CORPORATE GOVERNANCE FEATURE: SAY-ON-PAY AND RELATED COMPENSATION DISCLOSURE AND LITIGATION CONSIDERATIONS

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Shareholders, for the most part, approved their companies' say-on-pay proposals in 2015, often by wide margins. Of the Russell 3000 companies that held say-on-pay votes between January 1, 2015 and September 18, 2015, the average vote result was 91 percent in favor. Only 2.7 percent of these Russell 3000 companies had their say-on-pay proposal fail during that time period. Since say-on-pay first became required in 2011, 91 percent of these Russell 3000 companies have had their say-on-pay votes pass in all five years.[1]

A say-on-pay failure can result in weakened support for directors. Proxy Pulse, an initiative of Broadridge Financial Solutions, Inc., and PricewaterhouseCoopers LLP's Center for Board Governance (Proxy Pulse), reports that 46 percent of the companies that had a failed say-on-pay vote in 2014 and a director election between January 1, 2015 and June 30, 2015 had at least one director fail to receive 70 percent support.[2]

Failing to win majority support is not the only important benchmark for a say-on-pay vote. Significant opposition to an executive compensation program can impact future votes on say-on-pay and for the election of directors. For example, when the previous year's say-on-pay proposal receives less than 70 percent support of the votes cast, proxy advisory firm Institutional Shareholder Services Inc. (ISS) will consider recommending that its clients vote against compensation committee members (or, in exceptional cases, the full board).[3] Therefore, when holders vote a large percentage of shares against a company's say-on-pay proposal, the company may need to reach out to shareholders for feedback on the particular aspects of its executive pay program that shareholders found troubling, even if the company's advisory vote on executive compensation achieved majority approval.

According to Proxy Pulse, of the companies that held annual meetings between January 1, 2015 and June 30, 2015, approximately 10 percent failed to surpass the 70 percent support level for say-on-pay. Interestingly, of the companies that failed to attain at least 70 percent support for say-on-pay in the 2014 proxy season, 40 percent again failed to attain at least 70 percent support in 2015. On the other hand, another 36 percent of the companies that failed to attain 70 percent support for say-on-pay during 2014 achieved 90 percent or greater support in 2015.

Although say-on-pay is a nonbinding, advisory vote, it can be a sensitive agenda item for executive officers and directors. Therefore, public companies often devote considerable attention to how compensation is presented in the proxy statement, especially in the CD&A. Plain English is very important to a clear presentation. Executive summaries have become a very common (although not required) component of the CD&A. Some companies include a proxy statement summary at the beginning of the proxy statement that, among other matters, highlights key aspects of the executive compensation program, recent changes to such programs and rationales supporting compensation decisions. It has become common for companies to highlight performance measures in order to demonstrate that compensation is performance-based. To the extent that non-GAAP performance measures are disclosed in proxy statements, companies must pay attention to the requirements of Item 10(e) of Regulation S-K and related compliance and disclosure interpretations.

In the CD&A, companies are specifically required to discuss the extent to which compensation decisions were impacted by the results of the prior year's say-on-pay vote. This is required whether the previous year's proposal passed or failed. Compensation committees should be reminded of this reporting obligation so that they can decide whether to specifically address the results of the say-on-pay advisory vote when making subsequent compensation decisions.

Negative Proxy Advisory Firm Recommendations and Responses

Proxy advisory firms, such as ISS and Glass Lewis & Co., LLC, recommend to their institutional clients how to vote on meeting agenda items, including say-on-pay. However, a negative recommendation on executive pay from a proxy advisory firm will not necessarily result in a failed say-on-pay vote. There are precedents for companies receiving majority approval for their say-on-pay proposals even when a proxy advisory firm recommends voting against them, but it is likely that a negative recommendation will at least result in a lower percentage of approval.

Some companies increase their solicitation efforts if they receive a negative recommendation on say-on-pay from a proxy advisory firm. For example, they may prepare slides, a letter to shareholders, a proxy statement supplement, a script or talking points to counter assertions made in a proxy advisory firm's report or to emphasize why they believe executive compensation should be approved. However, before a company may use any additional solicitation material, the material must be filed with the SEC.

