Recent Developments in Say-on-Pay in the US and UK

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Latham & Watkins attorneys from the US and UK provide updates on the recent developments in Say-on-Pay from each of their jurisdictions.

United States: Recent Developments in Say-on-Pay

For public companies in the United States, the 2011 proxy season is over and the 2012 proxy season is getting into full swing.

The 2011 proxy season included the inaugural say-on-pay (SOP) for most companies. While most companies in 2011 received overwhelming shareholder support for their executive compensation programs, others will need to modify their programs if they wish to improve their voting results in 2012 and avoid negative recommendations from proxy advisers, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (Glass Lewis). This is especially important considering that a number of companies that failed to receive majority shareholder support for their executive compensation programs in 2011 have become the target of shareholder derivative lawsuits and this trend is expected to continue in 2012 and future years.

For the 2012 proxy season, executive compensation will once again be the primary focus in the corporate governance arena. Proxy advisers, including ISS, have redesigned their models for 2012 to take into account whether companies sufficiently responded to shareholder concerns in 2011. This adds a new twist in predicting potential negative recommendations from proxy advisers, even for companies that passed their 2011 SOP votes by a comfortable margin. But as the 2012 proxy season gears up, it is useful to review 2011’s inaugural SOP votes.

Recap of the 2011 Inaugural Say on Pay Proxy Season

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank) was enacted on July 21, 2010. It requires, among other things, that US public companies solicit advisory (non-binding) votes from their shareholders to approve the compensation paid to named executive officers in the prior fiscal year (the SOP vote), to determine how often the SOP vote should be held (the frequency vote), and to approve so-called “golden parachute payments” triggered by an acquisition, merger or other similar corporate transaction (the golden parachute vote). The following summarizes how companies prevailed in the 2011 proxy season:

Say on Pay

- Over 70 percent of Russell 3000 companies received over 90 percent shareholder approval
- Over 90 percent of Russell 3000 companies received over 70 percent shareholder approval
- 37 Russell 3000 companies failed to receive at least 50 percent shareholder approval
- 30 companies received 50-60 percent support

Frequency Vote

- Of Russell 3000 companies, approximately 81 percent of shareholder votes favored annual SOP frequency and 19 percent favored triennial SOP frequency
- Of Russell 3000 companies, approximately 52 percent of companies recommended annual SOP frequency and 42 percent recommended triennial SOP frequency
- Substantial majority of companies are expected to have annual votes
- Most companies adopted the shareholder preference that received a plurality of votes
Golden Parachute Vote

- The golden parachute vote is permitted, but not required, in annual proxy statements; most companies are electing to delay the golden parachute vote until the merger proxy.
- Of the at least 46 companies that have filed proxy statements proposing approval of “golden parachute payments,” it appears that most have seen their golden parachute payments approved by a substantial margin.

Influence of Proxy Adviser Recommendations

Proxy adviser recommendations have become increasingly important as institutional shareholders typically do not have the time or resources to analyze thousands of proxy statements in a short period of time each year. In 2011, the most significant proxy advisor was ISS and the other proxy advisor of note was Glass-Lewis. In 2011, institutional shareholders frequently relied on the recommendations from proxy advisers (particularly ISS) in casting their SOP vote. This effectively allowed ISS to significantly influence the SOP voting process. As a result, many companies took affirmative action in anticipation of the SOP vote, such as contacting shareholders directly, communicating with proxy advisers, hiring a proxy solicitor and even making changes to their existing compensation programs.

Proxy advisers, such as ISS and Glass-Lewis, were aggressive in making negative recommendations with respect to SOP votes based upon their review of company proxy statements with negative recommendations ranging from 13 percent to 17 percent of the total proxies reviewed in 2011. The influence of proxy advisers is evident as companies with negative recommendations from ISS received approximately 27 percent less support, on average, than those with favorable recommendations.

Negative recommendations from proxy advisers often occur when companies have adopted certain pay policies and practices that proxy advisers have deemed to be “problematic” or “egregious.” Of these poor pay practices and policies, the most significant is a finding by the proxy adviser that a pay-for-performance “disconnect” exists with respect to the company’s financial performance and its pay to executive officers. This remains a hot issue that many companies are planning to address in further detail in the 2012 proxy season. In addition, the US Securities and Exchange Commission is expected to issue proposed rules on pay-for-performance in 2012. Other poor pay practices include excise tax gross-up payments on golden parachute payments, single-trigger change-in-control payments, broad change-in-control definitions, excessive severance pay and excessive relocation payments. In response to these concerns, many companies have already eliminated excise tax gross-up payments altogether, moved from single-trigger to double-trigger change-in-control payments, raised the threshold percentage in the change-in-control definitions, and reduced the amount of severance and relocation payments.

Although each company subject to the SOP vote requirements needs to design its executive compensation programs in a way that it believes is appropriate to encourage the success of the company, it has become critical that companies understand the impact that ISS and other proxy advisors have on the SOP voting process.

