Key Takeaways

Skadden

SEC Reporting & Compliance and Corporate Governance Series

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On February 13, 2018, Skadden hosted a webinar titled " SEC Reporting & Compliance and Corporate Governance Series: Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices." Executive compensation and benefits partner Erica Schohn moderated the discussion. The panelists were executive compensation and benefits counsel Thomas Asmar and Michael Bergmann, and labor and employment law counsel Risa Salins.

Revised Internal Revenue Code Section 162(m)

Internal Revenue Code Section 162(m) Changes

Mr. Asmar began the session by discussing the changes made to Section 162(m) of the Internal Revenue Code pursuant to the Tax Cuts and Jobs Act (Act). Section 162(m) generally prohibits publicly held corporations from deducting more than $1 million per year in compensation paid to covered employees. The changes made by the Act, which include the elimination of the exception for performance-based compensation and commissions, the expanded definition of "covered employees" and the expanded definition of a "publicly held corporation," are effective for tax years beginning on or after January 1, 2018, unless the compensation arrangement is grandfathered under the transition rule. Because the exception from the $1 million deduction for performance-based compensation and commissions has been eliminated, all compensation paid to a covered employee in excess of $1 million per year is nondeductible. The Act expanded the definition of a "covered employee" so that it now includes any individual who served as the principal executive officer or the principal financial officer at any time during the taxable year, and the three other most highly compensated individuals who are named executive officers for the taxable year. In addition, once an individual becomes a covered employee after December 31, 2016, that individual will remain a covered employee for all future years, even after termination of employment. The scope of covered corporations also has been expanded to include corporations with publicly traded equity or debt, as well as foreign private issuers that meet the new definition of a "publicly held corporation."

Section 162(m) Transition Rule

Under the transition rule, the changes made to Section 162(m) will not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and is not materially modified after that date. The transition rule is not available for new contracts entered into after November 2, 2017. Also, amounts after there has been a material modification to the contract are subject to Section 162(m). Lastly, if the contract is in effect as of November 2, 2017, and subsequently renewed, then that contract would be treated as a new contract entered into on the effective date of renewal.

Mr. Asmar pointed out that while many companies have questions about how the transition rule applies to their compensation arrangements, at this point we only have the statutory language and a limited discussion in the Joint Explanatory Statement under the Act to rely on, which raises more questions than answers. Mr. Asmar provided three examples of how the transition rule may apply. First, if a contract is amended to increase the amount of compensation payable thereunder or accelerate or delay the timing of payment, that amendment probably would be viewed as a material modification in light of the Section 162(m) regulations that were issued in 1993, which include similar language to the transition rule. Ms. Schohn then pointed out that much of the terminology in the Act's transition rule is analogous to transition rules provided under those 1993 regulations, suggesting that it may be reasonable to assume that when the IRS does issue future guidance, it may include similar language to the 1993 regulations. Second, it would seem that the mere existence of negative discretion to reduce the payout of awards under an existing plan should not cause the plan to lose grandfathered status, considering that this was one of the requirements for the performance-based compensation exception under the old Section 162(m) rules. Similarly, the exercise of that negative discretion should probably not be viewed as a material modification, but query whether a plan that permits the company to reduce a payout to zero would be viewed as a written binding contract providing for compensation. Third, with respect to a severance agreement that provides for a fixed term subject to automatic renewal, unless the agreement is terminated earlier as a result of a termination of employment, that agreement would appear to lose its grandfathered status on the date of renewal, but query whether the agreement would lose its grandfathered status earlier if the agreement permits either party to terminate the agreement prior to renewal with advance notice to the other party. Mr. Asmar noted that future guidance on the transition rule is anticipated in light of the Treasury Department's update to its Priority Guidance Plan issued on February 7, 2018.

Section 162(m) Action Items

Mr. Asmar then suggested six actions items that companies should consider to address the changes under Section 162(m). First, companies should monitor their covered employees and the extent to which their covered compensation may exceed $1 million per year. Second, companies should take an inventory of all performance-based compensation arrangements and determine which of those may be grandfathered. Third, existing equity and cash incentive plans should be reviewed to confirm that performance awards may be granted without the restrictions formerly imposed by the performance-based compensation exception under Section 162(m). Mr. Bergmann noted that if a company is departing from its existing practice of paying out awards, then this may be material enough to warrant an 8-K filing if the payout is made under a previously undisclosed program. Fourth, for outstanding performance awards that are grandfathered, companies should remember to continue to comply with the operational requirements for qualified performance-based compensation and retain current Section 162(m) provisions in plans with grandfathered awards. Fifth, companies should consider addressing the impact of Section 162(m) in this year's proxy statement. Finally, equity plans, prospectuses and compensation committee charters will eventually need to be updated to eliminate references to the Section 162(m) performance-based requirements.

