Skadden

SEC Reporting & Compliance and Corporate Governance Series

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On February 5, 2019, Skadden hosted the webinar "Key Trends in Executive Compensation, Employment Law and Compensation Committee Practices." The panelists were **David Schwartz**, Skadden's global head of Labor and Employment Law; **Thomas Asmar**, Executive Compensation and Benefits counsel; **Michael Bergmann**, Executive Compensation and Benefits counsel; and **Anne Villanueva**, Labor and Employment Law associate. **Regina Olshan**, the firm's global head of Executive Compensation and Benefits, moderated the discussion.

Tax Reform's Impact on Pay Practices and Preparing for Proxy Season

Impact of Tax Legislation on Pay Practices

Mr. Asmar began with a discussion of how the 2017 federal tax legislation (the so-called "Tax Cuts and Jobs Act" (TCJA)) amended Section 162(m) of the Internal Revenue Code. Notably, the TCJA eliminated Section 162(m)'s qualified performance-based compensation exception, so that all compensation paid to covered employees in excess of $1 million annually is not deductible, unless it is grandfathered under the TCJA's transition rule. The legislation also expanded the definition of a "covered employee" to include anyone who served as the CEO or CFO at any time during the taxable year, as well as the three other most highly compensated officers other than the CEO and CFO for that year. The TCJA also made covered employee status attach for all future taxable years, which means companies should keep a running list of their covered employees. Additionally, the TCJA expanded Section 162(m)'s reach to companies with publicly traded debt and foreign private issuers. These changes took effect for taxable years after December 31, 2017 (*i.e.*, for 2018), for calendar year companies.

Next, Mr. Asmar reviewed the transition rule, explaining that the changes to Section 162(m) do not apply to compensation payable under written binding contracts in effect as of November 2, 2017, so long as the contracts are not materially modified thereafter. Mr. Asmar cautioned companies to consult with advisers prior to making any changes to these contracts to avoid inadvertent material modifications, because amounts paid after a material modification would become subject to the amended Section 162(m).

Mr. Asmar also discussed IRS Notice 2018-68, which provided guidance on certain of the changes to Section 162(m). One important takeaway from Notice 2018-68 is 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 in all events entitled to the amount under applicable state law. Mr. Asmar noted that many incentive plans have been designed to feature negative discretion, and payments under those plans are not eligible for grandfathering unless the state law exception applies. Moreover, the availability of the state law exception depends on each compensation arrangement's facts and circumstances. Mr. Asmar also reviewed IRS Notice 2018-68's guidance about material modifications. An increase in the amount of compensation payable, acceleration of payments and further deferrals of payments generally are material modifications, subject to exceptions.

In practice, companies are taking inventory of their performance-based compensation arrangements that were in effect on the transition date to determine which ones may be eligible for grandfathered treatment and treading carefully when amending them to avoid inadvertent material modifications. Mr. Bergmann emphasized that companies should do a fundamental review of all of their compensation arrangements to determine whether they may be grandfathered, because the changes to Section 162(m) extend beyond the elimination of the qualified performance-based compensation exception. Mr. Asmar observed that the changes to Section 162(m) may provide companies with flexibility to design new executive compensation programs that address pay for performance without having to conform to the prior performance-based compensation exception rules. For example, performance goals no longer need to be established within 90 days of performance periods, companies may exercise discretion to increase or decrease payouts, and shareholder approval is no longer required every five years. However, Mr. Asmar cautioned that, to the extent a company has grandfathered awards, these provisions should remain in place in compensation plans that govern them.

Mr. Asmar concluded the discussion about tax reform's impact on pay practices by highlighting certain planning considerations. Companies may consider spreading compensation payments over multiple years to fit within the former $1 million performance-based compensation threshold, and may provide for severance bonus payouts at target rather than actual performance. However, Mr. Asmar noted that performance-based compensation remains integral to incentivizing executives and responding to shareholder and proxy adviser firm demands, and companies have not been dramatically changing their compensation plans in practice. Mr. Bergmann agreed that performance-based pay will remain important to investors. He observed that the rationale for pay-for-performance has always extended beyond Section 162(m) considerations.

Key Considerations for 2019 Proxy Season

Mr. Bergmann began by noting that Institutional Shareholder Services (ISS) and Glass Lewis provide guidance each year about their approach to the upcoming proxy season. He reviewed important updates from ISS, including the following:

- ISS now considers a shift away from performance-based compensation to discretionary or fixed pay elements to be a problematic pay practice; and
- ISS added to its list of problematic pay practices (a) excessive termination payments generally exceeding three times base pay and annual bonus, including in situations beyond a change-in-control triggering severance obligations; and that (b) a "good reason" termination definition that presents windfall risks (*i.e.*, severance is triggered by potential performance failures, such as company bankruptcy or delisting).