Compensation Litigation

There have been several types of litigation instituted or threatened with respect to say-on-pay votes and proxy compensation disclosure. For example, some lawsuits alleged breach of fiduciary obligations, while some alleged insufficient compensation disclosures and sought to enjoin the shareholder vote and some challenged specific compensation actions. Although many of these actions have failed, there have been some victories for the plaintiffs, so public companies need to be aware of the potential for compensation-related lawsuits to be brought in connection with the 2016 proxy season. Compensation disclosures should be prepared, and compensation decisions should be made, with care, especially for companies that anticipate resistance to their say-on-pay proposals.

Director compensation can also be the subject of litigation. For example, in April 2015 the Delaware Court of Chancery denied a motion to dismiss in *Calma v. Templeton*,[4] a case in which the plaintiff alleged that restricted stock unit awards (RSU Awards), when combined with cash payments to nonemployee directors, were excessive in comparison with director compensation at peer companies. Although the defendants argued that shareholders had ratified the RSU Awards, the court concluded that the defendants did not establish such ratification "because, in obtaining omnibus approval of a Plan covering multiple and varied classes of beneficiaries, the Company did not seek or obtain stockholder approval of any action bearing specifically on the magnitude of compensation to be paid to its non-employee directors." As a result, the court treated the RSU Awards as "self-dealing decisions" and held that "the operative standard of review is entire fairness."

Companies should be cognizant of the lessons of *Calma v. Templeton* when determining director compensation or seeking approval of equity plans applicable to directors. Because directors might have to establish the entire fairness of their own compensation, there should be a meaningful process to determine amounts of compensation and types of awards. If an omnibus equity plan applicable to directors, or a specific outside director plan, is being submitted for shareholder approval, companies may want to consider providing for a maximum size of awards to non-employee directors, as well as an explicit approval of such directors' ability to grant awards to themselves, in each case in order to establish that shareholders specifically approved the granting and magnitude of compensation paid to directors.

Shareholder Engagement

While the say-on-pay vote is advisory and nonbinding in nature, it nevertheless has a practical impact. A vote against executive compensation will generate adverse publicity. It may also generate corporate governance consequences, such as poorer corporate governance ratings or increased votes against the election of directors. As a result, say-on-pay has given rise to increased shareholder engagement throughout the year, because outreach to key investors has been recognized as an important element of a successful say-on-pay vote.

Say-on-pay has heightened the need and demand for shareholder engagement. One effect of this is that institutional investors are increasingly asked to interact with companies in which they hold substantial positions. To make the most effective use of their investors' time, companies seeking to engage their shareholders should focus their engagement initiatives on specific goals. To the extent that a company seeks input on particular aspects of pay practices, it should contact influential and significant shareholders in time for the compensation committee to consider the feedback when making compensation decisions that will be disclosed in proxy statements.

Companies must ensure that their shareholder engagement efforts comply with proxy solicitation rules and filing requirements. In addition, companies must be careful not to selectively disclose material nonpublic information when engaging with any shareholders.

ENDNOTES:

[1] Semler Brossy, 2015 Say on Pay Results, September 28, 2015, *available at* http://www.semlerbrossy.com/wp-content/uploads/SBCG-2015-SOP-Report-2015-09-28.pdf.

[2] Broadridge Financial Solutions, Inc. and PricewaterhouseCoopers LLP's Center for Board Governance, Proxy Pulse 2015 Proxy Season Wrap-up, Third Edition 2015, *available at* http://media.broadridge.com/documents/ProxyPulse-Third-Edition-2015.pdf.

[3] SS's United States Summary Proxy Voting Guidelines 2015 Benchmark Policy Recommendations, *available at* https://www.issgovernance.com/file/policy/2015-ussummary- voting-guidelines-updated.pdf.

[4] *Calma v. Templeton*, 114 A.3d 563 (Del Ch. 2015), *available at* http://courts.delaware.gov/opinions/download.aspx?ID=223030.