

Employee Benefits and Executive Compensation

Preparing for the 2009 Proxy Season

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Public companies with calendar-year ends currently in the process of preparing their annual reports and proxy materials should be mindful of recent developments that deserve special attention. In comparison to recent proxy seasons, there are relatively few new disclosure requirements to take into account this year; however, recent turmoil in the financial markets has refocused attention on executive compensation. In addition, recent case law in Delaware and New York has highlighted the need for companies to review their advance notice bylaw provisions. In light of the weakened economy and reduced share prices, companies should also consider whether to adopt shareholder rights plans or amend existing plans in order to shore up takeover defenses, and in certain cases, to preserve certain beneficial tax treatment of operating losses. Moreover, the recommendation for an independent board chair warrants consideration in the new proxy season. Finally, companies should pay particular attention to the e-proxy rules, which are now applicable to all public companies and other soliciting persons.

Poor Pay Practices

The 2009 policy updates of RiskMetrics Group (RMG), one of the leading shareholder activist organizations, indicate that RMG may recommend a “withhold” or “against” vote on the chief executive officer, the compensation committee members, and potentially the entire board of directors if a company has poor compensation practices. RMG may also recommend an “against” vote for any equity compensation plan or policy that it feels may be a vehicle for these increasingly disfavored compensation practices. Companies should be aware that various compensation and benefit practices have become increasingly controversial items to RMG. Four additional poor pay practices have been identified as potentially warranting “withhold” or “against” votes: (1) severance or change in control arrangements that include excise tax gross-ups and/or severance payable on a voluntary termination following a change in control, (2) liberal change in control definitions which could result in change in control payments absent the occurrence of an actual change in control event, (3) tax gross-up payments, or (4) current dividend payments provided on unvested shares of performance units.

These new poor practices are in addition to existing items RMG has identified as problematic, including (1) employment contracts with guaranteed multi-year compensation increases, (2) discretionary performance metrics for bonuses or the unexplained modification of performance metrics prior to payout, (3) severance or change in control payments in excess of three times cash pay, or change in control payments that are unrelated to a termination of service, or (4) poor or vague disclosures that do not provide a true explanation of the company’s compensation setting practices. RMG compiled its list of poor pay practices following analysis of recent executive compensation disclosures and feedback from its institutional clients. Items such as tax gross-up payments received significant disapproval from RMG’s institutional clients, with 76 percent of clients noting the payments as “problematic.” RMG noted that investors were concerned that these often



arguably excessive payments serve to encourage executives to negotiate mergers that otherwise would not be in the best interest of the company.

RMG stated that it recognizes some companies must adopt various pay practices due to unique industry standards, and certain companies must be consistent with their peers' practices to remain competitive; however, RMG intends to stress the importance of true pay for performance compensation practices outside of extraordinary instances. In preparing their upcoming proxy statements, companies should closely analyze not only their compensation programs and policies, but the manner and extent of the disclosures regarding these items.

Tax Implications of Executive Compensation

The Internal Revenue Service (the IRS) allowed companies until the conclusion of 2008 to amend all applicable agreements to comply with Internal Revenue Code (the Code) section 409A. Many companies will have amended numerous executive compensation plans, employment agreements, and severance or change in control agreements during the 2008 year that will now require disclosure in the upcoming proxy statement; companies must clearly disclose the modifications made during the previous year as well as explain the tax consequences of the potential tax gross-ups to the extent included in these Code section 409A amendments.

Another 2008 IRS ruling provided that compensation paid to an executive would no longer be deemed qualified "performance-based compensation" for purposes of Code section 162(m) if the arrangement in question allowed for payment of compensation to the executive upon a "without cause" or "good reason" termination, or a voluntary retirement. The ruling impacts the deductibility of compensation even in years in which the executive does not terminate and the performance goals are attained. The IRS also provided a period of transition relief in which to amend agreements that no longer comply with Code section 162(m), and for many companies this transition relief will require an amendment of applicable arrangements before the end of 2009. Companies should review their current Code section 162(m) arrangements for compliance as well as to ensure that their narrative disclosures in annual reports and proxy statements for such plans properly address the deductibility of their current arrangements.

Additional Share Requests for Benefit Plans

Most public companies may not unilaterally increase the number of available shares for their compensation and benefit plans without the approval of shareholders, as mandated by either the Code or the applicable securities exchange on which their shares are traded. Worried that shareholders will turn down such a request in the face of the current economy, many companies are faced with the tough decision of whether or not to seek approval from hesitant shareholders to increase shares available for grant under executive compensation plans, or to risk losing a competitive edge by failing to provide adequate equity compensation for executives. In situations where approval has been sought by providing the investors with intelligent reasons for the increase and the amount of shares requested has been reasonable, approval is often given by otherwise cautious shareholders.



Companies that find themselves in this tenuous situation should seek advice from counsel and/or a proxy advisory firm regarding the appropriate share number to present to shareholders and, if necessary, utilize their proxy solicitors. Most companies should be able to successfully increase the shares for their benefit plans if the request for approval is seen as mutually beneficial to the company and the shareholders alike. Companies should not be afraid to approach this request.