Section 162(m) Planning Considerations

Effective for tax years beginning on or after January 1, 2018, companies will have the ability to design pay-for-performance programs without the need to comply with the strict rules of the performance-based compensation exception under Section 162(m). For example, performance goals and adjustments will no longer need to be pre-established and objectively determinable, and may be established more than 90 days into the performance period; companies may retain discretion to adjust payouts upward or downward based on actual performance (previously, only downward adjustments were permitted); companies will no longer be required to obtain shareholder approval of performance goals every five years; individual award limits under Section 162(m) will no longer be necessary; and Section 162(m) "umbrella" plans may be eliminated. Some companies also are choosing to adopt new plans, rather than amending old plans, to reflect the Section 162(m) changes, primarily to avoid any perceived risk of losing the grandfathered status for outstanding awards.

Mr. Asmar and Ms. Schohn then discussed how the ability to provide for upward adjustments to performance-based compensation would be unlikely to have a dramatic effect on future compensation arrangements and planning because of the ongoing need to address concerns from shareholders and proxy advisory firms, though Ms. Schohn suggested that there may be an increase in the number of year-end upward adjustments to reflect unforeseen circumstances.

As a final takeaway, Mr. Asmar noted that although compensation in excess of $1 million will no longer be deductible, performance-based compensation will remain an important component of executive pay in order to incentivize executives and respond to demands of pay-for-performance. Institutional Shareholder Services (ISS) recently indicated that it does not intend to change its framework for analyzing pay-for-performance as a result of the Section 162(m) changes. Lastly, companies should remember to continue to comply with the independence requirements for compensation committee members under the NYSE and NASDAQ listing standards, as applicable, and Section 16(b) of the Securities Exchange Act, even though the independence requirements for compensation committee members under Section 162(m) have been eliminated.

Recent Compensation Developments

Director Compensation

Mr. Bergmann provided an update on developments regarding director compensation, including recent case law and ISS policy developments. His discussion focused on Delaware corporations, but he noted that, while other states may have different rules, it is not uncommon for them to apply Delaware principles.

Stockholder Ratification

Subject to certain requirements, a director's conduct under Delaware law is generally subject to review under the "business judgment rule," where a court presumes action on an informed basis, in good faith and with an honest belief that it is in the corporation's best interest. However, that deferential standard does not apply if a majority of the directors are interested in the decision or would derive a personal financial benefit from it — a "self-interested transaction" — and, accordingly, director compensation decisions are typically subject to the more onerous "entire fairness" standard of review, where directors must prove their compensation was entirely fair to the corporation. This loss of deference is procedurally very significant, and so an important question is whether a company and directors can take steps to ensure that the more deferential business judgment standard will apply. A recent line of Delaware lower court cases held that, where a compensation plan contains meaningful limits on director awards and the limits are ratified by a vote of fully informed stockholders, the doctrine of stockholder ratification can apply and result in business judgment review. Accordingly, many companies incorporated such limits into their compensation plans in recent years.

Delaware Supreme Court Weighs In

In December 2017, the Delaware Supreme Court issued *In re Investors Bancorp, Inc. Stockholder Litigation*. Consistent with recent case law, the lower court had dismissed a challenge to director compensation grants based on stockholder ratification, but the Delaware Supreme Court reversed. Under its ruling, stockholder ratification of director compensation applies in only two scenarios — first, where stockholders approve specific awards and, second, where stockholders approve a plan with a self-executing formula such that directors have no discretion as to their awards. As a result, stockholder ratification is not a defense against entire fairness review if directors retain discretion to determine their own compensation, even if it was awarded under a plan with limits specifically applicable to the directors.

