with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement

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Clawbacks

- Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) already contains a clawback provision, although the standard under the Act is stricter than the SOX standard because SOX requires that the restatement occur “as a result of misconduct,” only applies to a company's CEO and CFO, and is limited to a 12-month period preceding the restatement.

- SEC plans to issue proposed rules in November-December 2011; final rules in first half of 2012

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Clawbacks

- Are companies currently including references to clawback policies in award agreements, employment agreements, etc. as they are being updated?
- Should they be?
- What are the key considerations in implementing effective clawback provisions?

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Pay Ratios

- Dodd-Frank requires the SEC to issue rules requiring issuers to disclose in their proxy statements a "pay ratio":
  - The median of the annual total compensation of all employees of the issuer, except the CEO; the annual total compensation of the CEO; and the ratio of those two amounts, with total compensation determined in accordance with Item 402 of Regulation S-K.
- AFL-CIO proposal to SEC to permit the "median" to be established through statistical sampling has reportedly gained favor with the SEC Staff
- SEC plans to issue proposed rules in November-December 2011; final rules in first half of 2012
- Have companies begun gathering data or establishing processes to enable them to make the expected calculations?
- What should companies be doing to prepare?

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Required Pay and Performance Disclosure

- Dodd-Frank requires the SEC to issue rules requiring issuers to disclose "pay for performance" in their proxy statements:
  - Information showing the relationship between executive compensation and the financial performance of the issuer, taking into account any change in the value of the issuer's shares, which may include a graphic representation of the information required to be disclosed.
- SEC plans to issue proposed rules in November-December 2011; final rules in first half of 2012
- What effect do you expect the requirement to disclose pay versus performance will have?

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Other Executive Pay Issues in 2012

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Effective Pay Structures

- What challenges do you expect compensation committees to face in terms of providing effective incentives and adequate retention features in the wake of the economic slowdown in 2011?
- If performance goals are missed as a result of the challenging economy, is it appropriate for companies to consider paying discretionary bonuses despite a decline in shareholder value?
- How should say on pay factor into this determination?
- In the debate over executive compensation, have we lost sight of the objective of building long-term shareholder value?

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Equity Plan Approval

- If companies are running up against share limitations under their equity incentive plans (whether because of decreased share values or normal share usage), and they are looking at putting a new equity plan in place or increasing the authorized shares, should they communicate with ISS and institutional investors?
- If so, how and when should companies communicate with these constituencies?
- What internal evaluations can a company perform to determine whether the plan changes being proposed will be met with approval by ISS or others?
- What plan terms are “hot buttons” right now such that they should be discussed with the compensation committee?
- What features should companies consider incorporating in equity incentive plans?

Say on Pay Report From the 2011 Proxy Season

When the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law in 2010, it included a requirement that most publicly traded companies include in their annual shareholder meeting agendas an advisory vote to approve the compensation paid to named executive officers in the most recent fiscal year (the "say on pay" vote) and an advisory vote on the frequency of future say on pay votes (the "say when on pay" vote). The 2011 proxy season was the first proxy season that included these mandatory say on pay and say when on pay votes. This article analyzes the outcomes of these votes in 2011 and provides some suggestions for companies preparing for say on pay votes in 2012.

Executive Summary

Key takeaways from the 2011 proxy season results include the following:

- The vast majority of companies received majority shareholder support for their say on pay votes
- For the frequency of future say on pay votes, shareholders favored annual say on pay votes by a wide margin
- Withhold vote campaigns against compensation committee members decreased in 2011 compared to 2010
- There was a correlation between failed say on pay votes and negative vote recommendations from proxy advisory services
- Leading factors contributing to failed say on pay votes in 2011 included:
  - A perceived disconnect between pay and performance
  - The presence of disfavored pay practices

The consequences of a failed say on pay vote include the following:

- All companies will be required to address the say on pay vote and any responsive actions in CD&A; for companies with failed say on pay votes this disclosure will be of heightened importance
- The potential that proxy advisory services will be more likely to recommend withholding votes from compensation committee members
- The potential for litigation

In preparation for next year's say on pay votes, companies should:

