2020 Compensation Committee Handbook

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Editor's note: Kristin Davis and Michael Bergmann are counsel at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden memorandum by Ms. Davis, Mr. Bergmann, Regina Olshan, Erica Schohn, Joseph Penko, and Joseph Yaffe. Related research from the Program on Corporate Governance includes Executive Compensation as an Agency Problem by Lucian Bebchuk and Jesse Fried; Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried.

Preface

The duties imposed on compensation committees of publicly traded companies have evolved and grown over time. This sixth edition of the *Compensation Committee Handbook* from the lawyers of the Executive Compensation and Benefits group at Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates is intended to help compensation committee members understand and comply with the duties imposed upon them. We have also undertaken to describe in some detail the concepts underlying a variety of areas within the bailiwick of compensation committees (for instance, the types of equity awards that are commonly granted and their respective tax treatment) and to provide our perspective on some of the many decisions that compensation committees must make (for instance, the pros and cons of hiring a compensation consultant and the factors that go into that hiring decision).

In short, we hope that this Handbook will help compensation committee members understand their responsibilities and how best to discharge them.

We deliberately wrote this Handbook in a non-technical manner. We intend it to be something to read, not something to parse—more of a "how to" guide than a reference source for arcane rules. With that said, some of the chapters deal with technical rules, and at some length, where we think it is essential for compensation committee members to appreciate them.

Precisely because so many of the applicable rules are technical and complex and because the circumstances addressed by compensation committees are often nuanced to begin with, it is important to recognize that this Handbook has limitations, in part again due to our non-technical approach to writing it. As such, compensation committee members should not expect this Handbook to be an exhaustive compliance manual.

Indeed, in some places, this Handbook may even raise questions, not answer them. We hope so, because that means we achieved what we set out to do—to help compensation committee members think in a fresh way about what they are charged with doing and why.

This Handbook focuses on considerations for publicly traded companies and specifically those listed on the NYSE or Nasdaq. Many of the principles discussed have broader application, however.

There have been significant developments over this past year to executive and director compensation practices and trends, and those are discussed in this new edition of the Handbook, particularly with respect to director compensation litigation (discussed principally in Chapter 13 of the complete publication, available here.), increased scrutiny of executive perquisites, the impact of the #MeToo movement and gender pay gap developments as well as increased attention on environmental, social and governance (sometimes called ESG) considerations (each discussed principally in Chapter 10 of the complete publication).

We expect that this Handbook will evolve further over time to address the seemingly never-ending developments in the legal and commercial landscape applicable to compensation committee responsibilities. In the meantime, we of course welcome any questions you might have.

Overview of Committee Member Responsibilities

Compensation committee (Committee) members' duties and responsibilities generally are outlined in the Committee's organizational charter (Charter) approved by the Board of Directors (Board) of the applicable company (Company), which should reflect requirements imposed by the securities exchanges, some of which are the result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), applicable Securities Exchange Commission (SEC) regulations and other legal limitations. All of those obligations are discussed in greater detail later in this Handbook.

The Committee is responsible for establishing and overseeing an executive compensation program for the Company. The Committee should make executive compensation decisions within the context of its members' executive compensation philosophies and the corporate governance standards applicable to directors generally.

This chapter provides an overview of the most important considerations that relate to the proper discharge of the Committee's responsibilities, including the role of advisors to the Committee. The remaining chapters address those considerations in more detail.

Overview of Committee Member Responsibilities

Adopting and Implementing a Compensation Philosophy

The Committee is responsible for establishing or recommending to the Board the various components of compensation for the Company's senior executives, which typically consist of some of the following components, among others: base salary, annual bonuses (which are usually paid in cash), long-term incentives (which may consist of cash or equity-based awards, or a combination), executive benefit plans (for instance nonqualified deferred compensation plans, including supplemental pension and savings plans) and perquisites. The Committee often will need to make compensation decisions on an ad-hoc basis, for example to provide specialized

incentives for particular circumstances (such as a corporate transaction or special performance initiatives) that were not contemplated in the ordinary course.

The Committee's overarching compensation philosophy should enable it to assess the suitability of various compensation program components in a rigorous way. The most common philosophy in more recent years surely has been and remains "pay for performance"—though that of course begs the question of what type of performance is rewarded and how. For most companies, stock price performance is one natural measure of success; that is not necessarily the case for all companies, however, and the Committee should be sure to consider whether other measures are appropriate (and of course to consider as well whether a pay for performance model is not appropriate for the Company in the first instance).

One consideration in implementing a compensation philosophy is determining how much potential pay should be fixed (typically in the form of salary and benefits) and how much should be "at risk" (typically in the form of cash or equity incentive compensation).

- The implementation of the philosophy may differ depending on the level of the affected For example, it is common for more senior executives to have more pay "at risk" than lower level executives.
- Another important consideration for the at risk component of compensation is whether the incentive should be short-term (typically annual) or longer-term in nature.

In recent years there has been a much-discussed trend toward a greater portion of pay being at risk in the form of long-term compensation based on performance rather than time-based vesting criteria, a trend that seems to have been well received by shareholders.