In deciding how to respond to a negative recommendation, companies have traditionally discussed the points of contention directly with proxy advisers in an attempt to persuade them to issue a correction. However, there was a dramatic shift in the approach of dealing with negative recommendations. In 2011, more than 100 companies filed public responses to proxy adviser negative recommendations with a majority of the controversy relating to companies disputing the findings by the proxy adviser that a pay-for-performance disconnect existed. Other companies changed their existing compensation agreements or made prospective commitments to modify their compensation policies to induce the proxy advisers to reverse their negative recommendations.
Shareholder Derivative Lawsuits Following SOP Vote

At least 10 companies have been subject to shareholder derivative lawsuits that were filed against the company’s board of directors and executive officers, and in some cases, the independent compensation consulting firms that advised them, following 2011 SOP votes. In almost all of these lawsuits, the companies failed to receive at least 50 percent shareholder approval of their SOP vote. Of the 10 shareholder derivative lawsuits filed in 2011, one has been dismissed, one has survived a motion to dismiss, two have settled and the remaining six are pending.

The plaintiffs in these shareholder derivative lawsuits face significant obstacles both substantively and procedurally. The lawsuits are similar in that the plaintiffs generally allege that: (i) the company’s board of directors breached its fiduciary duty of loyalty when it approved salary increases and bonuses for the company’s top executives during a year in which the company’s performance declined, and (ii) the failed SOP vote is evidence that the compensation paid to the top executives was not in the best interests of the company’s shareholders.

Before proceeding with the merits of a shareholder derivative lawsuit, a shareholder-plaintiff is generally required to either make a pre-suit demand on the company’s board of directors asking the board to pursue the alleged claims or plead with particularity that such pre-suit demand should be excused because it would be futile. If the board fails to enforce or pursue the alleged claim, then the shareholder has a derivative right to pursue it.

In assessing the merits of the alleged claim, the plaintiff must overcome the application of the “business judgment rule” which is a presumption that directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. This is a difficult presumption to overcome as courts have commonly found that compensation decisions regarding executive compensation made by independent directors fall within the protections afforded by the business judgment rule. As a result, many of these claims are dismissed at the early stages of litigation which reduces the time and expense associated with a long trial. Alternatively, many companies enter into settlement agreements with the shareholders early on to avoid expensive court cases.

Thus far, only one lawsuit has survived a motion to dismiss. Many companies are troubled by this case because the court’s decision appears to be inconsistent with the common application of the business judgment rule. However, in another lawsuit, the court granted the company’s motion to dismiss on multiple grounds and concluded that the pre-suit demand was not excused.

Conclusion

Although only approximately 2 percent of companies received a failed SOP vote in 2011, proxy advisers issued negative recommendations ranging from 13 percent to 17 percent of the total proxies reviewed in 2011. Proxy advisers have a significant influence on the outcome of voting and companies became increasingly vocal in 2011 by filing public responses to negative recommendations, especially on pay-for-performance issues. The 2011 proxy season also brought the added risk of costly shareholder litigation in the event of a failed SOP vote and the uncertainty surrounding the court’s application of the business judgment rule. Companies are expected to communicate directly with shareholders early and often to ensure that they have accurate and complete information when casting their SOP votes in 2012 and future years.

Say-on-Pay in the UK: The Current Regime

The last 12 months have seen a lot of discussion — at least on the political stage — about executive remuneration in the UK. The UK Government’s most recent statements suggests that action may soon be taken in an attempt to further regulate executive pay for UK-listed companies.
Currently, UK-listed companies must produce an annual remuneration report and send a copy to each shareholder. The report must contain certain information including, among other things:

- The company’s policy on current and future directors’ remuneration, including details and explanations of performance criteria for any long-term incentive plans
- Details of each director’s remuneration in the previous financial year including salary, bonuses, share options, long-term incentives and pension entitlements
- Performance graphs to provide historic information on the company’s “total shareholder return” performance over the last five years compared to that of other companies

The company’s shareholders must also be invited to vote on the remuneration report each year. The vote is intended to give shareholders the opportunity to consider the company’s remuneration policies and the remuneration actually paid to directors in the previous financial year. In that respect the vote is therefore “backward” not forward looking. The vote is also “advisory” as opposed to legally binding. No aspect of an individual director’s entitlements to remuneration under an employment agreement or other plan should be conditional on the vote being passed.

Shareholder participation in this so called “say-on-pay” mechanism has increased in recent years since the banking crisis has brightened the spotlight on executive pay. In 2003, only one company’s shareholders voted against the remuneration report, in 2009 that number increased to five. In 2011, there were a number of high profile votes where a significant number of shareholders voted against the remuneration report. However, recent government and independent publications have criticized this existing regime, noting that the level of shareholder activism is insufficient to properly regulate executive pay in the UK.

