CORPORATE ALERT

RISKMETRICS 2010 CORPORATE GOVERNANCE POLICY UPDATES

On November 19, 2009, RiskMetrics Group, a leading proxy advisory firm, released its “U.S. Corporate Governance Policy, 2010 Updates” and its “2010 Corporate Governance Policy Updates and Process, Frequently Asked Questions on U.S. Compensation” \(^1\) (collectively, the “2010 policy updates”). Generally, the 2010 policy updates are applicable to shareholder meetings occurring on or after February 1, 2010 (the “2010 proxy season”). This alert highlights significant executive compensation and corporate governance policy updates applicable to publicly traded U.S. companies.

I. EXECUTIVE COMPENSATION EVALUATION

RiskMetrics announced an integrated executive compensation evaluation policy derived from three existing RiskMetrics policies.\(^2\) The executive compensation evaluation policy consists of pay for performance, problematic pay practices and board communication and responsiveness.

In general, if a company has a management say on pay (MSOP) proposal on the ballot, any compensation-related recommendations will be applied to that proposal. In the event RiskMetrics identifies egregious practices or if a company previously received a negative recommendation on an MSOP resolution related to an ongoing issue, RiskMetrics also may recommend a withhold or against vote with respect to the compensation committee members, or in some cases, the entire board.

**Pay for Performance.** In prior years, RiskMetrics’ policy recommended withhold or against votes for compensation committee members if the chief executive officer (CEO) had been with the company for at least the last two completed fiscal years and there was a year-over-year increase in the total compensation\(^3\) paid to the CEO at the same time that the company’s one-year and three-year total shareholder returns were in the bottom half of its industry group. Commencing with the 2010 proxy season, if a company’s one-year and three-year total shareholder returns are in the bottom half of its industry group and its CEO has served for at least two fiscal years, RiskMetrics will consider the following factors in evaluating pay-for-performance—

- whether the CEO’s pay increased or decreased, and the magnitude of the pay change
- the source of pay increase (i.e., performance- versus non-performance-based elements\(^4\))

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\(^2\) The three existing policies are the pay for performance policy, poor pay practices policy and guidelines adopted in 2007 for management say on pay proposals.

\(^3\) “Total compensation” is defined as the sum of base salary, bonus, non-equity incentives, grant date full value of stock awards and options, target value of performance shares/units, change in pension value and nonqualified deferred compensation earnings and all other compensation.

\(^4\) For purposes of RiskMetrics’ analysis, neither standard non-qualified stock options nor performance-accelerated grants constitute performance-based awards.
• the alignment of the CEO’s total compensation with the company’s total shareholder returns measured over a period of at least five years, with particular focus on the most recent three years.

If RiskMetrics determines that a pay-for-performance disconnect exists, it may recommend a vote against an MSOP proposal and/or the election of directors (generally limited to compensation committee members). If a significant portion of the CEO’s misaligned pay is attributable to equity awards, and there is an equity plan on the ballot in which the CEO participates, RiskMetrics may vote recommend a vote against the equity plan.

**Problematic Pay Practices.** In prior years, if RiskMetrics determined that a company had problematic pay practices, it would recommend withhold or against votes on compensation committee members, the CEO and, potentially, the entire board of directors. Commencing with the 2010 proxy season, if RiskMetrics identifies problematic pay practices, RiskMetrics generally will recommend (i) against an MSOP proposal, (ii) in egregious situations, if no MSOP is on the ballot or if the board failed to respond to concerns raised in prior MSOP evaluations, against or withhold on compensation committee members or, in rare cases where the full board is deemed responsible, the entire board of directors (including the CEO) and/or (iii) against an equity-based incentive plan proposal if the major contributor to a pay-for-performance misalignment is excessive non-performance-based equity awards.

RiskMetrics has identified practices that are particularly contrary to a performance-based pay philosophy and, consequently, carry the greatest weight in RiskMetrics’ evaluation of poor pay practices. In certain instances, these practices may result in a negative vote recommendation on a stand-alone basis. These practices include—

- **Egregious employment contracts**—
  - contracts containing multiyear guarantees for salary increases, non-performance-based bonuses and equity compensation.

- **Excessive perquisites**—
  - perquisites for former and/or retired executives, including lifetime benefits, car allowances, personal use of aircraft or other inappropriate arrangements
  - extraordinary relocation benefits for current executives, including home buyouts.

- **Excessive severance and/or change in control provisions**—
  - change-in-control payments exceeding three times base salary and target bonus
  - change in control payments without job loss or substantial diminution of duties
  - new or materially amended agreements that provide for “modified single triggers” that permit an executive to voluntarily leave for any reason and still receive the severance package
  - new or materially amended agreements that provide for an excise tax gross-up, including a modified gross-up.

- **New CEO with overly generous new-hire package**—
  - excessive “make whole” provisions without sufficient rational
  - any problematic pay practices.

- **Abnormally large bonus payouts without justifiable performance linkage or proper disclosure**—
  - including performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and link to performance.