Corporate Governance Standards—Business Judgment Rule

Most directors are familiar with the so-called business judgment rule that applies in respect of Delaware companies and that has analogs in most other states. The business judgment rule was developed as a complement to a director's two fundamental fiduciary duties under Delaware corporation law, first, the duty of loyalty, which requires a director to act without self-interest and in a manner that the director honestly believes is in the best interests of the Company and its shareholders and, second, the duty of care, which requires the director to act prudently and with diligence.

The business judgment rule creates a rebuttable presumption that in making a business decision, directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the Company and its shareholders. The protection of the business judgment rule is not absolute. It can be rebutted if a plaintiff can present facts sufficient to support a claimed breach of duty.

In assessing a claim of breach of the duty of care, the courts place emphasis on process and look for objective evidence that directors undertook a careful, educated decision-making process. Accordingly, when making a decision, directors should:

- become familiar with all material information reasonably available in order to make an informed decision;

- secure independent expert advice (for instance from legal counsel or a compensation consultant) where appropriate and fully understand the expert's findings and the bases underlying such findings;
- actively participate in discussions and ask questions of officers, employees and outside experts, rather than passively accept information presented;
- understand and weigh alternative courses of conduct that may be available and the impact of such alternatives on the Company and its shareholders; and
- take appropriate time to make an informed decision.

These considerations apply equally to Committee members when making determinations regarding compensation matters.

Where compensation decisions involve directors paying themselves, Delaware courts are particularly cognizant of the need for careful scrutiny. Self-interested compensation decisions made without independent protections are subject to the same entire fairness review as any other interested transaction. The compensation of directors as such is discussed further in Chapter 13 of the complete publication, available here.

Special considerations apply in the case of tender offers and in the mergers and acquisitions (M&A) context generally. These considerations are discussed in Chapter 12.

Communicating the Executive Compensation Program to Shareholders

Compensation Discussion and Analysis

One of the most visible roles of the Committee is to discuss with management the Compensation Discussion and Analysis (CD&A) that is included in the Company's annual SEC filings and to recommend to the Board that the CD&A be included in the filings.

As discussed in greater detail in Chapter 4, the members of the Committee must sign a Compensation Committee Report attesting that it has discharged that obligation.

While preparation of the CD&A is the responsibility of management, it is important that the Committee be involved at all stages. Ultimately the CD&A is describing the compensation philosophy and programs that the Committee has approved for the Company's executive officers, and the Committee is effectively confirming it is in agreement with the contents by recommending inclusion of the CD&A in the Company's SEC filings.

It is not enough that the CD&A be accurate, however, because the CD&A can greatly influence the outcome of the say on pay shareholder vote discussed in greater detail in Chapter 4. It also should be a persuasive advocacy piece for why the compensation philosophy and programs are appropriate for the Company. Moreover, in some cases—typically where the Company received a low favorable say on pay vote in the prior year—the pay practices described in the CD&A may cause proxy advisory firms (such as Institutional Shareholder Services (ISS) and Glass Lewis) to recommend voting against a Committee member's reelection, which of course is unwelcome attention.

Where shareholder support for the say on pay vote is low, it can often make sense to meet with significant shareholders to explain the Committee's decisions and permit them to ask questions and raise concerns. While such meetings are sometimes arranged and attended by management rather than Committee members, in many cases direct involvement by Committee members can be helpful in addressing specific shareholder concerns.

Internal Controls/Risk

Item 402(s) of Regulation S-K (discussed in greater detail in Chapter 4) requires that the Company disclose in its SEC filings its policies and practices for compensating employees, including nonexecutive officers, as they relate to risk management practices and risk-taking incentives to the extent that the risks arising from those policies and practices are reasonably likely to have a material adverse effect on the Company.

- Companies typically conclude that their policies and practices do not create risks that are reasonably likely to have a material adverse effect.
- While the responsibility for making that determination is not expressly imposed on the Committee, the determination typically is made by the Committee based upon a management presentation, a result that is of course not surprising given the Committee's role in establishing those policies and practices.
- In making its determination, the Committee should also consider whether the Company has internal controls in place that are reasonably designed to ensure that the compensation policies and practices are properly administered and that they are not subject to manipulation and further to ensure that the information required to generate proxy disclosure of that compensation is accurately captured.

In short, it is rare, but not impossible, for a Company to conclude that its compensation policies and practices are reasonably likely to have a material adverse effect on the Company. If that is the case, the Committee would likely seek to mitigate those risks. Accordingly, as noted above, most disclosure that implicates Item 402(s) simply recites that the Company has determined that there is no such risk.

Input From Compensation Consultants/Management

The Committee may give considerable weight to the views of management and its advisors in establishing its compensation philosophy and making compensation decisions under it, but ultimately the Company's executive compensation programs are the responsibility of the Committee, not management or the Committee's advisors.

Committees often retain compensation consultants to help guide their view on the appropriate compensation for executive officers and particularly how the Company's programs compare to those at other peer companies. Such reliance can help the Committee substantiate that it has complied with the conditions underlying the protections offered by the business judgment rule as discussed above. However, the Committee must be sure not to substitute the judgment of its consultant for its own, as ultimate responsibility for the compensation philosophy and programs lies with the Committee.

