Corporate Governance Series

Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices

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On February 28, 2017, Skadden hosted a webinar titled "Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices." The Skadden panelists were labor and employment law partner David Schwartz, and executive compensation and benefits counsel Thomas Asmar and Michael Bergmann.

Recent Compensation Developments

Section 16(b) Short-Swing Profit Recovery

Mr. Bergmann began the session with a discussion about recent Section 16(b) (*i.e.*, short-swing profit recovery) developments. Rule 16b-3 of the Securities Exchange Act generally exempts from 16(b) short-swing profit recovery any transactions pursuant to awards that are approved by the board of directors or a committee thereof (typically the compensation committee) consisting solely of two or more "non-employee directors." While equity plans often provide the administrator authority to grant awards that permit net-share withholding, how administrators exercise that authority varies. Three common techniques that administrators use to deal with net-share withholding are "automatic" (required) net-share withholding; net-share withholding only if requested or approved by the company; and net-share withholding as requested in the grantee's discretion. Until recent litigation, the level of concern with using this latter approach was low to nonexistent. The essence of the plaintiffs' claims in these recent suits is that Rule 16b-3 exempts withholding only if it is "automatic" and not if it is elective. The claims are based primarily on what most, if not all, practitioners view as a distorted reading of a Securities and Exchange Commission (SEC) compliance and disclosure interpretation under Section 16 of the Securities Exchange Act, which provides that the automatic issuance of a new option upon the exercise of a previously approved reload option is exempt, as is the automatic withholding of shares to pay tax withholding.

There are several typical ways to mitigate concern over claims involving net-share withholding. Administrators may simply provide for automatic net-share withholding, which is the only approach the plaintiffs view as permissible if properly effected. Alternatively, administrators may provide for net-share withholding at the election of the grantee only; while the plaintiffs take issue with this approach, and thus it is subject to challenge, it is still commonly used. Lastly, companies may have the compensation committee expressly approve net-share withholding for all awards until it determines otherwise, which avoids the need for repeated committee action in respect of each award.

Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices

Update on Dodd-Frank Act

Mr. Bergmann continued with an update on the executive compensation and corporate governance rules under the Dodd-Frank Act. The discussion focused primarily on the uncertain future of the pay ratio rule, which generally requires disclosure in proxy statements beginning in 2018. Many companies have been devoting significant effort to preparing such disclosure given the substantial burden of assembling and presenting the required information. On February 6, 2017, the acting chairman of the SEC issued a notice indicating that he is "seeking public input on any unexpected challenges that issuers have experienced as they prepare for compliance with the rule and whether relief is needed." He requested that comments be submitted by March 23, 2017, and "directed the staff to reconsider the implementation of the rule based on any comments submitted and to determine as promptly as possible whether additional guidance or relief may be appropriate." Although it appears that the Trump administration would like to provide some relief, the outcome of this process is not clear. Accordingly, for now, issuers should continue to prepare as required to meet the current disclosure timeline.

More generally, President Trump said he would eliminate or "change greatly" the Dodd-Frank Act. Executive orders have been issued relating broadly to the financial system and in regard to a regulatory "freeze," although the effect of the freeze on SEC rules is unclear. Mr. Bergmann noted that the strongest administration efforts likely will relate to banking and financial sector regulation, but efforts will also likely address executive compensation and corporate governance provisions. Rules that have been proposed but not implemented are the most likely to be derailed. However, considering that many institutional shareholders welcome the disclosure required by several final and proposed rules, many companies may continue to provide such disclosure regardless of whether it is mandated by law. In any event, public companies should continue to monitor statutory and regulatory changes in the coming months.

Director Compensation

Mr. Bergmann provided an update on some recent developments regarding director compensation. While that historically has been in the spotlight much less than executive compensation, two recent developments — litigation challenging director compensation levels and Nasdaq's new "golden leash" disclosure requirements — signal increasing scrutiny.

