Skadden

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

November 25, 2009

RiskMetrics Group Issues Its 2010 Policy Updates: U.S. Corporate Governance/Executive Compensation Matters

RiskMetrics Group, or RMG, an influential proxy advisory firm, annually updates the policies that underlie its voting recommendations to its institutional investor clients. On November 19, 2009, RMG issued its policy updates applicable to shareholder meetings occurring on or after February 1, 2010.

Depending on a company's shareholder base, a RiskMetrics voting recommendation can have a meaningful impact on the outcome of items submitted to a shareholder vote. In the case of director elections, a negative RMG voting recommendation — combined with the absence of broker discretionary voting in director elections (new for 2010) and the increased incidence of companies with some form of majority voting for director elections — increases the risk that one or more directors are not elected and/or are required to submit their resignation. According to RiskMetrics, in the first nine months of 2009, 91 directors at 49 U.S. companies failed to receive a majority of votes in favor of their election — about three times the 32 directors at 17 companies for all of 2008.

This memorandum describes the more important corporate governance and executive compensation policy updates applicable to publicly traded U.S. companies. These policies, as well as frequently asked questions on U.S. compensation (FAQs), may be viewed in full at www.riskmetrics.com/policy.[1] Now is the time to be mindful of the potential impact of practices or provisions focused on by RMG and in similar policies of institutional investors in advance of the 2010 proxy season.

Key changes for the 2010 proxy season, discussed in more detail below, include:

- In general, if a management say on pay (MSOP) proposal is on the ballot, any RMG compensation related concerns will be applied only to that proposal. However, if egregious compensation practices are identified or if a company previously received a negative recommendation on an MSOP resolution due to a concern that has not been sufficiently addressed, RMG also may recommend a "withhold" or "against" vote with respect to compensation committee members or, in some circumstances, all board members.

1 Important RMG policy updates applicable to non-U.S. companies, also published on November 19, 2009, are described in our Skadden client memorandum "Riskmetrics Group Issues Its 2010 Policy Updates: International Corporate Governance/Executive Compensation Matters."

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

Marc S. Gerber
Washington, D.C.
202.371.7233
marc.gerber@skadden.com

Richard J. Grossman
New York
212.735.2116
richard.grossman@skadden.com

Michael A. Lawson
Los Angeles Office
213.687.5380
michael.lawson@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

Daniel E. Stoller
New York
212.735.3360
daniel.stoller@skadden.com

Joseph M. Yaffe
Palo Alto
650.470.4650
joseph.yaffe@skadden.com

* * *

- RMG has identified compensation practices that could, in its view, incentivize excessive risk taking by management and includes these as problematic pay practices.

- RMG also has identified those problematic pay practices that will carry the most weight in RMG's determination of whether to recommend a withhold or against vote, in the absence of mitigating factors.

- RMG's pay for performance analysis will consider the alignment of CEO total direct compensation and total shareholder return over a period of at least five years.

- RMG generally will recommend withhold or against votes for board nominees if a company adopts a long-term (greater than one year) poison pill or renews a short-term poison pill without shareholder approval. Also, this negative voting recommendation will apply periodically, or annually in the case of a company with a classified board, for so long as the poison pill remains in effect without shareholder approval. In addition, RMG will apply NYSE-based thresholds for making director independence determinations at NYSE listed companies.

Pay for Performance Policy

If there is a misalignment between CEO pay and performance, as measured by total shareholder return (TSR), RMG's policy recommends an "against" vote with respect to MSOP and/or the election of directors (generally, compensation committee members). In previous years, this analysis focused on whether the CEO's compensation increased at a time when the company was in the bottom half of the company's industry group in respect of one- and three-year TSR. An additional factor is being added to this analysis in 2010 — the alignment of the CEO's total direct compensation and TSR over a period of at least five years. Accordingly, RMG will continue to closely examine companies that have one-year and three-year TSR in the bottom half of their industry group and, where the CEO has served for at least two fiscal years, RMG will consider the following factors in its pay for performance analysis:

- Whether the CEO's pay has increased or decreased and the magnitude of the change;

- The reason for the change in pay within the pay mix; and

- The long-term (at least five years) alignment of the CEO's compensation with the company's TSR.

These factors and the FAQs issued by RMG[2] make it clear that a company may have a pay for performance issue even when the CEO's pay is unchanged or marginally decreased.

2 RMG's Frequently Asked Questions on U.S. Compensation can be viewed in full at www.riskmetrics.com/policy/2010_compensation_FAQ.

Problematic Pay Practices

RMG has consolidated its guidelines for MSOP review with its guidelines for the analysis of equity plan proposals and board elections. These guidelines focus on identifying "problematic pay policies." If RMG believes a company has problematic pay policies, RMG may recommend a vote against an MSOP, against an equity-based incentive plan proposal, and, in some circumstances, against or to withhold votes from compensation committee members or all directors (including the CEO).

RMG's definition of problematic pay practices has been revised to include those compensation practices that could incentivize excessive risk taking by management, such as:

- Guaranteed bonuses;
- A single performance metric used for short- and long-term incentive plans;
- Lucrative severance packages;
- High pay opportunities relative to industry peers;
- Disproportionate supplemental pensions; or
- Mega annual equity grants that provide unlimited upside with no downside risk.

RMG notes that there are factors that potentially mitigate the impact of risky incentives, such as "rigorous" claw-back provisions and "robust" stock ownership/holding guidelines.