Chapter 3 addresses particular concerns in regard to the retention of advisors by the Committee, including independence assessment requirements imposed under the Dodd-Frank Act and the related stock exchange rules.

Recent Legislative/Regulatory/Political Developments

The SEC adopted a new disclosure requirement pursuant to which Companies must disclose their director/employee hedging practices or policies in their annual proxy statements commencing with fiscal years beginning on or after July 1, 2019. Specifically, Item 407(i) of Regulation S-K requires a Company to describe any practices or policies it has adopted regarding the ability of its officers, directors and employees to engage in hedging and related transactions in relation to the Company's securities.

Additionally, certain Dodd-Frank rules that were proposed under the Obama administration (for example, the rule related to clawback of executive compensation) have still not been finalized. In 2018, the Trump administration helped engineer some changes to Dodd-Frank unrelated to executive compensation, and some commentators still expect to see additional changes to Dodd-Frank. In any event, it remains unclear whether the proposed clawback rules or the other still-pending executive compensation rules will be finalized anytime in the foreseeable future.

It is not possible to predict what additional changes to executive and director compensation practices may be forthcoming given the dynamic political atmosphere in Washington, but in any event Committees should take care to be sensitive and responsive to any developments.

Executive Compensation Trends and Developments

The world of executive compensation is a dynamic one, in part because of the keen attention it commands. As a result, the standard by which executive compensation is evaluated is always evolving. Recent years have seen no slowdown in the pace of trends and developments affecting executive compensation.

It is important that Committee members be familiar with these trends and developments so that steps can be taken to reduce the risk that the Company will become a target of unwelcome attention and so that the Company is in a position to respond promptly and confidently if it does become a target.

This chapter focuses on some recent trends and developments in executive compensation, including litigation and regulatory enforcement activity, areas of particular shareholder scrutiny such as Company airplane usage by executives, the impact of the #MeToo movement, gender pay gap considerations and an increasing focus on environmental, social and governance (sometimes called ESG) considerations.

Litigation

Executive compensation practices have seen various "waves" of litigations in recent years, in addition to the seemingly perpetual series of one-off challenges to executive compensation decisions. The latter cases—often involving claims of breach of fiduciary duty and corporate

waste—are of course significant to any individual Company but are less relevant to this Handbook because of their typically fact-intensive nature.

Some of the earlier “waves” of cases dealt with matters such as failed say on pay votes under Dodd-Frank and failure to qualify for then-available exceptions to the otherwise applicable federal income tax deduction limitations under Section 162(m) of the Code.

Probably the most significant litigation development in recent years has been the wave of proxy litigation that began in 2012 and was initiated primarily by a single plaintiffs’ law firm. The strategy borrows from an approach common to the M&A context, where a shareholder alleges that merger proxy disclosure is inadequate because it misstates or omits material information. The shareholder seeks to delay the vote to approve the transaction until supplemental disclosure is provided, and such suits often settle (generally with attorney’s fees paid) once the supplemental disclosure is provided.

In the executive compensation context, the case is typically filed (or, in many instances, no case is filed but a letter threatening a lawsuit is sent to the Company) shortly after the Company files its definitive proxy statement and seeks to delay the annual meeting until supplemental disclosure is provided. The plaintiff’s threatened or actual claims allege breaches of fiduciary duties in connection with compensation-related proposals, generally the say on pay proposal or, more commonly now, a proposal to adopt or increase the amount of shares reserved under an equity compensation plan.

These cases are generally brought as putative class actions in the state court in which the Company’s principal place of business is located. The demands for additional disclosure often are not based on allegations of deficient disclosure under SEC rules but rather on the theory that a director may breach his or her state-law fiduciary duties by failing to disclose material information in connection with a request for shareholder action (*e.g.*, the say on pay or equity plan approval vote). Plaintiffs claim that a variety of additional information is necessary for shareholders to make an informed vote.

A preliminary injunction was granted in one of the earliest cases, the April 2012 California state court case of *Knee v. Brocade Communication Systems, Inc.* In that case, plaintiffs alleged insufficient disclosure regarding a proposal for a relatively significant increase in shares reserved for issuance under an equity plan where the increase was based on undisclosed equity grant projections. Despite the plaintiffs’ initial victory in that case, companies that have been willing to resist these lawsuits have largely been successful. In a string of 2013 decisions, courts held that the information requested by plaintiffs, while potentially helpful, was not material and thus not a required subject of disclosure.

Some companies concerned about potential disruption to their annual meetings have been willing to settle these claims, however. These settlements have generally involved supplemental disclosure and payment of plaintiffs’ attorneys fees (up to $625,000 in one case).

While “investigations” have continued to be announced by law firms specializing in this type of litigation, it appears there has been a slowdown in reported litigation activity arising from those investigative efforts. The Company should nevertheless be aware of the threat of litigation.

Although there is no single approach to avoiding these lawsuits and shareholder demands, the Company should determine whether additional proxy disclosure is warranted, particularly with respect to equity compensation plan proposals.