- **Egregious pension/supplemental executive retirement plan payouts**—
  - including additional years of service not worked that result in significant additional benefits, without sufficient justification, and long-term equity awards in the pension calculation.
• Tax reimbursements—
  − Reimbursement of income taxes on perquisites or other payments, including, without limitation, personal use of corporate aircraft, executive life insurance, or bonus.

• Dividends—
  − Dividends or dividend equivalents paid on unvested performance shares or units.

• Hedging activities—
  − Executives using company stock in hedging activities, such as “cashless” collars, forward sales, equity swaps or other similar arrangements.

• Repricing of options—
  − Repricing or replacing of underwater stock options or stock appreciation rights without prior shareholder approval, including cash buyouts and voluntary surrender or subsequent regrant of underwater options.

RiskMetrics also has added a separate assessment of policies and practices that may incentivize excessive risk-taking. These practices include—

• guaranteed bonuses
• a single performance metric used for short- and long-term plans
• lucrative severance packages
• high pay opportunities relative to industry peers
• disproportionate supplemental pensions
• mega annual equity grants that provide unlimited upside with no downside risk.

Rigorous claw-back provisions and robust stock ownership/holding requirements potentially may mitigate the impact of incentives RiskMetrics views as risky.

II. POISON PILLS.

In prior years, RiskMetrics generally recommended withhold or against votes on all nominees (except new nominees who are considered on a case-by-case basis) if a board adopted or renewed a poison pill without shareholder approval, did not commit to put a pill to a shareholder vote within 12 months of adoption or reneged on a commitment to put it to a vote, and had not previously received a withhold recommendation. RiskMetrics’ policy was to only make the recommendation once. In its 2010 policy updates, RiskMetrics has established separate processes for making vote recommendations, which depend on whether the poison pill adopted is a short-term or a long-term pill. The revised policy described below will apply to all companies adopting or renewing poison pills after November 19, 2009.

Poison Pill with Term of More than 12 Months (Long-Term Pill)

RiskMetrics will recommend a withhold or against vote on all nominees of the board of directors (except new nominees who are considered on a case-by-case basis), if the board adopts a long-term pill or renews any existing pill (including a short-term pill) without shareholder approval, or makes a material, adverse change to an existing poison pill without shareholder approval.

A company’s commitment or policy to put a newly adopted pill to a binding shareholder vote may offset an adverse vote recommendation. In addition, RiskMetrics will review companies with classified boards every year, and companies with annually elected boards at least once every three years. RiskMetrics will recommend withhold or against votes on all nominees during the period of time that a company maintains a non-shareholder-approved poison pill, which could lead to multiple withhold/against recommendations.

5 RiskMetrics also has adopted a separate policy regarding poison pills adopted by a company to protect its net operating loss.
Poison Pill with Term of 12 Months or Less (Short-Term Pill)

RiskMetrics will vote on a “case-by-case basis” on all nominees if the board adopts a short-term pill without shareholder approval, taking into account the following factors—

- the date of the pill’s adoption relative to the date of the next meeting of shareholders
- the issuer’s rationale
- the issuer’s governance structure and practices, including whether it has a classified board
- the issuer’s track record of accountability to shareholders.

III. DIRECTOR INDEPENDENCE

Inside Director. In its 2010 policy updates, RiskMetrics changed one of the criteria for “Inside Director” from “non-employee officer of the company if among the five most highly paid” to “among the five most highly paid individuals (excluding interim CEO).” As a result, a director that is among the five most highly paid individuals at a company will be deemed an Inside Director, regardless of whether the director is an officer.

Professional Services. In its 2010 policy updates, RiskMetrics noted that, while it changed the characterization of professional services from “advisory in nature” to “advisory in nature, generally involve access to sensitive company information or to strategic decision-making, and typically having a commission- or fee-based payment structure,” the latter is in line with how RiskMetrics has previously applied the policy.

Material Transactions. In its 2010 policy updates, RiskMetrics bifurcated the materiality test for transactional relationships. NYSE- and AMEX-listed companies will now be subject to an NYSE-based test of the greater of $1 million or 2 percent of the recipient’s gross annual revenues. NASDAQ companies and other companies that do not follow the NYSE or AMEX listing standards will continue to be subject to a NASDAQ-based test of the greater of $200,000 or 5 percent of the recipient’s gross annual revenues. In addition, RiskMetrics has clarified that materiality for transactional relationships will be examined: (i) if the director (or an immediate family member) has the transactional relationship; or (ii) if the director (or an immediate family member) is a partner in, a controlling shareholder, or an executive officer of, an organization that has the transactional relationship.

IV. ELECTION OF DIRECTORS

RiskMetrics clarified its language under the election of directors policy to reflect that it will consider a potential adverse vote recommendation at the board, committee or individual level, on an exceptional basis if a director has had significant involvement with a failed company and/or where a director has in the past appeared not to have acted in the best interests of all shareholders.

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