Say On Pay Best Practices For 2012

by John K. Wilson and Joshua A. Agen

Most public U.S. corporations faced their first shareholder "say on pay" vote last proxy season, and the results were mixed. While the great majority of shareholders endorsed how their companies pay top executives, a few votes were lost. It also became apparent that anything short of overwhelming investor approval was a sign that trouble was brewing among shareholders. What say on pay lessons were learned in 2011, and how are smart corporations taking them to heart for 2012?

For the 2012 proxy season, many publicly-traded companies now face their second mandated shareholder advisory vote on the pay of their named executive officers, known as a "say on pay" vote. This requirement arose from the Dodd-Frank Act, and was first applicable during the 2011 proxy season. The results of the 2011 proxy season offer a number of lessons and best practices for companies to consider when preparing for a say on pay vote in 2012.

Most companies achieved successful say on pay vote outcomes in 2011. Through December 16, 2011, nearly 3,000 companies reported annual meeting results that included say on pay votes. Of these, more than 98 percent received majority shareholder support for their say on pay votes, with average shareholder support of more than 90 percent.

The advent of say on pay corresponded with a decrease in withhold vote campaigns against compensation committee members compared to 2010. This trend was consistent with predictions by some observers that say on pay would reduce shareholders' use of withhold vote campaigns to express displeasure over executive pay.

Not surprisingly, there was a correlation between negative vote recommendations from proxy advisory firms and failed say on pay votes in 2011. All of the companies with a failed say on pay vote in 2011 had a thumb's down recommendation from the proxy advisory firm Institutional Shareholder Services (ISS). However, ISS' voting recommendations did not assure the outcome in every case. ISS supported less than 90 percent of say on pay proposals, but, as noted above, 98 percent of these passed.

The foremost factor contributing to failed say on pay votes in 2011 may have been a perceived disconnect between pay and performance.

Although ISS' voting recommendations were thus not always the final word, they correlated to voting margins. Companies with a negative recommendation from ISS had, on average, fewer votes cast in favor of their pay plans than companies with a positive recommendation.

The foremost factor contributing to failed say on pay votes in 2011 may have been a perceived disconnect between pay and performance. ISS has updated its analysis of pay and performance for 2012, but, in 2011, it defined a pay for performance disconnect generally as one-year and/or three-year total shareholder return below a company's industry median combined with a corresponding rise or moderate decrease in year-over-year total direct pay for the chief executive officer not linked to performance.

Of the Russell 3000 companies with *failed* say on pay votes through June 30, 2011, 78 percent had a one-year or three-year total shareholder return below the median of their peer groups. Seventy-six percent of the companies increased or did not change their respective CEO's compensation.

Disfavored pay practices also played a role in failed say on pay votes. ISS and Glass Lewis, another significant proxy advisor, have identified certain pay practices that bring negative say on pay vote recommendations. These pay practices include:

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- ☐ New agreements with severance pay 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 through June 30, 35 percent had a GRiD "level of concern" ranked as "high," while 46 percent had been assigned a "medium" level of concern.

A significant number of the companies that received negative vote recommendations from ISS reacted by seeking either a change in recommendation from ISS, or to overcome the negative recommendation by directly persuading shareholders. These efforts were successful in some cases.

By May 2011, nearly 70 companies had filed supplemental proxy materials to address issues with proxy firms' findings or to communicate to shareholders their disagreement with the recommendations. Several companies (including Alcoa, Disney, General Electric and Lockheed Martin) changed their pay plans to address problematic pay practices or pay for performance disconnects to persuade ISS to change its negative vote recommendation.

Another significant say on pay trend that emerged in 2011 was shareholder derivative litigation based in part on failed say on pay votes. The Dodd-Frank provisions on say on pay specifically provide that the "advisory" say on pay resolutions will not be construed to:

- ☐ Overrule the board's pay decisions.
- ☐ Change the issuer or board's fiduciary duties.
- ☐ Add any fiduciary duties for issuers or boards.
- ☐ Limit shareholders' ability to make other pay proposals.

Despite this statutory disclaimer, however, several companies are now facing state law shareholder derivative lawsuits following failed say on pay votes. Many of these suits are still in their infancy with early results mixed and, as a result, it is uncertain how much traction the suits will ultimately have.