Not surprisingly, it is now common to see equity compensation plan proposal disclosure that is much more fulsome than in years past and that includes the type of information that has typically been provided in supplemental disclosure as part of claim settlements, including as applicable:

- a summary of the relevant information presented to the Committee by its independent compensation consultant;
- how the Board determined the number of additional shares to be authorized;
- the contemplated size and timing of new award issuances and the potential equity value and/or costs of the issuance of the additional shares;
- the dilutive impact that issuing additional shares may have on existing shareholders and the amount of planned additional stock repurchases;
- the Company's gross burn rate, net burn rate and overhang compared to the compensation peer group or the survey data used to formulate the overall size of the plan; and
- a detailed breakdown of the different groups of individuals who may receive grants under the plan (*g.*, employees, directors, consultants), the size of each such group and the extent to which foreign subsidiary employees receive grants.

Providing such disclosure in the proxy as initially filed may make the Company a less likely target of this type of litigation.

SEC Enforcement Activity

In recent years, the SEC has indicated renewed interest in enforcing the Regulation S-K 402 compensation disclosure requirements, particularly involving disclosure of perquisites. Such disclosure requirements are described in greater detail in Chapter 4.

For example, in January 2017, the SEC issued an order instituting cease-and-desist proceedings against MDC Partners for its failure to disclose more than $11 million in perquisites paid from 2009 to 2014 to its then-CEO. MDC took a number of remedial actions and paid a $1.5 million penalty to settle those charges, among others. In May 2017, the SEC issued a separate order against the CEO alleging that he knew, or was reckless in not knowing, that the proxy statements contained materially false and misleading executive compensation disclosures and that they omitted numerous personal expenses for which he sought reimbursement as business expenses. The CEO agreed to repay the perquisites and personal expense reimbursements, pay $5.5 million in disgorgement and penalties to the SEC, and be banned from serving as an officer or director of a public company for five years.

In early July 2018, the SEC issued an order finding that The Dow Chemical Company failed to properly disclose approximately $3 million in perquisites. The SEC imposed a $1.75 million penalty, required Dow to retain an independent consultant to evaluate and recommend changes to the company's policies and procedures relating to perquisites disclosure and generally to implement the consultant's recommendations.

Later that same month, the SEC filed a complaint against the CEO of Energy XXI alleging various disclosure violations, including the company's failure to report at least $1 million in compensation over a five-year period—including expenses that the SEC claimed were unreasonable, personal and/or not appropriately documented. The CEO agreed to a $180,000 penalty and a five-year ban on serving as an officer or director of a public company.

In September 2019, the SEC settled charges against Nissan Motor Co., Ltd., its former CEO Carlos Ghosn and a former director related to false financial disclosures that omitted more than $140 million to be paid to Ghosn in retirement. According to the SEC, the falsification involved secret contracts, backdating letters to grant Ghosn interests in Nissan's long-term incentive plan, changing the calculation of Ghosn's pension allowance and misleading Nissan's CFO. The SEC charges were made in an administrative proceeding and a separate federal district court action, each generally implicating the anti-fraud provisions of the Exchange Act. The settlements of those charges involved, among other things, a payment by Nissan of a $15 million penalty, a payment by Ghosn of a $1 million penalty and a payment by the director of a $100,000 penalty, in each case without their admitting or denying the SEC's allegations and findings. While the case did not directly implicate proxy disclosure requirements, it serves as another reminder of the SEC's focus on ensuring that investors know how, and how much, a Company compensates its top executives.

In light of the foregoing, companies should ensure that their policies and procedures for compliance with perquisite disclosure rules—a relatively tricky area of disclosure—are appropriate and consistently followed. In practice, it can be difficult to determine whether a benefit is a perquisite. Although the SEC has provided general principles and interpretive guidance, companies must analyze the applicable facts and circumstances in order to determine whether a benefit is a perquisite, and significant grey areas remain. Once the determination has been made, the disclosure rules themselves also are rather complicated, and care must be taken to ensure compliance.

Areas of Particular Shareholder Scrutiny

Executive Airplane Use

In light of increased attention from the SEC, it is not surprising that perquisites have become a hot button issue for shareholders as well, particularly Company airplane usage. Indeed, activist shareholders have begun to draw attention to the use of Company airplanes by executives, often through direct contact with the Company, calling into question the Company's airplane use policies or practices. Activist shareholders have been particularly critical of such airplane use where a Company's overall financial performance is not meeting expectations.

As discussed in Chapter 7, perquisites related to personal airplane use by Company executives may draw a negative comment or negative vote recommendation from proxy advisory firms, particularly if they are coupled with other pay practices that are, in the view of the firms, problematic.

In light of this growing attention on the use of Company aircraft by executives, Companies and Committees should review their existing policies and practices regarding airplane use and determine whether the extent of such use is appropriate for the Company's specific

circumstances. Committees also should look closely at the Company's perquisite-related disclosures to ensure accuracy and compliance with the disclosure rules.