Additionally, ISS expressly addressed front-loaded awards for the first time and made clear that ISS is unlikely to support grants covering more than four years and that they expect a firm commitment from a company not to grant additional awards for that same performance period. Glass Lewis similarly scrutinizes front-loaded awards and expects a company to make a firm commitment to refrain from granting additional awards.

Regarding ISS' pay-for-performance screens, there were no changes to ISS' *quantitative* screen this year, but ISS made clear that it is continuing to explore potential use of an economic value added (EVA) measure and that it will start to display EVA measures in its research reports. Companies should therefore understand their EVA scores and anticipate that they will be on display. Moreover, ISS' *qualitative* screen features a new measure: the emphasis of objective and transparent metrics. Mr. Bergmann underscored that ISS stated it does not endorse or prefer the use of any particular metric, including total shareholder return. Finally, ISS made clear that pay ratio will not impact its vote recommendations at this time, but it will continue to display pay ratio results in its reports.

Mr. Bergmann then briefly covered updates to ISS' Equity Plan Scorecard that it uses to evaluate shareholder proposals on U.S. equity compensation plans. Notable changes to the EPSC include:

- Companies may earn full credit for a change-in-control provision by providing clear disclosure of the treatment upon a change-in-control. However, Mr. Bergmann anticipates that change-in-control provisions will nevertheless continue to feature double-trigger treatment and that ISS would view a departure from that negatively.

- ISS added excessive equity dilution as an overriding factor. An overriding factor is one that might cause ISS to issue a negative vote recommendation on an equity plan even if it has a passing score.
- ISS is giving additional weight to the plan duration factor, even though the EPSC passing scores remain the same. Mr. Bergmann explained that ISS aims to encourage companies to frequently seek shareholder approval of their equity plans, especially in light of the amendments to Section 162(m), which removed an incentive to seek shareholder approval every five years.

Next, Mr. Bergmann highlighted updates from Glass Lewis. Glass Lewis provided guidance that excessive sign-on awards, multiyear guaranteed bonuses and severance provisions exceeding the upper limit of market practice may contribute to a negative vote recommendation. Like ISS, Glass Lewis views excise tax gross-ups unfavorably, particularly where a company previously committed not to add any. Glass Lewis also made clear that it plans to scrutinize clawback policies and noted that clawback policies should extend beyond Sarbanes-Oxley Act requirements. Glass Lewis indicated that they do not have an inherent concern with nonformula bonus plans but that they do expect a meaningful discussion of the rationale for having a nonformula plan and the board's rationale in determining the bonuses under it for any particular year.

Mr. Bergmann then covered key pay ratio considerations. Companies should understand where their pay ratio stands relative to their peers. Moreover, companies should carefully consider whether to use the same or a different median employee, which requires determining whether during the preceding year there were any changes to employee demographics or pay practices that may cause the company to believe that its pay ratio could be significantly impacted. Mr. Bergmann expects some companies to make voluntary disclosures regarding pay ratio matters (i.e., beyond those required by the rule), in part in response to institutional investor requirements for additional information disclosure.

The SEC's New Hedging Policy Disclosure Rule

Mr. Asmar noted that in 2015 the Securities and Exchange Commission (SEC) included a proposal to implement rules from the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding hedging disclosures in proxy statements. Three years later, the hedging rule was finalized in the form of Item 407(i) of Regulation S-K. Under Item 407(i), companies will be required to disclose policies or practices that allow employees or directors to hedge or offset any decrease in the market value of equity securities that are granted as compensation to, or held directly or indirectly by, an employee or a director.

Mr. Asmar observed that the rule applies not only to executives but also to other employees and directors. Also, the rule does not define the term "hedging" and broadly refers to transactions that have the economic effect to hedge or offset any decrease in the market value of equity securities. The term "equity securities" encompasses equity securities of the company along with equity securities of the company's parent and subsidiaries, and the parent's subsidiaries. Companies should recognize that the disclosure requirement is focused on whether the company permits hedging transactions pursuant to its written or unwritten policies and practices. If a company does not have hedging policies or practices, it should disclose that hedging transactions are generally permitted. Mr. Asmar then discussed the level of detail that will be necessary to satisfy Item 407(i). Companies can comply with Item 407(i) by (a) disclosing the practices or policies in their entirety or (b) providing a summary of them, including the categories of people affected and types of hedging transactions that are specifically permitted or forbidden.