Most Votes Win

2011 Say On Pay Votes From The Russell 3000

Voting Results		Average Support	
Pass	98%	Passing Companies	91%
Fail	2%	Failing Companies	42%

In March 2011, a suit based on the failure of an early say on pay vote resulted in KeyCorp making changes to its compensation practices and paying $1.75 million in a settlement. 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., survived a motion to dismiss in 2011. Potential settlements such as that in KeyCorp will likely encourage the plaintiffs' bar to pursue such suits.

Companies with less than 70 percent say on pay support in 2011 should plan for action in 2012. This is the level below which ISS plans greater scrutiny.

In light of the potential negative consequences of a failed say on pay vote, for 2012 companies should continue to be vigilant, and work to ensure a successful outcome. The following strategies may help to secure favorable recommendations from proxy advisory firms—and, most importantly, favorable vote outcomes.

☐ *Plan your response to say on say votes from 2011.* Under SEC rules, all companies that hold a say on pay vote (whether or not successful) will be required to address the results in the Compensation Discussion & Analysis (CD&A) sections of their proxy statements in 2012. The company must disclose whether and how its compensation committee took into account the results of the 2011 vote when making subsequent executive pay decisions.

Companies that received less than 70 percent shareholder support for their plan in 2011 should consider what actions are necessary in response for 2012. The 70 percent threshold is relevant because ISS has indicated it will generally recommend "against" or "withhold" votes if compensation committees fail to adequately respond after a say on pay vote receiving the support of less than 70 percent.

ISS will examine whether companies take new steps on pay, or simply reiterate existing practices. Avoid "boilerplate" disclosure in say on pay responses.

ISS has suggested that it expects companies receiving less than 70 percent support to respond through engagement with shareholders and to disclose any changes made voluntarily in advance of the proxy statement. ISS will examine the company's response, including:

- □ Disclosure of engagement efforts with major institutional investors on issues prompting the low level of support.
- □ Specific actions taken to address the issues that contributed to the low level of support.
- □ Other recent compensation actions taken by the company.
- □ Whether the issues raised are recurring or isolated.
- □ The company's ownership structure.
- □ Whether the support level was less than 50 percent, which would warrant the highest level of responsiveness.

ISS has advised that it will consider whether company actions indicate new steps or simply a reiteration of existing practices. Companies should avoid "boilerplate" disclosure about their responsive actions.

□ *Understand the new ISS approach to say on pay in 2012.* ISS' influence on votes is likely to continue in 2012, so companies will need to understand ISS' updated method of evaluating say on pay proposals for 2012 which is intended to refine and emphasize the quantitative elements of its analysis. The updated method includes two initial, quantitative "screens" that are intended to be used to identify outliers.

□ The first is "peer group alignment," consisting of the *degree of alignment* between the company's total shareholder return (TSR) and the CEO's total pay rank within a peer group as measured over one- and three-year periods (with the one-year period weighted 40 percent and the three-year period weighted 60 percent). It also includes the multiple of the CEO's total pay relative to the peer group median.

□ The second "screen" measures *absolute alignment* between the trend in the CEO's pay and the company's TSR over the prior five fiscal years.

In the peer group alignment element, the peer group for the TSR calculation will not, as in past years, comprise all Russell 3000 companies in a company's industry group. Instead, the peer group will generally be 14 to 24 companies selected by ISS based on size, using market capitalization or revenue, and industry group.

Quantitative screens of the CEO's compensation will continue to be based on the total pay levels disclosed in the Summary Compensation Table of the proxy statement. ISS continues to use its own set of assumptions (rather than the assumptions used in the Summary Compensation Table) to assign grant date fair values to equity-based awards.

ISS will subject companies with unsatisfactory alignment based on the two quantitative screens to a further qualitative analysis that considers:

- □ The ratio of performance-based to time-based equity awards.
- □ The overall ratio of performance-based compensation to overall pay.
- □ The completeness of disclosure and rigor of performance goals (including any non-GAAP adjustments).
- □ The company's peer group benchmarking practices.
- □ Results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc. (both absolute and relative to peers).

- Special circumstances. For example, was a new CEO named in the prior fiscal year, or were there unusual equity grant practices (biennial awards, etc.)?
- Any other factors deemed relevant.

Decisions on executive pay should always be made in the best interests of the company and its shareholders—not by voting policies or proxy advisory firms.