Recent Director Compensation Litigation. Where directors make compensation decisions affecting their own compensation, recent Delaware case law has shown that the protections of the business judgment rule may not always be available. Companies should be aware of the risk that actions may be brought alleging that directors have breached their fiduciary duties and been unjustly enriched when granting themselves incentive compensation where "meaningful" director-specific limits on those grants have not been approved by shareholders. Where there has been such approval, companies may be able to avail themselves of the protection of the business judgment rule. Mr. Bergmann presented a few key lessons from this litigation. First, companies should carefully review any limits that apply under cash and noncash director compensation programs. Second, where no meaningful limits on director grants exist, companies should consider implementing them. Additionally, companies should seek shareholder approval of director limits if practicable. If shareholder approval is not available, companies should try to develop supporting facts (including a peer group analysis) that would provide a basis for withstanding "entire fairness" scrutiny. Finally, companies should ensure that proxy statement disclosure regarding director compensation is clear and expand it beyond historical norms if necessary to provide a thorough description of director compensation amounts and how they were determined.

Nasdaq "Golden Leash" Disclosure. New Nasdaq Rule 5250(b)(3), which was approved by the SEC on July 1, 2016, requires Nasdaq-listed U.S. companies to disclose any compensation arrangement provided by a third party to directors or nominees (typically compensation provided by a shareholder). Effective July 31, 2016, disclosure generally must be made either through internet access (*e.g.*, the company website) or in the next filing of the company's proxy statement (the 2017 annual meeting proxy statement for most companies). Thereafter, disclosure is required annually until the director's departure or one year following termination of the arrangement. While the SEC has acknowledged overlap with its existing disclosure requirements (e.g., Form 8-K and Regulation S-K Item 402), the regimes are not coextensive, and therefore care must be taken to disclose the information required by Nasdaq where the SEC regime does not capture a particular arrangement or payment.

Other Recent Compensation Developments

Compensation litigation and enforcement proceedings have been on the rise in recent years. In addition to the Rule 16b-3 and director compensation litigation discussed earlier, other examples of recent litigation include claims relating to disclosure supporting incentive plan approval by shareholders, Internal Revenue Code Section 162(m) disclosure and compliance, and severance arrangements. Moreover, the SEC has recently increased its focus on the disclosure and use of financial measures that are based on but not specifically authorized by generally accepted accounting principles (GAAP).

Mr. Bergmann noted that some of the activity has been percolating for several years, such as shareholder approval of incentive plans and the Section 162(m) disclosure and compliance issues. He believes that activity may be diminishing in those areas because of increased awareness of the nature of the claims and the pre-emptive steps that can help thwart them. He noted that some other activity is very recent, however, including the January 2017 resolution of a challenge to a Mattel, Inc. severance payment — in which the Delaware Court of Chancery dismissed a derivative claim seeking recovery of a $10 million payment — and the SEC enforcement relating to non-GAAP financial measures (generally relating to noncompensation matters but nonetheless with relevance for compensation disclosure).

Overview of Other Compensation Issues

2017 Proxy Season: Say on Frequency

Mr. Asmar highlighted some of the key issues that need to be considered in this year's proxy season. The first item he noted is the say-on-frequency vote. The say-on-frequency vote requires companies to provide for a shareholder advisory vote at least once every six years, on whether the say-on-pay vote will occur every one, two or three years, pursuant to Rule 14a-21(b) of the Securities Exchange Act. Most companies (except for smaller reporting companies that first held the vote in 2013) held their first say-on-frequency vote in 2011, making this year the second time they are including a say-on-frequency vote. By the end of 2011, nearly 90 percent of companies had adopted an annual say-on-pay vote, and this trend is expected to continue. There are a few important reminders regarding disclosure requirements. First, the say-on-frequency proposal must clearly state that shareholders may vote as to the frequency of holding future say-on-pay votes every year, every two years or every three years, or abstain. Next, the results of the say-on-frequency vote must be disclosed in a Form 8-K within four business days following the annual shareholder meeting, as with other shareholder proposals. Finally, companies must disclose their decision as to the frequency of future say-on-pay votes.

2017 Proxy Season: Say on Pay

For say-on-pay proposals held during the 2016 proxy season, approximately 75 percent of companies passed with more than 90 percent support, and 90 percent of companies passed with 70 percent or more support. The number of companies that failed their say-on-pay vote decreased to 41 companies (or 1.7 percent of companies) in 2016 compared to 60 companies (or 2.8 percent of companies) in 2015. The most common reasons for failing the say-on-pay vote are a pay-for-performance disconnect, problematic pay practices and a lack of rigorous performance goals, according to leading compensation consulting firms.