Companies will be required to comply with the new disclosure requirements for proxy statements and information statements for shareholder meetings at which directors will be elected for fiscal years beginning on or after July 1, 2019. This means calendar year companies do not need to make Item 407(i) disclosures in proxy statements filed this year. Smaller Reporting Companies and Emerging Growth Companies will first be required to make Item 407(i) disclosures for fiscal years beginning on or after July 1, 2020.

Mr. Asmar shared insights about where to place the Item 407(i) disclosure in the proxy statement. The rule permits placement of the Item 407(i) disclosure outside the Compensation, Discussion and Analysis section of the proxy statement (CD&A), without any cross-reference or direct inclusion of the Item 407(i) disclosure in the CD&A, which would result in the Item 407(i) disclosure not being subject to the say-on-pay vote applicable to executive compensation. If, however, the CD&A does include the Item 407(i) disclosure or a cross-reference to it, then the Item 407(i) disclosure may be picked up in the say-on-pay vote. Mr. Asmar noted that what happens in practice with respect to these disclosures remains to be seen. In the meantime, companies should prepare for Item 407(i) by considering whether to adopt or change their hedging policies or practices.

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

Recent Trends in Executive and Director Compensation

The SEC Cracks Down on Inadequate Perquisite Disclosures

Mr. Asmar noted that the SEC has recently pursued several high-profile enforcement actions against companies for failing to disclose executive perquisites in their proxy statements. For example, the SEC announced that a company agreed to settle charges relating to inadequate disclosure of perquisites by paying a $1.75 million civil penalty, and the company was required to hire an independent consultant for one year to review and evaluate its procedures and controls. In another recent case about failure to disclose perquisites in a proxy statement, the SEC entered into a settlement agreement with a former CEO that included a $180,000 fine and a five-year ban on serving as a corporate officer of a public company. The SEC's rules generally provide that an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties. Otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect regardless of whether it is provided for a business reason, unless it is generally available on a nondiscriminatory basis to all employees. Mr. Asmar encouraged companies to review their executive perquisite policies and procedures in connection with upcoming proxy statements and to consider their internal policies, procedures and questionnaires in place.

The #MeToo Movement's Influence on Compensation

Mr. Asmar then shared updates about another important topic: the effect of the #MeToo movement on executive compensation. Companies have been taking an increasingly active role in preventing and responding to sexual misconduct in the workplace. In addition to taking a fresh look at their codes of conduct and similar policies and procedures, some companies have been weighing whether to include specific terms in their executive compensation plans or agreements to address the consequences of sexual misconduct in the workplace and deter such behavior. Mr. Asmar explained that some companies have revised their definition of "cause" to include sexual misconduct, expressly permitting them to terminate an executive who engaged in sexual misconduct without providing severance. Some companies also have considered updating their compensation recovery policies to provide for clawback of compensation if an executive engages in sexual misconduct in the workplace. Some companies also have been asking newly hired executives to make affirmative representations or warranties that they have not been subject to any sexual misconduct claims or otherwise engaged in such behavior. Similar representations are beginning to appear in corporate transaction documents, such as merger agreements. Some companies have been proactive about channeling the #MeToo movement's momentum to update their executive compensation practices, and it remains to be seen how the #MeToo movement will continue to influence executive compensation.

Director Compensation Updates

Mr. Bergmann observed that the Delaware Supreme Court's decision in *In re Investors Bancorp* is sustaining the trend of increased scrutiny of director compensation. Prior to *Bancorp*, the more deferential business judgment standard, as opposed to an entire fairness standard, applied if a director compensation decision or plan was ratified by shareholders and had meaningful limits on the amount that could be paid to directors. In *Bancorp*, the Delaware Supreme Court found that the shareholder ratification path to the business judgment standard of review is unavailable and entire fairness applies, even where shareholders have approved an equity or other compensation plan, if the plan gives directors discretion to grant themselves awards only within general parameters (*e.g.*, subject to a limit). However, business judgment review is available where shareholders approve specific director awards or a plan with a specific formula.

Mr. Bergmann advised companies on reducing their risk of director compensation litigation. Retaining existing limits in plans will not make business judgment review available, but it still can be a favorable factor if a court is conducting an entire fairness review. Companies should also determine whether their compensation is in fact reasonable compensation for directors, in part by benchmarking against their peers. Moreover, it can be helpful for companies to separate employee and nonemployee director compensation decisions, but Mr. Bergmann cautioned that such separation alone will not ensure rigorous compensation decisions. Companies also should carefully document the process they use to determine director compensation and provide a transparent description in their proxy statement so that investors can understand the compensation decisions. Mr. Bergmann noted that it is uncommon in practice for companies to request shareholder approval of specific director awards or specific plan formulas.