- Carefully assess individual alignment of pay and performance
- Evaluate pay arrangements for disfavored pay practices
- Know their shareholders and communicate effectively with them and proxy advisory services through the proxy statement (CD&A) and direct communications
- Prepare for the contingency of a failed say on pay vote
- Consider challenging any negative vote recommendations

Survey of 2011 Say on Pay Results

Through September 25, 2011, 2,746 companies have reported annual meeting results that included say on pay votes.[1] Of these companies, only 38 (less than two percent) did not receive majority shareholder support for their say on pay votes.[2] More than 250 of these companies received majority support but had more than 20 percent of their voted shares opposing their say on pay proposals.[3] Average (mean) shareholder support for say on pay at the 98 percent of Russell 3000 companies who received majority shareholder support for say on pay was 91 percent through June 30, 2011 (the end of the 2011 proxy season for most companies). Average shareholder support at the fewer than two percent of such companies with failed say on pay votes as of that date was 42 percent.[4]

For the say when on pay vote, Dodd-Frank required that shareholders be given four voting alternatives: to vote that future say on pay votes be held every year, every other year, or every third year or to abstain. In the first months of the 2011 proxy season, many companies recommended that shareholders vote for a frequency of every third year, but this trend changed as the proxy season progressed, and increasing numbers of companies recommended that shareholders vote for annual say on pay votes. In the end, 54 percent of the Russell 3000 companies recommended annual votes, 41 percent recommended triennial votes, two percent recommended biennial votes and three percent did not make a recommendation. Shareholders favored annual say on pay votes by a wide margin, with shareholders at 81 percent of Russell 3000 companies expressing a preference for annual votes. Shareholders at 18 percent of companies expressed a preference for triennial votes, and only one percent of companies saw shareholders express a preference for biennial votes.

Withhold vote campaigns against compensation committee members decreased in 2011 compared to 2010, consistent with predictions by some observers that say on pay would reduce shareholders' use of withhold vote campaigns to express displeasure over compensation matters. In that sense, having say on pay votes was a positive. However, the next question on shareholders' minds will be whether compensation committee members respond appropriately to say on pay votes at their companies.

Reasons for the Say on Pay Vote Failures

Not surprisingly, there was a correlation between negative vote recommendations from proxy advisory services and failed say on pay votes. All 38 companies with a failed say on pay vote in the 2011 proxy season had a negative vote recommendation from ISS. ISS's voting recommendations were not, however, outcome-determinative in every case. For example, ISS recommended in favor of the say on pay proposals of only 87 percent of the Russell 3000 companies, but as noted above, 98 percent of the proposals passed. Even if ISS's voting recommendations were not dispositive, they correlated to voting margins, as companies with a negative recommendation from ISS had, on average (mean), fewer votes cast in favor of their say on pay proposals than companies with a positive recommendation.

Glass Lewis, another major proxy advisor, does not make its voting recommendations available to the same extent as ISS. It has been reported, however, that Glass Lewis recommended against the say on pay proposals of 17 percent of companies overall.[5]

The foremost factor contributing to failed say on pay votes in 2011 may have been a perceived disconnect between pay and performance. In ISS's analysis, a pay-for-performance disconnect is generally defined as one-year and/or three-year total shareholder return below a company's GICS code industry median, combined with a corresponding rise or moderate decrease in year-over-year total direct compensation of the chief executive officer that is not linked to performance. ISS defines total direct compensation for these purposes as the sum of base salary, bonus, non-equity incentives, stock awards, option awards, target value of performance shares/units, change in pension value and nonqualified deferred compensation earnings, and all other compensation, generally as disclosed in the proxy statement (except that the grant date present value of options is calculated using ISS's or Equilar's Black-Scholes option pricing model). Of the Russell 3000 companies with failed say on pay votes in 2011, 78 percent had a one-year or three-year total shareholder return below the median of their respective peer groups (as selected by ISS), and 76 percent of the companies increased or did not change their respective chief executive officers' compensation.[6]

Disfavored pay practices also played a role. ISS and Glass Lewis have identified certain pay practices that they weigh against a favorable say on pay vote recommendation. These pay practices include, among other things:

- New or extended agreements with severance greater than three times salary plus bonus, excise tax gross-up, or single-trigger severance
- Excessive perquisites and gross-ups
- Repricing underwater options without shareholder approval