2017 Proxy Season: ISS Equity Plan Scorecard

In December 2016, the Institutional Shareholder Services (ISS) FAQs and the primer on Equity Plan Scorecard (EPSC) methodology were updated effective for shareholder proposals to approve equity plans at meetings held on or after February 1, 2017. EPSC generally applies to proposals to approve equity plans, as well as proposals to amend such plans if they may increase the potential expense of the plan from a shareholder's perspective. Under the EPSC, factors are grouped under three pillars: plan cost, plan features and grant practices. Each factor has a maximum potential score (*i.e.*, weighting), with 53 out of a maximum 100 total potential points required to "pass" the EPSC model, provided that the plan has no egregious failures. Mr. Asmar noted that many companies get ahead of potential ISS problems by highlighting their best pay and corporate governance practices in their proxy disclosures and addressing these issues upfront. Mr. Asmar highlighted the key changes to the EPSC in 2017. For more information, see our January 26, 2017, client alert discussing ISS policy.

Trend Toward Enhanced Director Compensation Disclosure

An increasing number of companies are providing enhanced disclosure of director compensation in their proxy statements in response to the recent director compensation litigation and ISS views on director compensation programs. Companies are providing more disclosure of director pay limits under their equity programs as well as the process that the board or committee follows in setting director compensation levels, including the extent to which the board has conducted an independent review of its compensation program or analyzed market data. Although not specifically required by the SEC rules, this type of disclosure is becoming more prevalent.

Rigor of Performance Targets

Another key area of focus is the rigor of performance goals under company incentive programs. Mr. Asmar pointed out that investors, proxy advisers and the SEC are highly attuned to pay for performance, with a particular focus on the rigor of performance goals. For example, ISS takes note of whether there is a pay-for-performance misalignment and evaluates the rigor of performance goals. Mr. Asmar outlined a number of items to consider when disclosing performance targets under incentive programs in the CD&A: discussing the rationale for selecting performance targets and how they were determined, describing any significant changes in performance targets from those used the previous year and being careful about relying on competitive harm as a basis for not disclosing performance targets.

Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices

Use of Non-GAAP Measures

In May 2016, the SEC issued new interpretive guidance on using non-GAAP measures in proxy statements, which included several examples of potentially misleading non-GAAP measures. Mr. Asmar pointed out that, notwithstanding this heightened focus on the disclosure of non-GAAP measures, the rule for using non-GAAP measures in a proxy hasn't changed. If non-GAAP measures are used to establish performance targets, those targets must be disclosed in the CD&A along with an explanation of the method of calculation, but a full reconciliation to GAAP isn't required. If non-GAAP measures are used for any purpose other than to disclose performance targets (such as to explain the connection between pay and performance), then a full reconciliation to GAAP generally is required. However, there is a special rule for pay-related disclosure of non-GAAP measures (which should include most uses of non-GAAP measures within the CD&A) in which the GAAP reconciliation may be included in an annex to the proxy statement or with a cross-reference to Form 10-K. There have been a couple of recent cases in which the SEC issued sanctions to companies for violating the non-GAAP disclosure rules.

Equity Award Tax Withholding

In April 2016, the Financial Accounting Standards Board issued guidance permitting companies to withhold a participant's share of taxes for equity awards up to the maximum statutory rate without triggering liability accounting. Previously, the rule required withholding at the minimum rate. A plan amendment to permit maximum tax withholding is not considered a material amendment requiring shareholder approval under New York Stock Exchange and Nasdaq rules. Mr. Asmar highlighted a few issues for companies to consider in deciding whether to adopt this change with respect to the company's insider trading policy, Section 16 issues, the ability of award holders to determine the particular applicable tax withholding percentage, and required amendments to the equity plan and award agreements.

Section 162(m) Reminders

Mr. Asmar concluded his portion of the presentation with a few reminders on Section 162(m) compliance: If the business criteria for performance goals under a plan were last approved in 2012, they will need to be submitted to shareholders for approval in 2017. Companies that went public through an initial public offering in 2013 and previously relied on the applicable special transition rule under Section 162(m) will need to submit plans for shareholder approval and comply with Section 162(m) starting in 2017. Companies should review the status of the members of the compensation committee to ensure they are independent and qualify under Section 162(m). Before annual bonuses get paid, companies should ensure that the compensation committee has certified in writing the level of achievement of the applicable performance goals. If companies are contemplating adjusting performance goals at the end of the performance period, remember that negative discretion is permitted under Section 162(m), but use of discretion to increase the amount of compensation that would otherwise be payable is prohibited. For new programs, performance goals generally need to be established within 90 days after the beginning of the performance period. Lastly, an award will not qualify under Section 162(m) if the arrangement provides for payment upon a covered executive's retirement or involuntarily termination of employment without regard to whether the related performance goals were achieved.