Lessons From Investors Bancorp

The ruling increases the likelihood that a motion to dismiss on similar facts will not prevail and, because entire fairness is largely a factual question, costly discovery and litigation may result. There are steps that companies can take to reduce the risk: Perhaps most important is to conduct a peer review of director compensation programs and ensure that compensation is fairly consistent with their peers. Companies should carefully document the peer review process and consider expanded proxy disclosure about both the process and the actual compensation; such steps may make the company a less attractive target to plaintiffs. Finally, of course, companies can try to satisfy the *Investors Bancorp* stockholder ratification requirements and, accordingly, have shareholders approve either specific awards or award formulas.

ISS Statements on Director Pay

Presumably in response to what seems to be an increased focus on director compensation in recent years, late in 2017 ISS adopted a new policy on what it calls "excessive" nonemployee director pay. It is important to note that this policy will not affect voting recommendations for 2018, but going forward, and beginning potentially as soon as 2019, ISS may recommend votes against board or committee members that determine director compensation if there is excessive pay without a compelling rationale. While ISS did not precisely define what constitutes "excessive" pay for this purpose, it did note that it is looking for "extreme outliers," and there are indications that it is looking at companies with pay above the 95th percentile.

Pay Ratio

Mr. Bergmann then turned to a discussion of pay ratio disclosure, including the effect of recent Securities and Exchange Commission (SEC) guidance and some early experience with actual disclosures.

Review of the Rule

Mr. Bergmann began the pay ratio discussion with a quick review of the rule, including the fact that disclosure is required for the first fiscal year commencing on or after January 1, 2017 (*i.e.*, for calendar year taxpayers, in 2018 with respect to 2017 compensation). While disclosure of the median employee compensation and pay ratio is required annually, the median employee generally needs to be identified only once every three years, absent changes in demographics or pay that could be expected to significantly impact the disclosure. Mr. Bergmann also noted in particular that there are special rules applicable to non-U.S. employees that are potentially very important, given that the treatment of such employees appears to have been one of the greater areas of challenge for issuers. Mr. Bergmann also briefly discussed the ability to use a "consistently applied compensation measure" (CACM) in identifying the median employee, which is of importance not only because it can take some pressure off the data-harvesting aspect of the compensation determination but also because of some relief offered by recent SEC guidance in regard to CACMs.

SEC Guidance

The SEC guidance made clear, among other things, that the SEC will not base enforcement action on the use of estimates, assumptions or methodologies unless the company lacked a reasonable basis for doing so or did not act in good faith. While avoiding enforcement action is, of course, not the goal of disclosure, the SEC position does provide welcome relief for companies that are diligently trying to comply and underscores the need for robust recordkeeping and documentation in preparing the disclosure. Another important aspect of the SEC guidance was with respect to the treatment of independent contractors, another particular source of difficulty for many issuers. The SEC made clear that companies may identify independent contractors based on an otherwise widely recognized test under another area of law that the company generally uses, such as employment or tax law. The SEC also provided additional guidance specifically around CACM use and made clear that companies may use internal records to measure median employee compensation, even if the measure does not include every element of compensation, so long as it reasonably reflects annual compensation. Mr. Bergmann mentioned that he has noticed that companies appear to be open in particular to disregarding equity compensation, at least where equity is either widely used or alternatively does not extend deeply down into the employee population.

Some Early Experience

Mr. Bergmann noted that, while the bulk of pay ratio disclosure will come out once the 2018 proxy season is in full swing, we have seen some early examples. One lesson is that cash compensation appears to be a common CACM. Mr. Bergmann mentioned that he has seen some measure of reliance on W-2 compensation, sometimes with adjustments, and that, somewhat surprisingly to him, statistical sampling does not appear to be particularly common — likely because of the potentially intricate nature of the required calculations, which undermine its utility in simplifying data gathering. Mr. Bergmann briefly discussed the proper location of pay ratio disclosure in the proxy and stated that, in his view, it seems to fit best at the end of the existing compensation tables. Mr. Bergmann noted that the disclosure around pay ratio so far has been relatively brief and generally incorporates just the required disclosure with relatively little discussion of its significance, likely because companies want to see what disclosure norms develop. Mr. Bergmann also noted that he expects that pay ratio results will vary dramatically, based particularly on things like company size (whether measured by revenue or number of employees), industry and location, and that some early studies are showing substantial variance along those lines and others. Lastly, Mr. Bergmann mentioned that ISS has indicated that, while it will report on pay ratio disclosures in 2018, those disclosures will not affect its recommendation in 2018, presumably because ISS wants some experience with the different types of disclosure before it takes them into account.