ISS scores companies on a system called GRiD that takes into account, among other things, these disfavored pay practices. Of the Russell 3000 companies with failed say on pay votes in 2011 through June 30, 2011, 35 percent had a GRiD compensation level of concern ranked as "high," while 46 percent had been assigned a "medium" level of concern.[7]

Consequences of Failed Say on Pay Votes

It is still too soon after the 2011 proxy season to know all of the consequences of failed say on pay votes, but a few are clear and some trends have begun to emerge. Under the SEC rules on say on pay, all companies that have had a say on pay vote (whether or not successful) will be required to describe in the CD&As of their proxy statements in 2012 whether and how their respective compensation committees took into account the results of the 2011 say on pay votes when making subsequent executive compensation decisions. Accordingly, one consequence of a failed say on pay vote will be a need to address the vote and any response in CD&A. ISS also has indicated that it may recommend withholding votes from compensation committee members of companies that receive a negative say on pay recommendation and take no action to address the policies that caused the negative recommendation, and some observers believe the likelihood of a withhold vote recommendation for compensation committee members is higher if the prior year's say on pay vote failed.[8]

In addition to these disclosure and governance considerations, a significant consequence of a failed say on pay vote may be litigation. The Dodd-Frank provisions on say on pay specifically provide that say on pay resolutions will not be construed to 1) overrule the board's compensation decisions, 2) create or imply any change to the issuer or board's fiduciary duties, 3) create or imply any additional fiduciary duties for issuers or boards, or 4) limit shareholders' ability to make other compensation-related proposals. Despite this disclaimer of new or enhanced fiduciary duties arising from these "advisory" votes, several companies are now facing state law shareholder derivative lawsuits following failed say on pay votes by which shareholders rejected board-approved compensation arrangements. At least 10 companies are facing derivative suits (and in many instances, more than one such suit), and plaintiffs' class action/derivative firms have announced investigations of additional companies that suffered failed say on pay votes. Many of these suits are still in their infancy, and, as a result, it is uncertain how much traction the suits will ultimately have. The early results have been mixed: In March 2011, a suit based on the failure of a say on pay vote required by the Troubled Asset Relief Program resulted in a monetary settlement when KeyCorp agreed to make changes to its compensation practices and procedures and to pay $1.75 million to the plaintiffs' law firms. In August 2011, the defendants in *Teamsters Local 237 v. Beazer* succeeded in having the say on pay suit against them dismissed. By contrast, a third suit, *NECA-IBEW Pension Fund v. Cox*, involving Cincinnati Bell, Inc., recently survived a motion to dismiss. The potential of achieving settlements similar to the settlement in KeyCorp will likely encourage the plaintiffs' bar to continue to pursue such suits, and the perceived settlement value of such suits may have been enhanced by the recent result in the Cincinnati Bell suit.

For more analysis of say on pay related litigation, please refer to Foley's July 25 Legal News titled, "When a Nonbinding Vote Binds: The Perils of Ignoring a 'No' Vote on Executive Compensation," available at http://tinyurl.com/6cf2krt.

Preparing for Say on Pay in the 2012 Proxy Season

In light of the potential negative consequences of a failed say on pay vote, companies that will have say on pay votes again in 2012 should continue to be vigilant and proactive to ensure a successful outcome. In this regard, the strategies below may help to secure favorable recommendations from proxy advisory services and, more importantly, favorable votes from shareholders.

Carefully assess individual alignment of pay and performance. A company's assessments of its pay for performance alignment should take into account not only ISS's formula, but also the company's own internal metrics for measuring pay and performance. As described above, ISS's vote recommendation is not always outcome-determinative, and the company has an opportunity to make its own case for its pay for performance linkage in the CD&A, in the supporting statement for the say on pay proposal in the proxy statement and in other communications to shareholders.

Evaluate pay arrangements for disfavored pay practices. It is important to identify all disfavored pay practices well in advance of the 2012 proxy season. Doing so will enable preparation of a thorough explanation in the CD&A as to why the pay practice is appropriate (if it is) and will also allow time to modify or eliminate any such practices that are deemed no longer appropriate or for which the benefits no longer outweigh the costs. In evaluating pay practices in the current environment, it is important to keep in mind that decisions on executive compensation should always be made by directors in the best interests of the company and its shareholders, and should not be dictated by voting policies or proxy advisory firms.