Advance Notice Bylaws

Advance notice provisions in a company's bylaws are used to provide an orderly process for shareholders to nominate a competing slate of directors or seek to conduct other business at a shareholder meeting. As a result of recent case law in Delaware and New York, companies should carefully examine their advance notice bylaw provisions. The courts in these cases have indicated that ambiguities in the advance notice provisions will be strictly construed against the company and in favor of activist shareholders. RMG has recently issued its 2009 policy updates indicating that it will support bylaw revisions that allow shareholders to submit proposals as close to the meeting date as reasonably possible. In addition, RMG continues to support bylaw provisions intended to ensure full disclosure regarding a proponent's economic and voting position in a company. As such, companies should closely review their bylaw provisions to mitigate the risks associated with activist shareholders using equity derivative positions to obtain large holdings without disclosing their ownership levels or intentions. In reviewing its bylaws, a company should consider expanding the definition of beneficial ownership to expressly capture derivative positions and require a continuous disclosure obligation of such beneficial ownership upon reaching an ownership threshold of 7.5 percent or 10 percent. This disclosure obligation would be in addition to any disclosure required by Schedule 13D and the Securities Exchange Act of 1934 (the Exchange Act). In addition, failure to comply with the required disclosure obligations would prevent the shareholder from submitting proposals pursuant to the advance notice provisions in the company's bylaws. Finally, if the notice procedures are amended, the proxy statement discussion should be revised to properly describe the new notice procedures in the amended bylaws. Companies should confirm that their advance notice provisions clearly indicate that these provisions are separate and distinct from the requirements under Rule 14a-8 of the Exchange Act and should eliminate other ambiguities. Companies should also be aware that they are required to file a Form 8-K regarding any such bylaw amendments within four business days from the date of the adoption.

Shareholder Rights Plans

The recent economic downturn, significant percentage declines in equity values, increases in hostile takeover offers, and the increase in shareholder activism are just a few of the reasons why some companies are considering the adoption of a shareholder rights plan or "poison pill." However, before adopting a shareholder rights plan, the board of directors of a company should carefully consider the advantages and disadvantages of such an action and whether the company should seek shareholder approval of the plan. RMG's 2009 policy update regarding rights plans requires that, in addition to RMG's specific requirements relating to the content of such a plan (including a 20 percent or higher triggering threshold



and a shareholder redemption feature), the company must also thoroughly explain its rationale for adopting a shareholder rights plan and submit the plan to its shareholders for ratification. Thus, companies seeking shareholder support for pills should be prepared to provide in their proxy statements disclosure of key factors such as industry conditions or factors unique to their business in order to gain a favorable RMG recommendation. In addition, RMG has recommended a “withhold” or “against” vote on any board that adopts or renews a shareholder rights plan without shareholder approval or ratification within a specified period of time. It should be noted that RMG differentiates the treatment of a traditional poison pill from the treatment of poison pills adopted by management in order to preserve the beneficial tax treatment of net operating losses (NOL Pills). In making its recommendation as to NOL Pills, RMG will consider, among other things, the trigger, the value of the NOL, the term, shareholder protection mechanisms, and other appropriate terms. However, RMG has suggested that it currently does not support the adoption of NOL Pills due to their traditionally low triggering threshold.

Independent Board Chair Shareholder Proposals

In the current proxy season, RMG continues to recommend in favor of shareholder proposals requiring an independent chair of the board of directors, but has made slight modifications, including eliminating the requirement for disclosures comparing the duties of the lead director and the chair and a rationale for combining the roles of the chair and chief executive officer. RMG’s 2009 policy update revealed that academic research has not shown a positive correlation between total shareholder return and the presence of an independent chair; however, RMG continues to recommend a vote “for” an independent chair proposal unless: the company maintains an established set of governance guidelines and an independent lead director; independent directors make up two-thirds of the board and all key committees of the board; the company has performed in the top half of its industry group (unless there has been a change in the chair/CEO position during the preceding three years); and the company has no problematic governance or management issues. RMG illustrated “problematic governance or management issues” with such examples as egregious compensation practices, corporate or management scandals, multiple related party transactions, or other issues putting director independence at risk. In evaluating a director’s status under RMG’s guidelines, companies should take note that the New York Stock Exchange and NASDAQ have amended their independence thresholds such that the level of direct compensation below which a director will remain independent will be increased from \$100,000 annually to \$120,000 annually, to conform with the threshold set forth in Item 404(a) of Regulation S-K.

E-Proxy Rules

This year marks the first year that all public companies and other soliciting persons must comply with the SEC’s e-proxy rules and furnish proxy materials to shareholders via the Internet. Large accelerated filers were subject to these rules as of January 1, 2008 and faced certain challenges that can help inform companies implementing the e-proxy rules for the first time this year. For their 2009 annual meetings, reporting companies must decide if they want to rely on Internet availability of proxy materials and use the “notice only” method or use the “full-set delivery” method and will need to balance several factors in deciding



which model to use. While the “notice only” method is ultimately intended to provide companies with a more cost-effective means of soliciting proxies, companies need to assess their ability to meet the 40-day notice requirement and related requirement for earlier completion of the annual report and proxy statement, as well as their ability to meet the three-business day requirement to fulfill shareholder requests for paper copies of proxy materials. Last year’s experience showed that the “notice only” method may also lead to reduced voting participation by retail investors. Thus, companies should carefully estimate the potential savings from a “notice only” method against the potential increase in voting participation when using “full-set delivery.” Alternatively, companies may opt to use a hybrid approach to satisfy the e-proxy rules by following the “notice only” option for some shareholder groups and the “full-set delivery” option for other shareholder groups.

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