Dodd-Frank Status

Mr. Asmar provided an update on the status of rulemaking under the Dodd-Frank Act for executive compensation and corporate governance. While we have final rules governing say-on-pay, say-on-golden-parachute, say-on-frequency, pay ratio and the independence of compensation committee advisers, the rules on pay-versus-performance, hedging and clawbacks remain in proposed form. It is unclear when these proposed rules will be finalized, but the SEC indicated in January 2018 that they remain on its agenda.

Sexual Harassment

Next, Ms. Salins discussed new developments in the area of sexual harassment in the #MeToo era. She noted that employers in every industry can expect an increase in sexual harassment claims and investigations. Further, employers should also expect to see greater regulation with respect to harassment at the state and local levels. While sexual harassment training is good social practice for all employers, several states, including California, Connecticut and Maine, require such training. More states and local governments are likely to adopt mandatory annual training for all employees.

Ms. Salins next noted that, at the federal level, the new Tax Cuts and Jobs Act includes a provision for "payments related to sexual harassment and sexual abuse," which may make sexual harassment settlements more expensive for employers who wish to keep the settlements confidential. Specifically, a settlement related to sexual harassment and the attorneys' fees related to such settlement are no longer a deductible business expense if such settlement is subject to a nondisclosure agreement. Employers will now have to weigh this additional cost of a nondisclosure provision and the value of such a provision on a case-by-case basis.

Ms. Salins also discussed another bill, the Ending Forced Arbitration of Sexual Harassment Act, which was introduced in Congress in December 2017. If enacted, the bill would prohibit employers from enforcing arbitration agreements with respect to employee allegations of workplace sexual harassment. This would give courts the power to invalidate arbitration agreements in their entirety if they require arbitration of sexual harassment claims. Recently, on February 12, 2018, a letter in support of this legislation signed by the attorneys general in all 50 states was submitted to congressional leadership.

Current Administration — One Year In

Ms. Salins highlighted that the current administration has been focused on immigration reform. In April of last year, U.S. Citizenship and Immigration Services (USCIS) announced new H-1B Fraud and Abuse Prevention measures designed to protect American workers by taking a more targeted approach to site visits to identify employers who are abusing the H-1B program. Also in April of last year, President Donald Trump signed the Buy American and Hire American Executive Order, which directs the Department of Labor (DOL), Department of Justice, Department of Homeland Security and Department of State to review employment-based foreign worker programs to ensure U.S. workers are provided with adequate protections from lower-cost foreign labor. Ms. Salins additionally noted President Trump's endorsement of the controversial Reforming American Immigration for a Strong Economy Act, which, if enacted, would replace the employment-based immigration visa system with a merit-based/points system, in which prospective immigrants would earn points based on education, English-speaking ability, high-paying job offers, age, extraordinary achievement and high-value investment.

In other areas, among the first actions President Trump took once in office was to nullify two Obama-era labor regulations: (i) the "Fair Pay and Safe Workplaces" rule, which required prospective federal contractors and subcontractors to disclose labor and employment violations during the previous three years and provide wage statements with pay and hours to employees and independent contractors and (ii) the Occupational Safety and Health Administration's (OSHA) "Volks Rule," which gave OSHA the power to issue citations and levy fines on employers who did not maintain proper records of work-related injuries and illnesses for five years.

Next, Ms. Salins noted that, in June 2017, the DOL withdrew two interpretations issued under the Obama administration. The first pertained to proper classification of workers as employees or independent contractors (and took the position that "most workers" should be classified as employees). The second interpretation addressed joint employer liability, with the DOL taking a broad view of when subcontractors and staffing agencies could be considered joint employers. Ms. Salins additionally highlighted that, just last month, the DOL replaced its long-standing and stringent six-factor unpaid intern test, which did not allow the employer to receive any immediate advantage from activities of an intern, with a more flexible "primary beneficiary" analysis. Under the new test, if the primary beneficiary of the relationship is the individual worker, then the individual worker can be properly considered an intern. Ms. Salins explained that, by endorsing this test, the DOL is aligning itself with recent federal court of appeals decisions. Ms. Salins noted, however, that this is the federal test, and that some states, including New York, have their own stricter tests for determining whether an intern is an employee.

Ms. Salins also provided an update on the status of the new EEO-1 pay data collection and reporting requirements discussed in last year's webinar, Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices, noting that, as of August 29, 2017, these collection and reporting requirements have been suspended. The EEO-1 collection and reporting requirements would have forced employers with more than 100 employees to report summary wage data and hours-worked data categorized by employees' gender, ethnicity and race.