Impact of #MeToo Movement

The #MeToo movement brought renewed focus to the gender-based policies and practices of companies. Recent corporate #MeToo incidents indicate that allegations of sexual misconduct at public companies adversely affect both a Company's share price and a Company's reputation. Given the current sociopolitical climate, Committees have started to take an increasingly active role aimed at preventing and responding decisively to sexual misconduct in the workplace, including by updating Company policies and procedures relating to sexual misconduct and becoming more involved in situations where an executive faces allegations of misconduct. Additionally, some Companies have amended their Committee charters to give the Committee authority to oversee these issues relating to sexual misconduct.

It is advisable for the Committee (or, if not the Committee, some other committee of the Board or the Board as a whole) to work with the Company's management to periodically review and update the Company's policies on sexual misconduct, including training and reporting procedures related to such conduct as well as the Committee's role in overseeing allegations of sexual misconduct.

The #MeToo movement also has impacted executive compensation practices. Committees are increasingly considering whether to include specific terms in their executive compensation plans and agreements and in some cases, broad-based employee benefit plans, to address the consequences of sexual misconduct in the workplace and to deter such behavior. For example, some Companies have revised their definitions of "cause" to include sexual misconduct, expressly permitting the Company to terminate an individual's employment for cause and potentially limit a specified benefit if the individual is determined to have engaged in sexual misconduct. 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. Finally, some Companies have contemplated updating their compensation recovery policies to provide for clawback of compensation if an executive is determined to have engaged in sexual misconduct in the workplace.

While some Companies have been proactive in channeling the #MeToo movement's momentum by updating their executive compensation practices, it remains to be seen to what extent the #MeToo movement will have a longer-term impact on executive compensation practices.

Gender Pay Gap and Workplace Equity Issues

Human capital management, including pay and workplace equity, also has become an area of significant focus for investors, with a number of institutional investors engaging with Companies on the issue. There is a growing call for Companies to perform equal pay audits of their workforces, to publicly commit to workplace equality and to provide increased disclosure evidencing to investors the extent to which the Company's stated commitments are being achieved. Indeed, as of October 2019, approximately 100 investors representing $1.73 trillion in assets under management had signed an investor statement urging Companies to provide enhanced disclosure to investors regarding workplace equity policies and practices relating to workforce composition, recruitment, retention, pay, promotion and workplace safety, along with

the resulting outcomes of such practices and policies. These investors are increasingly focused on equal access to higher paying positions within the Company (commonly referred to as the "pay gap") as opposed to strictly equal pay for the same position.

In addition to such investor scrutiny, 47 states have enacted pay equity laws that typically are more employee-friendly than the federal Equal Pay Act. A growing number of states also have enacted laws banning employers from asking job applicants about their compensation history.

In light of the increased focus on pay equity issues, Committee members are advised to discuss the issue of gender pay equity proactively, ideally before a Company is targeted by a shareholder activist. Companies also may want to consider disclosing policies and programs that support gender equity and related efforts in respect of recruiting, employee development and elimination of unconscious bias. Indeed, a number of Companies have begun including voluntary disclosure describing the Company's commitment to, and programs on topics related to, human capital management generally, including creating a diverse and inclusive work environment and overseeing matters relating to culture, employee engagement and talent development.

In August 2018, the SEC proposed new disclosure requirements under Item 101 of Regulation S-K, which would replace the current requirement that Companies disclose their number of employees with a new mandate requiring Companies to describe their human capital resources, to the extent such disclosures would be material to an understanding of the Company's business, including "any human capital measures or objectives that management focuses on in managing the business (such as, depending on the nature of the [Company's] business and workforce, measures or objectives that address the attraction, development and retention of personnel)." The SEC's final rule (if any) may differ significantly from the proposed rule, and the timeline for the SEC to issue a final rule is not yet known.

ESG Considerations

ESG-related considerations represent another area of focus that has attracted increased attention from customers, investors and employees. ESG factors cover a wide range of issues, including measures of company carbon emissions, labor and human rights policies, and corporate governance structures. Many large investors increasingly are interested in assessing the long-term investment risks and benefits associated with ESG matters. Indeed, some large investors have published proxy voting and engagement guidelines relating to ESG issues.

In recognition of the growing attention on ESG factors, some Companies have started tying executive incentive compensation performance metrics to ESG factors. Committee members should consider whether such ESG-related metrics are appropriate for a Company's incentive programs and, regardless of the decision regarding incentive programs, whether it is appropriate to proactively disclose ESG topics in the Company's public filings.

Director Compensation

Director compensation considerations differ from those applicable to executive compensation in some significant respects, and compensation awarded to directors continues to come under particular scrutiny from shareholders. This chapter provides an overview of some typical director compensation arrangements and discusses the special considerations that apply.

Overview

Often the Board as a whole sets the compensation of directors, though, in some cases, that responsibility may fall within the duties assigned by the Board to the Committee or another committee of the Board, or the Committee (or other such committee) may make recommendations to the Board about the director compensation program.

Most of the considerations discussed in the context of an executive compensation program apply to the establishment of director compensation as well, although, as described below, director compensation programs typically have fewer components than executive compensation programs.

