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Trending Topics in Executive Compensation

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In 2018, a number of executive compensation issues made headlines, with trending topics including director compensation litigation, the impact of the recent U.S. tax reform on performance-based compensation, the influence of the #MeToo movement, persisting gender pay disparity issues and enforcement actions by the Securities and Exchange Commission (SEC) on executive perquisite disclosure. We expect further developments on these topics in 2019 and beyond and encourage companies to consult with their legal advisers as needed in order to stay informed and prepare for new developments in the rapidly changing landscape of executive compensation.

Delaware Case May Shift Approach to Director Compensation

On December 13, 2017, the Delaware Supreme Court issued an opinion in *In re Investors Bancorp, Inc. Stockholder Litigation,* which has caused companies to rethink the shareholder-approved director compensation limits in their equity plans. This case involved allegations of self-dealing and corporate waste due to excessive director compensation. Prior to this case, courts typically applied the business judgment standard of review, which establishes a presumption that the board acted in good faith and in the best interest of the company's stockholders with respect to decisions relating to director compensation. This presumption applies if the compensation was awarded pursuant to a plan that stockholders ratified and that contained "meaningful limits" on director compensation. As a result, many cases regarding these types of allegations were dismissed at an early stage of the litigation process. In *In re Investors Bancorp*, the court held that a decision to grant awards to directors was not entitled to the protection of the business judgment rule at the pleading stage if the plaintiff properly alleged that the discretion was inequitably exercised. This is the case even if the awards otherwise fell within the shareholder-approved limit. Rather, the court applied the more onerous entire fairness standard of review, under which courts assess whether the decision is entirely fair to the corporation. (For more on *In re Investors Bancorp*, see our December 19, 2017, client alert "Boards Beware: Delaware Supreme Court Limits Application of Deferential Standard for Reviewing Director Equity Awards.")

Companies should consider how to reduce their risk of director compensation litigation by, for example, retaining any existing limits in their incentive compensation plans, ensuring there is a rigorous process for establishing director compensation, working with a compensation consultant to review grants by peer companies, carefully documenting the review of director compensation, and providing enhanced proxy disclosure regarding the process for determining director awards. Some companies also may want to consider a formula-based determination of equity grants, which, although currently uncommon, has been implemented by some companies.

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In response to the focus on excessive director pay, Institutional Shareholder Services (ISS) introduced a policy in 2017 that would potentially result in adverse vote recommendations for directors responsible for approving or establishing director pay that ISS determines fits an established pattern (two or more consecutive years) of excessive pay levels without a compelling rationale or other clearly explained mitigating factors. In 2018, ISS announced that it will be revising its methodology for identifying excessive director pay and delaying the first possible adverse vote recommendations under the policy until 2020.

Impact of Tax Reform on Performance-Based Compensation

The Tax Cuts and Jobs Act that was enacted on December 22, 2017, amended Section 162(m) of the Internal Revenue Code, which generally imposes a $1 million annual deduction limit for compensation paid to covered employees. (See "US Tax Reform and Cross-Border M&A: Considering the Impact, One Year In.") Statutory changes include eliminating the qualified performance-based compensation exception to Section 162(m), expanding the definition of a covered employee and broadening the scope of companies that are subject to Section 162(m). These changes do not apply to compensation under written binding contracts in effect as of November 2, 2017, so long as those contracts are not materially modified. On August 21, 2018, the Internal Revenue Service (IRS) issued Notice 2018-68, which provides guidance on this transition rule and the new rules for identifying covered employees. One of the key takeaways from the notice is the IRS view that awards are not grandfathered if companies are permitted to exercise negative discretion to reduce or eliminate the award amount, regardless of whether that discretion is exercised, unless the employee is entitled to the amount under applicable state law. This is a fact-intensive and complex issue that should be carefully considered.

Companies should continue to assess the impact of the changes to Section 162(m) on their compensation arrangements. The new rules may provide more freedom to design executive compensation programs that address pay for performance without having to comply with the strict rules of the performance-based compensation exception. In addition, companies may consider alternative compensation designs in an attempt to fit within Section 162(m)'s annual $1 million deduction limit. They should review the terms of their incentive compensation plans and arrangements with their legal advisers to determine whether grandfathering may be available and, if so, exercise caution to avoid either inadvertently losing grandfathered status when contemplating any modification to pre-existing arrangements or otherwise risk jeopardizing the deductibility of compensation paid to covered employees for current and future taxable years.

#MeToo and Executive Compensation

The #MeToo movement has caused many companies to take a more active role in preventing and responding to sexual harassment or sexual misconduct in the workplace. (See "Expanding Theories of Liability in the #MeToo Era.") In addition to re-examining the code of conduct policy and other related policies and procedures, some have included or modified specific terms in individual compensation arrangements with executives to address the consequences of sexual harassment or sexual misconduct, such as with respect to the definition of "cause" under employment, severance and similar agreements. In addition to serving as an incentive to prevent this type of behavior, specifically addressing the issue in the definition of "cause" under these agreements may more clearly permit a company to avoid paying severance benefits upon a termination of employment of an executive who engages in sexual harassment or sexual misconduct.

In further response to the #MeToo movement, some companies are considering updating their compensation recovery policy to provide for a clawback or forfeiture of previously paid compensation if an executive engages in sexual harassment or sexual misconduct in the workplace. Recently, some also have been asking newly hired executives to include an affirmative representation to the effect that they have not been the subject of any sexual harassment or sexual misconduct claim or otherwise engaged in any such behavior. It remains to be seen whether these provisions will evolve into standard practice, but we anticipate that more companies will modify their executive compensation programs and agreements in some manner to discourage sexual harassment or sexual misconduct in the workplace as these issues continue to receive attention.

Gender Pay Disparity

Recent studies show that gender pay disparities continue to be a significant issue in executive compensation. In particular, a significant discrepancy in the level of incentive compensation exists for men and women serving similar roles. In 2017, the Trump administration suspended the equal pay rule that was initiated by the Obama administration and would have required large companies to report pay by race and gender to the government. Meanwhile, in the United

Kingdom, 2018 marked the beginning of a regulatory requirement for U.K. companies with more than 250 employees to annually report the results of certain "pay gaps" between male and female employees on both a government website and the company's own website. In the United States, despite companies reaffirming their commitment to eliminate gender pay disparities, legal and regulatory efforts, social activism and ongoing research indicate that more work needs to be done. Companies are encouraged to remain vigilant in this area by reviewing internal processes, designing and implementing executive compensation philosophies and programs, and staying informed of regulatory and legislative developments with the goal of eliminating the disparities. (See "Responding to the Call for Equal Pay.")

SEC Enforcement on Executive Perquisite Disclosure

Over the last several years, the SEC has pursued several enforcement actions against companies for failing to disclose executive perquisites in their public filings. In the most significant enforcement action, on July 2, 2018, the SEC announced that a company agreed to settle charges relating to the understatement of and failure to disclose certain perquisites by paying a $1.75 million civil penalty. The SEC also required the company to hire an independent consultant for one year to review and evaluate its policies, procedures and controls regarding perquisite disclosure, and implement the consultant's recommended changes. Companies should review internal perquisite policies and procedures as well as director and officer questionnaires to help identify perquisites disclosable as executive compensation.

Click here for a full list of executive compensation and benefits-related articles authored by Skadden attorneys in the last year.