Ms. Salins then discussed recent developments of the National Labor Relations Board (NLRB), noting that, in just one week in December, the NLRB reversed five controversial Obama-era decisions. Flagging a few of those decisions, Ms. Salins noted that the NLRB reverted to its old pre-*Browning-Ferris* joint employer test,[1] adopted a new standard for determining whether employment policies violate the National Labor Relations Act and overturned the *Specialty Healthcare* micro-unit standard in favor of its former approach for determining the appropriateness of a petitioned-for bargaining unit.

Overtime — Final Rule

Ms. Salins discussed the current state of one of President Barack Obama's major labor-related achievements — the DOL's final rule revising the Fair Labor Standards Act (FLSA) overtime regulations (Final Rule). The DOL's Final Rule nearly doubled the minimum salary level at which an employee can qualify as exempt from overtime pay under the FLSA, raising the threshold from $455 per week ($23,660 per year) to $913 per week ($47,476 per year) for the FLSA's executive, administrative and professional exemptions. In November 2016, just prior to the date on which the Final Rule was to go into effect, a federal district court judge suspended the regulation. Then, in August 2017, the Final Rule was found invalid by the U.S. District Court for the Eastern District of Texas. The DOL appealed the decision to the U.S. Court of Appeals for the Fifth Circuit, but on November 6, 2017, the Fifth Circuit granted the DOL's motion to hold the appeal in abeyance to allow the DOL to engage in a new rulemaking process. Ms. Salins noted that employers should be mindful that some state and local wage and hour laws, including New York's and California's, impose their own higher minimum salary levels for employees to be eligible for exempt status.

State/Local Salary History Bans

Ms. Salins stated that, at the state and local level, governments are passing salary history bans in an effort to fight wage discrimination and the gender pay gap. Ms. Salins then put forth New York City's salary history ban, which went into effect on October 31, 2017, as an example. Specifically, Ms. Salins noted that, under the New York City law, employers may not (i) request an applicant's salary history, (ii) solicit information about an applicant's salary history from a current or former employer or by searching public records, or (iii) rely on salary history information accidentally discovered while conducting a lawful background check or verifying non-salary-related information to make compensation decisions.

State/Local Leave Laws

Ms. Salins also noted that, each year, the number and types of paid leave laws at the state and local levels are growing, and that it is now common for states or cities to require paid sick leave, which may include "safe time" — paid sick leave for reasons related to domestic violence, stalking or abuse — in some jurisdictions. Ms. Salins indicated that the latest trend is paid family leave, which typically entitles eligible employees up to 12 weeks of paid time off at a certain percentage of the employee's average weekly wages for the birth or adoption of a child, a serious medical condition of the employee or the employee's family member, or to assist with family situations arising when the employee's family member is deployed abroad. Ms. Salins explained that multijurisdictional employers must ensure that they provide their workers with sufficient paid leave to comply with all applicable state or local laws. Ms. Salins then noted that, although it is possible to implement a single policy using the most generous of applicable laws, as more states and localities pass differing laws, it will become increasingly difficult for multijurisdictional employers to create uniform policies.

The Gig Economy

Ms. Salins ended by discussing the growing gig economy, in which companies hire workers for specific "gigs." The gig economy has provided significant cost savings for employers and flexible work schedules for gig workers. However, whether gig workers are properly classified as independent contractors rather than employees remains an open issue. Ms. Salins noted that a recent victory for meal delivery company GrubHub may or may not signal how other courts will make this determination. The GrubHub case is the first case where there has been a ruling on the misclassification issue in the context of the gig economy, with prior cases against major gig economy companies settling out of court. Ms. Salins noted that, while helpful, employers should not rely too much on the GrubHub case, as the decision was extremely fact-driven and based on California law.

[1] However, on February 26, 2018, the National Labor Relations Board issued an order vacating its decision in this case (*Hy-Brand Industrial Contractors, Ltd. and Brandt Construction Co.*, 365 NLRB No. 156 (2017)), in light of the determination by the NLRB's Designated Agency Ethics Official that member William Emanuel should have been disqualified from participating in the proceeding. This action put the *Browning-Ferris* standard, which expanded the definition of "joint employer" to companies that have "indirect control" over workers, back in effect.