The focus of director compensation is also different from the focus of executive compensation. The focus of director compensation is on encouraging director oversight of management, protecting the long-term interests of shareholders and avoiding the kind of entrenchment that jeopardizes director effectiveness. By contrast, the focus of executive compensation is on, among other things, rewarding successful strategic decisions during the course of the day-to-day management of the Company and the tenure of high-achievers. Given these differing points of emphasis, director compensation programs focus less on retaining top talent and more on encouraging ongoing engagement and fresh perspectives.

Components of Director Compensation

Directors typically are compensated through a mix of cash and equity with a modest emphasis on equity, particularly for larger companies. More specifically, directors generally historically have received some or all of the following forms of compensation:

Cash Compensation	Equity Compensation
Annual Cash Retainer	Stock Options
Per-meeting Fees	Restricted and Unrestricted Stock Awards
Deferred Cash	Stock-based Awards (*e.g.*, RSUs)

ISS considers it a problematic pay practice for directors to receive retirement benefits or other perquisites. Nevertheless, in addition to reimbursement for travel and other business expenses, directors sometimes receive additional benefits, such as life, travel and accident insurance; perquisites (if provided, typically including products, services or health insurance at reduced costs and/or participation in matching charitable contribution programs); and perquisites for spouses and other family members (such as travel to board meeting locations and entertainment while there).

Director compensation programs vary widely based on a company’s size, industry and other factors. However, several generalizations can be made.

First, companies generally have moved away from per-meeting fees toward annual cash retainers. This trend is the result of a number of factors, including the expectation of ongoing communications among directors outside of the company's formal meetings.

Most directors at public companies are already strongly incentivized to attend board and committee meetings without the added incentive of per-meeting fees. The proxy advisory firms described in Chapter 5 track the attendance of these meetings, and if a director fails to attend at least 75% of a company's meetings, the proxy advisory firms generally will recommend voting against the director's reelection.

Second, the general trend in equity compensation (for both directors and employees) has moved away from stock options in favor of full-value awards in the form of restricted stock or restricted stock units. (Additional information about these types of awards and equity-based compensation more generally is provided in Chapter 6.) Full-value awards are granted in either fixed-dollar or fixed-share amounts, but the trend has favored fixed-dollar equity awards, which afford a board additional precision in determining the absolute dollar value of equity compensation. ISS considers it a problematic pay practice for directors to receive performance-conditioned incentive awards.

Third, at many companies, directors who take on additional responsibilities receive additional compensation. For example, a non-executive chairperson may receive a larger annual retainer than other board members due to the additional duties that come with the position. Members of the audit, compensation or other committees also may receive larger annual retainers or larger per-meeting fees, and the chairs of the various board committees may receive additional compensation for serving as such.

Finally, for the reasons described below under "Recent Developments in Director Compensation," it has become increasingly common for companies to impose specific limitations on director compensation awarded pursuant to shareholder-approved compensation plans, though the utility of doing so is uncertain and limited.

Stock Ownership Guidelines

Stock ownership guidelines for directors are the norm among public companies. These guidelines serve as an important link between the interests of directors and shareholders and achieve the desired linkage by requiring each director to acquire and hold a meaningful number of the company's shares while serving as director. The number of shares varies from company to company, but, typically, the value of shares that a director must hold is equal to a specified multiple of the director's annual cash compensation. Multiples typically range from three to five times a director's annual cash compensation. (ISS believes that the requirement should be at least four times the annual cash retainer.) Directors are generally given a period of time following their initial appointment—typically between three and five years—to accumulate the shares required to meet the stock ownership requirement.

Recent Developments in Director Compensation

Standard of Judicial Review

Where compensation decisions involve directors paying themselves, Delaware case law provides that the protections of the business judgment rule typically will not be available.

As discussed in Chapter 2, under Delaware law, a claim involving director conduct generally is subject to review under the "business judgment rule," under which the court will presume the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the decision at issue was in the corporation's best interest. This deferential standard does not apply if a majority of directors are interested in the decision or would derive a personal financial benefit from the decision. Consequently, claims relating to director compensation typically are reviewed under a more onerous level of scrutiny—the "entire fairness" test—which requires that directors bear the burden of proving that their compensation decision was entirely fair to the corporation.

However, if the board can show that the challenged decision was ratified by a vote of fully informed stockholders, then the entire fairness review will not apply, and director action will be reviewed under the more deferential business judgment rule. In recent years, a number of Delaware lower court cases had examined the extent to which shareholder approval of an equity-compensation plan is sufficient to cause grants to directors under such plans to be analyzed under the business judgment rule—a line of cases beginning with *Calma v. Templeton*. Those cases held that stockholder approval of a discretionary equity plan could constitute "ratification" if the equity plan contained a "meaningful limit" on director compensation.

In 2017, the Delaware Supreme Court issued a decision in *In re Investors Bancorp, Inc. Stockholder Litigation*, which held that, except under limited circumstances, the deferential business judgment rule will not be applied in reviewing challenges to director compensation awards granted by Delaware companies pursuant to stockholder-approved equity plans. Instead, such awards will be subject to the entire fairness standard of review.

