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2021 Compensation Committee

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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, Joseph Penko, Erica Schohn, and Joseph Yaffe.

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 post 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 complete publication (available here) address those considerations in more detail.

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 executive. 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 the complete publication.

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

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 the complete publication, 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 the complete publication. 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 the complete publication) 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.

The complete publication 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

Effective November 9, 2020, the SEC updated Regulation S-K, which will now require companies to make certain human capital-related disclosures in their annual reports on Form 10-K to the extent material to an understanding of the business, including disclosing the number of employees and any human capital measures or objectives that the company focuses on in

managing the business (such as measures or objectives that address the development, attraction and retention of personnel). These requirements are more fully described in the complete publication.

Separately, the SEC adopted a disclosure requirement pursuant to which Companies must disclose their director/employee hedging practices or policies in their annual proxy statements, which took effect for 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.

Still, 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. After lack of action on these rules during the Trump administration, the transition to the Biden administration will likely generate momentum for the proposed clawback and other compensation-related rules and significantly increase the likelihood of their adoption or continued development.

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.

The complete publication, including footnotes, is available here.