Problematic pay practices continue to include the following practices, which are accorded the most weight by RMG:

- "Egregious" employment contracts (those providing for multi-year guarantees for salary increases, non-performance based bonuses and equity compensation);
- An "overly generous" new hire package for CEO (*e.g.*, containing make-whole provisions without sufficient rationale or any of the pay practices deemed problematic by RMG);
- "Abnormally large" bonus payouts without justifiable performance linkage or proper disclosure; notably, this includes performance metrics that are changed, canceled or replaced during a performance period;
- "Excessive" perquisites, meaning:
  - Perquisites for former and/or retired executives such as lifetime benefits, car allowances, personal use of corporate aircraft or other inappropriate items; and
  - Extraordinary relocation benefits for current executives (including home buyouts);
- "Egregious" pension/SERP terms (those that provide for additional years of service not worked that result in significant benefits in new arrangements or inclusion of performance-based equity awards in the pension calculation);

- "Excessive" severance and/or change-in-control (CIC) provisions, meaning:
  - Change in control payments exceeding three times base salary and bonus;
  - Change in control payments without the loss of job or substantial diminution in duties (single trigger);
  - New or materially amended employment or severance agreements that provide for modified single triggers, under which an executive may voluntarily leave for any reason and still receive severance payouts; and
  - New or materially amended employment or severance agreements that provide for an excise tax gross-up (note that modified gross-ups will be treated in the same manner as full gross-ups);
- Tax reimbursements with respect to income taxes on certain perquisites or other payments (*e.g.*, personal use of corporate aircraft, executive life insurance, bonus, etc.);
- Paying dividends/dividend equivalents on unearned performance awards;
- Executives using company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps or other similar arrangements; and
- Repricing or replacing underwater stock options or stock appreciation rights without prior shareholder approval.

While the problematic pay practices listed above are given the most weight according to the 2010 policy updates and FAQs, the following practices are also considered problematic:

- Other "overly generous" perquisites, including but not limited to personal use of corporate aircraft, personal security systems and maintenance, car allowances and executive life insurance;
- Internal pay disparity (*i.e.*, between the CEO and other proxy-reported executives); and
- Liberal CIC definitions such that payments could result without an actual CIC occurring.

Guidance Regarding Option Exchange Programs

RMG has clarified in its FAQs that in addition to including certain shareholder-friendly features such as value-for-value exchanges and exclusion of the named executive officers and directors, option exchanges should be the last resort as a tool to re-incentivize employees. In particular:

- Only deep underwater options should be eligible for the program rather than somewhat underwater options, especially if the company's stock is volatile;
- As a rule of thumb, the threshold exercise price for eligible options should be the higher of the 52-week high or 50 percent above the current stock price;

- Further, the company's stock price must be a consideration – for example, RMG would consider a premium of 50 percent for a company trading at $1 per share to be inadequate if the company's stock price is volatile; and

- The company should disclose the various levels of employees (management versus non-management) who will be eligible to participate in the program. Absent such disclosure, institutional investors may assume that equity grants are generally awarded to management.

Shareholder Rights Plans ("Poison Pills")

RMG has updated its policy with respect to voting on directors at companies that have adopted or renewed shareholder rights plans or "poison pills." For 2010, RMG will apply this new policy to companies adopting or renewing rights plans after November 19, 2009 (the date its new policy was announced). RMG warns, however, that in future years it may apply the new policy retroactively to companies that previously adopted rights plans.

The key changes are (1) distinguishing between "long-term" rights plans — those having a term of more than 12 months — and "short-term" rights plans - those with a term of 12 months or less and (2) making a voting recommendation based on the presence of a rights plan lacking shareholder approval every three years (from the first year following adoption of the rights plan until it expires or the rights are redeemed) for boards where all directors are elected annually and every year for classified boards (rather than the current RMG policy of a one-time negative voting recommendation in the first year following adoption).

As revised, RMG will recommend an "against" or "withhold" vote from all board nominees (with "new" nominees considered on a case-by-case basis) if the board adopts a long-term rights plan, or renews any rights plan (including a short-term rights plan), without shareholder approval. RMG states that a company commitment or policy to submit a newly adopted rights plan to a binding shareholder vote may offset an adverse voting recommendation.

In the case of a short-term rights plan, RMG will consider board nominees on a case-by-case basis, taking into account the date of adoption of the rights plan relative to the shareholder meeting, the company's rationale in adopting the rights plan, the company's governance practices and the company's track record of accountability to shareholders.

RMG continues to have a separate voting policy where rights plans are adopted for the stated purpose of preserving a company's net operating loss (NOL). The analysis remains case-by-case, considering the rights plan trigger, the value of the NOL, the term of the rights plan and the existence of other shareholder-friendly features in the rights plan. In a change, RMG also will take into account the company's governance structure and track record of responsiveness to shareholders.

Director Independence

RMG has updated its evaluation of director independence. In the case of NYSE-listed companies, RMG will apply NYSE's "greater of $1 million or 2 percent of the recipient's gross revenues" test rather than applying Nasdaq's "greater of $200,000 or 5 percent of the recipient's gross revenues" test to all companies in order to assess the materiality of transactional relationships.

In addition, RMG has clarified that the limitation of $10,000 applicable to an independent director directly or indirectly providing professional services to the company encompasses services that are "advisory in nature, generally involv[ing] access to sensitive company information or to strategic decision-making, and typically having a commission- or fee-based payment structure." RMG notes that this articulation of "advisory services" generally would include insurance services, information technology (IT) services other than "tech support," marketing services, lobbying, executive search services and property management/realtor services.