Know your shareholders. Long before any vote takes place, the board may wish to consider factors such as the following to assess the risk of a shareholder "no" vote:

- Have significant institutional investors — the parties who drive these votes — indicated in the past that they are unhappy with the company's compensation practices or decisions?
- Have any of these same institutions "no" voted other companies or filed suit, and if so, is it clear why?[9]
- What are the particular influences on each major institutional shareholder in terms of proxy advisory services or other voting guidelines?
- Are there aspects of the company's recent performance that a shareholder could seek to characterize (rightly or wrongly) as "disappointing"?
- If so, how do those aspects factor into the company's compensation philosophy and decisions?
- Are there steps that the company can take, by way of additional communication, disclosure, or the like, to address these risk factors proactively and render it more likely that the company will obtain a positive say on pay vote?

Communicate. Communication with shareholders and proxy advisory firms can come in several forms, all of which can potentially be useful in ensuring a successful say on pay vote.

- Proxy statement/CD&A. The CD&A and the supporting statement for the say on pay proposal in the proxy statement are perhaps the most important communications in connection with say on pay. Both the CD&A and the supporting statement should clearly depict how the company's pay arrangements encourage and reward performance, using graphics or charts wherever feasible, and highlight both the favored pay practices that the company maintains (e.g., holding periods on equity awards) and disfavored pay practices in which the company does not engage (e.g., no excise tax gross-ups). Companies also should include executive summaries that highlight the most relevant say on pay considerations.

In light of the risk of litigation, moreover, companies should consider explaining what they mean by terms such as pay for performance. In lawsuits following failed say on pay votes challenging compensation decisions, the plaintiffs' bar often seeks to use the CD&A to support their claims. For example, in the complaint in the derivative lawsuit filed against the board of directors of Helix Energy Solutions Group, Inc. and its compensation consultant, the plaintiffs take issue with CD&A language stating that executive pay is based on performance. To do so, the plaintiffs point to a decline in the company's performance and allege that, despite the decline, the company increased the compensation of its executives. On this basis, the plaintiffs assert that the company is not, in fact, paying executives based on the company's performance, and the plaintiffs charge the directors with ignoring the company's compensation policy.

- **Direct communications with shareholders.** Companies that believe significant shareholders may potentially vote against their say on pay proposals would in most cases be well advised to communicate with the shareholders in advance of the vote to identify the shareholders' specific concerns and any measures that could be taken to address them. Even companies without such specific concerns, however, should consider establishing channels of communication on the topic of executive compensation to increase the likelihood of advance warning of any shareholder concerns in the future. In communicating with shareholders, companies should, of course, be careful to comply with applicable proxy and other disclosure rules, such as Regulation FD.
- **Communications with proxy advisory services.** The proxy advisory firms provide some companies an opportunity to review their initial reports to correct any factual errors. Companies should be prepared to do a careful review and push back on any factual mistakes as well as any erroneous characterizations of pay practices. Companies also may engage ISS's governance consulting services prior to proxy season to identify potential issues in advance.

Prepare for the contingency of a failed say on pay vote. If there is genuine risk of a shareholder "no" vote, or of a say on pay vote passing with less than an 80 percent favorable vote, companies may wish to develop a plan to address the worst-case scenario. An 80 percent margin is relevant because, as some proxy solicitation firms have reported, large institutional holders have indicated that they will apply greater scrutiny to companies who receive 20 percent or greater opposition to say on pay.[10] Relevant considerations in planning a response might include the following: Will the compensation committee revisit a past compensation decision that likely contributed to a negative vote and consider adjustments to it, or will adjustments be considered on a prospective basis only? What are the tax, accounting, and other ramifications of a retroactive adjustment, and are they problematic? Does a decision to make adjustments depend on the percentage of shareholders that vote against the say on pay proposal (e.g., 51 percent versus a supermajority) or other factors? If no adjustments will be made, will the company provide an explanation as to why it is maintaining a compensation program that the shareholders have rejected, at least in part? As a matter of good corporate housekeeping, the minutes of compensation committee and board meetings should, of course, capture and accurately convey the rationale for any action or non-action that the compensation committee and board decide to take in light of a negative shareholder vote.