EEO-1 Report Update

Mr. Schwartz discussed the Equal Employment Opportunity Commission's (EEOC) updates to the EEO-1 report, which include expanded employer obligations for 2017 data. While covered employers currently provide sex and race data, the revised form will now also require data by job category and pay band. The EEO-1 deadline for the 2017 report is March 31, 2018. In response to a question from the audience, Mr. Schwartz explained that covered employers, for purposes of the updated report, include all employers, including federal contractors, with 100 or more employees. Federal contractors with 50 to 99 employees will not be required to report pay data but will continue to report sex and race. Consistent with current practice, noncontractor employers with 99 or fewer employees and federal contractors with 49 or fewer employees will not be required to file the EEO-1 report.

Because the EEOC did not implement the new EEO-1 requirements through the formal rulemaking process, Mr. Schwartz said the new administration's appointees could withdraw the changes without going through that same process.

State Pay Equity and Equal Pay Laws

Mr. Schwartz noted that many states, including California and New York, recently passed laws strengthening existing pay equity and equal pay laws. In California, recent amendments to the California Fair Pay Act (FPA) prohibit employers from relying on an employee's prior salary to justify a disparity between the salaries of similarly situated employees. The amendment also expands the FPA's requirements to apply to race and ethnicity as well as gender. Similarly, in New York, the Achieve Pay Equity Act (APEA) requires employers to justify pay disparities with a bona fide factor other than sex and prohibits any retaliation against employees who ask about, discuss or disclose wages. Further, the APEA expands the geographical area in which employee salaries may be compared to "workplaces located in the same geographical region, no larger than a county."

The Defend Trade Secrets Act

Mr. Schwartz then discussed the Defend Trade Secrets Act of 2016 (DTSA), which took effect on May 11, 2016, and amends the federal Economic Espionage Act of 1996 (18 U.S.C. § 1831, et seq.) by creating a private cause of action for trade secret misappropriation under federal law. He explained that benefits of the DTSA include federal court jurisdiction, expanded remedies (*e.g.*, exemplary damages and attorneys' fees) and the DTSA's broad definition of "trade secret." However, Mr. Schwartz said, an employer may only recover exemplary damages or attorneys' fees in an action against an employee if the employer previously provided the employee with written notice of the immunity provisions of the DTSA. Importantly, employers need not change existing agreements, as the notice requirement is prospective only (as of May 11, 2016).

SEC Whistleblower Enforcement

Mr. Schwartz highlighted an October 2016 SEC risk alert that notified employers of its intention to inspect compliance manuals, codes of ethics, employment agreements and severance agreements to determine whether these documents restrict or discourage employees from acting as whistleblowers in violation of Rule 21F-17. Mr. Schwartz summarized the agreements and provisions the SEC has scrutinized the most, including those that: expressly limit communications with or the types of information that can be conveyed to the SEC or other authorities; require waiver of the right to apply for or accept a whistleblower award from the SEC or any individual monetary recovery in any governmental proceeding; require notice to, or permission from, an employer to disclose information pursuant to a formal legal process, without exception for the SEC and other government agencies; and limit disclosures of confidential information to those required by law, without any express exception for voluntary communications with the SEC concerning possible securities violations. Mr. Schwartz then discussed recent SEC enforcement actions that reflect the SEC's commitment to a broad interpretation of Rule 21F-17 as applied to severance agreements and recommended employers review their current agreements for compliance.

EEOC's Enforcement Position

Similar to the SEC, Mr. Schwartz explained, the EEOC has identified provisions often found in employment agreements and policies that, in its view, may interfere with employees' right to participate in proceedings with government agencies that enforce discrimination laws. Mr. Schwartz noted the provisions most likely to attract negative EEOC attention include: cooperation provisions requiring employees to inform an employer of any legal proceedings, including an administrative investigation; nondisparagement provisions; provisions prohibiting disclosure of confidential information to third parties without prior permission of the employer's human resources or legal officer; releases that extend to all "causes of action, lawsuits or charges including any claim of unlawful discrimination of any kind" without an express exception for claims or charges filed with a civil rights enforcement agency; covenants not to sue that fail to adequately exempt discrimination claims; and provisions imposing penalties for breaching an overbroad covenant not to sue.