☐ *Evaluate disfavored pay practices.* Companies should identify unpopular pay practices in advance of the 2012 proxy season. This will allow them to modify or eliminate any practices that are deemed no longer appropriate or for which the benefits no longer outweigh the costs. Or, companies can prepare a thorough explanation in the proxy statement's CD&A as to why the pay practice is appropriate.

In evaluating pay practices, it is important to keep in mind that decisions on executive pay should always be made by directors in the best interests of the company and its shareholders—they should not be dictated by voting policies or proxy advisory firms.

☐ *Communicate regarding executive compensation.* Companies should actively communicate with shareholders and proxy advisory firms regarding their executive pay practices.

If significant shareholders may vote against say on pay proposals, companies would be well advised to communicate with the shareholders in advance of the vote to identify specific concerns and any measures that could be taken to address them. Even companies without specific concerns should consider establishing channels of communication on executive pay matters to improve advance warning of any shareholder concerns in the future.

In communicating with shareholders on pay-related matters, companies should keep in mind that the investment and governance/voting functions at their institutional investors may be divided. Thus, the company's normal point of contact may not be the appropriate person for a discussion of say on pay voting policies. In addition, companies should, of course, be careful to comply with applicable SEC proxy and other disclosure rules (such as Regulation FD).

ISS Speaks, Investors Listen

Impact of ISS Recommendations At The Russell 3000

ISS Voting Recommendations		Average Passing Vote When	
For	87%	ISS **for** Recommendations	94%
Against	13%	ISS **against** Recommendations	73%

Companies should communicate through proxy statements and their CD&A. The CD&A and the supporting statement for the say on pay proposal in the proxy statement are 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. Use graphics or charts wherever feasible, and highlight both the favored pay practices that the company maintains (holding periods on equity awards, etc.) and disfavored pay practices which the company does *not* use (excise tax gross-ups). Also include executive summaries that highlight the most relevant say on pay considerations.

Avoid unsupported "we pay only for performance" claims. Plaintiff attorneys can use these to their advantage.

Draft your CD&A in light of the lawsuits that followed failed say on pay votes to minimize the likelihood that plaintiffs can use the disclosures to support their claims. Avoid unsupported and unexplained statements that your company "pays only for performance." Plaintiffs can use these to their advantage. Instead,specific pay elements should be tied to specific performance measures so that claims of pay for performance can be supported with concrete evidence. The CD&A should be clear about which elements of pay are performance-based and, equally, which elements are not.

Companies should also communicate with proxy advisory services. Companies can engage ISS' governance consulting services prior to proxy season to identify potential issues in advance. Certain proxy advisory firms also provide firms an opportunity to review their initial reports to correct any factual errors. Be prepared to do a careful review and push back on factual mistakes, as well as any erroneous characterizations of pay practices.

☐ *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 70 percent, consider developing a plan to address the worst-case scenario. Relevant considerations in planning a response might include:

▫ Whether the compensation committee will revisit a past pay decision that likely contributed to a negative vote and consider adjustments to it, or consider adjustments on a prospective basis only.

▫ The tax, accounting, and other ramifications of a retroactive adjustment.

▫ Whether a decision to make adjustments depends on the percentage of shareholders that vote against the say on pay plan (such as 51 percent versus a supermajority), or other factors.

▫ Whether, if no adjustments will be made, the company will provide an explanation of why it is maintaining a pay 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 capture and accurately convey the rationale for any action or non-action taken in light of a negative shareholder vote.

☐ *Challenge negative vote recommendations.* During the 2011 proxy season, some companies sought to challenge or offset negative say on pay vote recommendations from proxy advisory firms. Similar actions may become more common in the future out of necessity. Still, it is preferable to address any issues through publicly disclosed voting policies, or through communications with proxy advisory firms or shareholders in advance of the proxy season, rather than through supplemental disclosures or later changes.

In conclusion, although most companies received strong shareholder support for their inaugural say on pay votes in 2011, there is no guarantee of similar results this year. Companies must be responsive to their 2011 say on pay votes, understanding ISS' methodologies, updating their pay practices, communicating with shareholders and reacting to negative vote recommendations or outcomes. Companies that apply these lessons and best practices from 2011 are better positioned for success on their say on pay votes in 2012. ■

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