The rules relating to director remuneration reports and voting sit alongside, and to some extent overlap with, the UK listing rules (which also require disclosure of information on director remuneration) and the UK Corporate Governance Code (the Code). The Code applies to UK companies with a premium listing of equity shares and contains a number of principles which companies should adhere to when setting executive pay. A key principle is that “Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.”

There are also a number of supporting principles such as “performance-related elements of executive directors’ remuneration should be stretching and designed to promote the long-term success of the company” and that when determining director pay, the remuneration committee should “be sensitive to pay and employment conditions elsewhere in the group.”

Under the UK listing rules, premium listed companies are required to comply with the Code and to the extent they do not comply they must explain their divergence from the Code in their annual report. This so-called “comply or explain” regime has also come under fire in the various government and independent reports on executive pay published in recent months.

**Recent developments**

The past six months have seen a number of initiatives targeted at introducing more regulation of executive pay. This included at least three government consultation papers and a report by the High Pay Commission (an independent, non-government body which held an inquiry into pay in the UK private sector last year). Each of these initiatives highlighted failings in the existing
system of regulating executive pay and called for reform. The High Pay Commission report published in November 2011 argued that that excessive pay of UK executives was “deeply damaging” to the UK economy and urged urgent reform to prevent Britain from returning to “Victorian” levels of pay disparity.

A number of recurring themes and questions emerged through these reports and consultation papers, in particular:

- The need to improve the existing content and format of the directors’ remuneration report to simplify it and ensure that it provides clear and usable information on the total remuneration paid to directors, a demonstrable link between pay and performance and the process by which directors’ remuneration is decided
- Whether disclosing directors’ remuneration was sufficient or alternatively if the disclosure rules should be extended to senior executives below board level for example, the top ten highest paid executives in the company below board level
- Whether the ratio of the CEO’s earnings and the average earnings of the company’s workforce should be disclosed as part of the remuneration report
- Whether the shareholder vote on the remuneration report should become a binding, forward-looking vote
- Whether there should be greater employee participation in executive remuneration decisions such as having an employee representative on the remuneration committee or a separate employee vote to endorse the annual remuneration report
- Whether the complexity of sophisticated remuneration packages camouflages the escalation of executive pay and therefore director remuneration packages should be simplified e.g. into one basic salary and one, single performance-based element
- Whether there is a practice of “cronyism” or “back-scratching” whereby executive directors of one company sit as non-executive directors on the remuneration committees of other companies and are therefore more willing to approve excessive remuneration packages in expectation of receiving the same treatment of their own executive pay packet
- Whether there is sufficient shareholder activism and scrutiny of executive pay or if investors should be required to disclose how they voted (in their capacity as shareholders) on remuneration reports
- Whether the practice of using remuneration consultants is increasing executive pay and the need for greater transparency regarding fees paid to remuneration consultants and the services they provide

New Regulations on the Horizon? January 2012 Proposals

The result of these consultation papers and reports was announced on 23 January 2012, when the UK government’s business secretary outlined proposals for new executive pay reforms for listed companies. The proposals, which are still subject to consultation, include the following:

- A reconfiguration of the annual director remuneration reports to include (i) two separate sections, one dealing with pay in the last year and another dealing with the company’s future remuneration policy, (ii) an explanation of the performance targets used and how employee earnings were taken into account when determining director remuneration, and (iii) a single total pay figure for each director, along with “real numbers” on potential pay-outs and a distribution statement which compares the value of executive pay against other dispersals such as dividends, tax, business investments and general staff costs.
Remuneration reports will have to explain how the company consulted employees and took account of their views when determining executive remuneration. The extent of this consultation obligation is still not clear. The Government has suggested that the consultation might harness existing information and consultation arrangements established in large companies. However, for companies which do not have works councils or similar employee forums already in place, this will require new arrangements to be put in place.

Reform of the existing shareholder vote on the company’s remuneration report. In particular, it is proposed that new binding votes will be made on (i) the company’s future pay policy; (ii) any director notice periods which exceed one year and (iii) exit payments which exceed one year’s salary. There will also be consultation on increasing the majority required for a shareholder vote to “pass” from 50 percent to 75 percent. Clearly these reforms would have a huge impact on listed companies and are likely to cut across contractual arrangements between executives and their employers which could lead to a number of high value claims.

Greater transparency regarding the work and pay of remuneration consultants.

Amending the Code to prevent serving executives sitting on other companies’ remuneration committees and to require large public companies to adopt incentive clawback provisions.

A new “High Pay Centre” will be established to publish research on executive pay levels in the UK and to engage with policy makers and companies about reforming current practices.

The government has indicated that these reforms will be introduced “later this year” and it remains to be seen how far-reaching the reforms will be. Clearly, if all of the above proposals are implemented this will have a significant impact on how UK-listed companies pay their directors and report their remuneration practices. Whether the reforms will achieve any of the government’s objectives is an even more complex question.