Next, Mr. Bergmann reviewed the ISS response to increased scrutiny of director compensation. ISS first developed an evaluation methodology for nonemployee director pay in December 2017. At that time, ISS stated that a finding of excessive nonemployee director pay over two or more consecutive years without a compelling rationale or mitigating factors could result in an adverse vote recommendation starting in 2019. Late last year, ISS announced that it would reevaluate its existing nonemployee director pay methodology and that the first possible adverse vote recommendations would be in 2020.

ISS has since finalized its nonemployee director pay evaluation policy:

- Pay outliers will be nonemployee directors with pay in the top 2-3 percent of comparable directors, whereas under the earlier proposed policy it targeted those in the top 5 percent. Nonemployee directors will be compared against a peer group identified by ISS. Nonexecutive chairmen and lead independent directors will be compared against their counterparts on other boards.
- If ISS determines that nonemployee director pay is a quantitative outlier, it will conduct a qualitative evaluation to determine whether those concerns are mitigated. Circumstances that could mitigate concerns are special onboarding grants, pay that is linked to a specific transaction, or scientific expertise. However, payments that are justified only as rewarding general performance will not be treated as a mitigating factor.

Mr. Bergmann concluded by noting that nonemployee director pay is expected to be a continuing source of investor concern. Companies should pay careful attention to director compensation amounts and how director compensation decisions are made.

#MeToo and the Renewed Focus on Gender Pay Equity

Ms. Villanueva began by noting that equal pay audits and gender pay gap disclosure issues have become especially relevant in our current sociopolitical climate. For example, the #MeToo Movement has put a spotlight on women's issues in the workplace following ongoing revelations about sexual harassment and has resulted in a renewed emphasis on workplace equality by large companies that have decided to publicly discuss pay analyses.

Ms. Villanueva discussed varying initiatives such as the White House Equal Pay Pledge and a recent Senate bill reintroduced on January 30, 2019, to close loopholes in the Equal Pay Act of 1963.

Recent Pay Equity Developments

Ms. Villanueva explained that in addition to the Senate bill noted above, there are various initiatives aimed at minimizing pay inequity at the state level. In particular, Ms. Villanueva explained:

- California S.B. 826 requires all NYSE- and Nasdaq-listed public companies with principal executive offices in California to have one female board member by December 31, 2019. This law applies regardless of the state of incorporation and imposes fines of $100,000 for the first violation and $300,000 for any subsequent violation.
- Forty-seven states have equal pay acts. Some, such as California, New York, New Jersey and Massachusetts, have more expansive protections, including new forums, longer statutes of limitation, different standards for equity, higher burdens for employers and increased damages.
- A growing number of state and local governments have passed legislation designed to prohibit inquiries into salary history with the goal of breaking the cycle of potential prior wage discrimination. This legislation exists in states such as California, Connecticut, Delaware, Hawaii, Massachusetts, Oregon and Vermont, as well as Puerto Rico.

Pay Audits and Disclosures: Best Practices

Next, Mr. Schwartz explained that managing pay equity can have many positive consequences. More and more companies are undertaking pay audits, and some of those companies have committed to publishing their results. Either way, said Mr. Schwartz, there are a number of factors to consider when undertaking either endeavor. Some potential benefits of performing pay audits and publishing results are positive reputational effects, avoidance of future pay inequity issues and shareholder activism. Some potential drawbacks are that pay audits can be expensive and time-consuming and publishing results may give ammunition to plaintiffs and critics.

Mr. Schwartz discussed best practices with respect to performing pay audits, including clearly establishing goals and objectives and protecting the attorney-client privilege. Mr. Schwartz highlighted the importance of retaining outside counsel, as some courts have explained that advice from outside counsel enhances the privilege and creates a presumption that a company is obtaining protected legal advice. In addition, Mr. Schwartz said that organizations should minimize communications to nonlawyers, consultants and third parties, who should all sign nondisclosure agreements to maintain confidentiality.

Mr. Schwartz further discussed best practices with respect to disclosing the results of pay audits, including carefully considering how to communicate the results and tailoring organization-wide messaging.

Performing Pay Audits and Disclosures: Next Steps

Mr. Schwartz recommended next steps, including, among other things: updating handbooks and policies to eliminate references to reliance on prior salary or prohibitions on discussing compensation, developing a formal policy about setting starting salaries, implementing training for employees who will be making compensation decisions and preparing for shareholder activism.

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