Challenge negative vote recommendations. During the 2011 proxy season, several companies took extraordinary measures to challenge or offset negative say on pay vote recommendations from proxy advisory firms. At least 40 companies filed supplemental proxy materials in 2011 to address issues with the proxy advisory firms' fact-findings or analysis or simply to communicate to shareholders the companies' disagreement with the recommendations. Several companies (including Alcoa, Disney, General Electric, and Lockheed Martin) made retroactive changes to their compensation arrangements to address problematic pay practices or pay for performance disconnects in an effort to persuade ISS to change its negative say on pay vote recommendation. These strategies may become more common in the future out of perceived necessity, but it is likely that most issuers will seek to address any issues or potential issues identified through publicly disclosed voting policies, or through communications with proxy advisory services or shareholders in advance of the proxy season rather than through supplemental disclosures or retroactive changes.

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Joshua A. Agen
Milwaukee, Wisconsin
414.297.5535
jagen@foley.com

Patrick G. Quick
Milwaukee, Wisconsin
414.297.5678
pgquick@foley.com

Courtney Worcester
Boston, Massachusetts
617.502.3218

cworcester@foley.com

[1]*See* Mark Borges, "This Week's "Say on Pay" Vote Results (September 25, 2011) (available at www.compensationstandards.com).

[2]The following 38 companies failed to receive majority shareholder support in the 2011 proxy season:

- Ameron International Corporation
- Beazer Homes USA, Inc.
- BioMed Realty Trust, Inc.
- Blackbaud, Inc.
- Cadiz Inc.
- Cincinnati Bell Inc.
- Cogent Communications Group, Inc.
- Constellation Energy Group, Inc.
- Curtiss-Wright Corporation
- Cutera, Inc.
- Dex One Corporation
- Exar Corporation
- Exar Corporation Freeport-McMoRan Copper & Gold Inc.
- Helix Energy Solutions Group, Inc.
- Hercules Offshore, Inc.
- Hewlett-Packard Company
- Intersil Corporation
- Jacobs Engineering Group Inc.
- Janus Capital Group Inc.
- Kilroy Realty Corporation
- M.D.C. Holdings, Inc.
- Masco Corporation
- Monolithic Power Systems, Inc.
- Nabors Industries Ltd.
- Navigant Consulting, Inc.
- Nutrisystem, Inc.
- NVR, Inc.
- Penn Virginia Corporation
- PICO Holdings, Inc.
- Premiere Global Services, Inc.
- Shuffle Master, Inc.
- Stanley Black & Decker, Inc.
- Stewart Information Services Corporation
- Superior Energy Services, Inc.
- The Talbots, Inc.
- Tutor Perini Corporation
- Umpqua Holdings Corporation
- Weatherford International Ltd.

[3]As discussed further below, some proxy solicitation firms have reported that large institutional holders have indicated that they will apply greater scrutiny to companies who receive 20 percent or greater opposition to say on pay. *See* Morrow & Co., LLC, Say on Pay and Say on Frequency ("Say When on Pay") Results at the End of the Proxy Season (July 1, 2011).

[4]*See* Frederic W. Cook & Co., Inc., 2011 Proxy Season De-Brief (August 9, 2011).

[5]*See* Frederic W. Cook & Co., Inc., 2011 Proxy Season De-Brief (August 9, 2011).

[6]*Id.*

[7]*Id.*

[8]*See* Erin McNally, Shareholders Have Their Say on Pay, But What Are the Proxy Advisory Firms Saying? (August 2011).

[9]In this regard, note that Dodd-Frank added a requirement to the Securities Exchange Act of 1934, as amended (Exchange Act), that every institutional investment manager subject to Section 13(f) of the Exchange Act report at least annually how it voted on say on pay and say when on pay.

[10]See Morrow & Co., LLC, Say on Pay and Say on Frequency ("Say When on Pay") Results at the End of the Proxy Season (July 1, 2011).

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The attorneys of Foley's Transactional & Securities Practice provide sophisticated legal advice on the issues most important to public and private companies, including all aspects of merger and acquisition transactions, capital markets transactions, securities matters, investment company matters, corporate governance and counseling, and other matters. We are a significant resource for organizations worldwide in need of insightful and innovative legal and business counsel.