In that case, the board of directors submitted an equity plan for stockholder approval pursuant to which the maximum number of shares that could be issued to all directors totaled 30 percent of all option or restricted stock shares available for awards. The plan did not impose any other limits on grants to directors. After the plan was approved by the company's stockholders, the directors awarded themselves equity awards, the aggregate grant date fair value of which for all 12 board members was approximately $51.5 million.

The plaintiff alleged that the directors' compensation exceeded the compensation paid to directors of peer companies. Although the Court of Chancery noted that the director awards in this case appeared to be quite large, it dismissed the case because the plan contained "meaningful, specific limits on awards to all director beneficiaries," and the actual awards granted fell within those limits. As a result, the Court of Chancery found that the stockholder approval of the plan was sufficient to allow defendants to invoke a stockholder ratification defense.

However, the Delaware Supreme Court reversed the Court of Chancery's decision, holding that the discretion granted to directors in the equity plan to approve specific awards precluded the

stockholder ratification defense. Consequently, the Delaware Supreme Court found that the grants were "self-interested decisions" and subject to the entire fairness standard of review.

According to the Delaware Supreme Court, ratification is a permissible defense in two scenarios: (1) when stockholders approve specific director awards and (2) when the equity plan is a self-executing formula plan, such that the directors have no discretion in granting the awards to themselves. If directors retain discretion to make awards under the general parameters of a plan—even when the parameters are specific to directors—then the shareholder ratification defense cannot be used to foreclose a breach of fiduciary duty claim.

On May 31, 2019, the Delaware Court of Chancery relied upon the decision in *Investors Bancorp* in a case stemming from compensation paid to directors of The Goldman Sachs Group, Inc. (*Stein v. Blankfein)*. In that case, the court held that because the directors had the discretion to set their own compensation pursuant to stock incentive plans with no meaningful limit on the compensation they could pay themselves, the entire fairness standard of review applied. The defendants attempted to avoid the application of the entire fairness standard of review by including a statement in the stock incentive plans to the effect that the directors could not be held liable for any action taken in good faith with respect to the stock incentive plans or any awards granted pursuant to such plans. The defendants argued that because the shareholders approved the plans with the "good faith" language, the plaintiff had to show that the directors' actions were taken in bad faith. The Court of Chancery disagreed. The court found that this provision was insufficient to bind the stockholders who approved the plans and could not operate as a waiver of their rights because the stockholders were not informed of the contemplated self-interested transactions, which would otherwise be subject to entire fairness review. The Court of Chancery, however, did not state that all such waivers would be held invalid if the elements of a waiver were present, including (1) a right or requirement that (2) is known to the waiving party and (3) that the waiving party intends to waive the right.

In light of the rulings in *Investors Bancorp and Stein*, the utility of director specific limits on compensation is unclear, as is the question of whether stockholders can waive their right to enhanced scrutiny. While director limits that still permit discretion when making the awards clearly no longer are sufficient to secure business judgment rule review (even if shareholder approved), they may serve as evidence that there was—or at least serve as a catalyst for establishing—a process for determining that actual director compensation was in fact entirely fair. Moreover, as a result, prospective plaintiffs may prefer to target Companies without such limits. For Companies that already had established such limits, eliminating them may, as a practical matter, prove difficult to explain to shareholders absent compelling circumstances.

Derivative Action Pleading Requirements

An October 2019 decision of the Delaware Court of Chancery shed important light on the related question of what pleading requirements are applicable to a shareholder derivative suit alleging excessive director compensation. The case involved a claim by a stockholder of Ultragenyx Pharmaceutical Inc. that the company's board had awarded itself excessive pay. Under applicable Delaware law, a stockholder asserting such a claim has two mutually exclusive options: make a pre-suit demand on the Board or plead with particularity the reason it would have been futile to do so. A stockholder who makes a pre-suit demand may not later claim demand futility, but instead must make the more difficult claim that the Board wrongfully refused the

demand, which is essentially a business judgment analysis. The Court of Chancery has noted that pleading demand futility is a steep road, but that making a pre-suit demand road is "steeper yet."

Some members of the plaintiffs' bar have sought—as the Court of Chancery put it—to "cover all the bases" by sending a stockholder communication within the meaning of the applicable Delaware rule for a demand, but later claiming that they did not make a demand. As part of that tactic, the plaintiff's counsel in *Ultragenyx* sent a pre-suit letter to the company's board "suggesting" that the board take remedial action, while expressly stating that the letter was not a demand within the meaning of the applicable Delaware rule. The court likened this approach to a famous 1929 surrealist painting by René Magritte depicting a pipe above the caption, "This is not a pipe."

Upon receipt of the letter, the company's board treated it as a demand and conducted an investigation into the allegations and concluded not to pursue them on behalf of the company. The defendants (the company and its directors) subsequently moved to dismiss the complaint because the plaintiff had failed to plead wrongful demand refusal. The court agreed that the pre-suit letter was in fact a pre-suit demand. Revealing what it called the "proverbial wolf in sheep's clothing," the court found that the pre-suit letter was not "a harmless letter seeking prospective board action" but rather "something with far more legal bite—a pre-suit demand." As such, the court found that the board's determination that it would be in the best interests of the company not to authorize commencement of a civil action or changes in its board compensation practices was a proper exercise of its fiduciary duties and entitled to the protection of the business judgment rule.

The court went on to hold that when considering whether a communication is a demand, the court is not constrained by "the subjective intent of the sender," there are no "magic words" establishing whether a communication is a demand and Delaware's prohibition on stockholders both making a demand and pleading demand futility "would become

a virtual nullity if a stockholder could avoid a judicial determination that pre-suit demand was made by simply stating 'this is not a demand' in [a] pre-suit communication to a board." The opinion stands as a clear rejection of plaintiffs' counsel using a tactical, "stock form" letter to pressure a board to settle baseless director compensation claims.

ISS Voting Policy Relating to Director Compensation

ISS has adopted a policy, which was to have been first effective with respect to shareholder meetings occurring on or after February 1, 2018, that provides for potential adverse vote recommendations for Board or Committee members who are responsible for approving or setting director compensation where there is a recurring pattern (two or more consecutive years) of excessive director pay without disclosure of a compelling rationale for those prior years or other mitigating factors. As a result of the two-year pattern requirement, this new policy was not to have impacted votes until 2019, but ISS subsequently announced in November 2018 that the first possible adverse vote recommendations would be delayed until 2020 to give it additional time to refine the policy in light of feedback it has received.

In December 2018, ISS updated the methodology to identify high director pay through a quantitative analysis, which will be followed by a qualitative analysis of a company's disclosure to determine if any concerns over excessive compensation can be mitigated.

As further refined in December 2019, the quantitative analysis focuses on identifying director compensation outliers, which ISS has deemed to include any director with pay figures above the top 2% of all comparable directors. It compares directors' compensation within the same two-digit Global Industry Classification Standard group and within the same index grouping. The index groupings include S&P500, combined S&P400 and S&P600, remainder of the Russell 3000 index, and the Russell 3000-Extended. Similarly, pay for directors in board-level leadership positions that typically provide for a compensation premium—limited to non-executive chairs and lead independent directors—will be compared to the compensation of other directors in similar leadership positions at Companies within the same index and sector.

ISS identified several factors that typically would serve to mitigate issues with high director pay, including the following:

- onboarding grants for new directors that are clearly identified to be one-time in nature;
- payments related to corporate transactions or special circumstances (such as special committee service, requirements related to extraordinary need or transition payments to a former executive for a limited period);
- payments made in consideration of specialized scientific expertise (as may be necessary in certain industries such as biotech/pharma); or
- payments made to directors in a sector-index grouping where there is a narrow distribution of pay magnitude.

Payments in connection with separate consulting/service agreements will be assessed by ISS on a case-by-case basis with a particular emphasis on the Company's rationale, and ISS will focus in particular on the extent to which the required services go beyond typical director responsibilities, whether the agreement has a set term and what additional benefits it confers on shareholders.

ISS has indicated that the following circumstances generally will not mitigate concern around high director pay:

- payments made to reward general performance/service;
- payments made under separate consulting/service agreements that have an indefinite or prolonged term or which provide payments for services that appear to be within the scope of routine director responsibilities; and
- payments that ISS identifies as problematic, such as performance-conditioned incentive pay, perquisites and retirement benefits

With *Investors Bancorp* and this new ISS policy in mind, the Board should consider taking the following actions to the extent it has not yet already done so:

- Carefully review any limits that currently apply under its cash and non-cash director compensation programs.
- If the Board determines that the current director compensation programs do not include meaningful limits, the Board should consider amending the applicable plan to include

meaningful limits and seeking shareholder approval of the amended plan. As explained above, however, the utility of such shareholder approval is at best uncertain (though ISS views them as positive feature in any event). Accordingly, Companies also may wish to consider whether to provide for grants of director compensation awards pursuant to a stockholder-approved formula plan or via grants of awards specifically approved by stockholders.

- If a shareholder ratification or waiver defense is not available or otherwise not likely to prevail, the Board should be mindful of considering and developing the relevant factors that would provide a basis for withstanding "entire fairness" Among other steps in that regard, Companies should work with their compensation consultants to regularly conduct a peer review of their director compensation programs in order to determine whether their director compensation, including equity grants, are reasonable. Companies should carefully document this process and disclose it in their annual proxy statements.
- Ensure that the disclosure regarding director compensation in the Company's annual proxy statement is clear and expand it beyond historical norms if necessary to provide a thorough description of its amount and how that amount was determined. While it is clear that nothing along the lines of a CD&A is required, it may be appropriate in particular—as has become increasingly common—to include additional detail regarding the process used by directors to evaluate and set their compensation and any role played by compensation consultants in that regard.
- If director compensation is above the top 2% of pay to all comparable directors, the Company should describe any and all mitigating factors that would justify such outlier compensation to avoid a possible unfavorable vote recommendation.

The complete publication, including footnotes, is available here.