

I N S I D E T H E M I N D S

Recent Changes in Employee Benefits and Executive Compensation

*Leading Lawyers on Understanding ERISA
Changes, Navigating Disclosure Guidelines,
and Designing Compliance Strategies*

2016 EDITION



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Say-on-Pay, the Golden Parachute, and Other Executive Compensation Issues

Doreen E. Lilienfeld

Partner

Shearman & Sterling LLP



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Introduction

In the aftermath of the 2008 financial crisis, compensation programs and practices have become the subject of intense regulatory and shareholder scrutiny. In light of the non-binding shareholder say-on-pay vote required by Dodd-Frank, as well as the other executive compensation provisions of Dodd-Frank that the SEC is in the process of implementing, public companies are enhancing both their proxy disclosures and their shareholder engagement efforts. As these companies adapt to this new regulatory regime, they are also facing new challenges to their director compensation programs in light of recent Delaware case law. This chapter will discuss the new challenges facing executive compensation decision makers, and the strategies employed in response.

Regulatory Pressures and Corporate Governance

Executive compensation governance measures form a key part of the Dodd-Frank Act (Dodd-Frank)¹ and, by the end of the summer of 2015, the SEC had either finalized or proposed rules implementing all of Dodd-Frank's executive compensation provisions. The most well-known reform under Dodd-Frank is the required say-on-pay vote, which mandates that each public company provide its shareholders with a non-binding vote on the company's executive compensation program. Since being implemented in 2011, say-on-pay has caused many companies to reconsider their pay programs and the manner in which those programs are disclosed to shareholders.

In addition to say-on-pay, Dodd-Frank will require each public company to disclose the relationship of its pay to its performance (using a total shareholder return metric), the ratio of its CEO's compensation to the median compensation of all other employees, and the company's policies on hedging. Further, Dodd-Frank will require each company to implement and disclose a policy requiring the recovery of certain erroneously awarded incentive-based compensation.

Although certain of these rules have yet to be finalized, companies have already begun to adapt to this new regulatory regime. Each year, Shearman

¹ Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376.

& Sterling LLP surveys the corporate governance and executive compensation practices of the one hundred largest US companies (Top 100 Companies). This year's survey shows, for example, that of the Top 100 Companies, ninety-six already disclose that they prohibit hedging of company stock and eighty-seven of the Top 100 Companies already maintain clawback policies. This voluntary compliance reflects the fact that many proxy advisory groups consider these policies to be an element of sound corporate governance and risk management.

Clawback Policies and Practices

In July of 2015, the SEC proposed rules to implement Dodd-Frank's clawback provision. Under Dodd-Frank, issuers will be required to recover incentive-based compensation that is received by an executive officer of the issuer during the three-year period preceding the date on which the company is required to restate a financial statement due to a material error, to the extent that compensation is in excess of what would have been received had it been determined using the restatement.

Unlike the clawbacks mandated by Sarbanes-Oxley, which require misconduct to trigger a clawback, the proposed Dodd-Frank rules provide for unqualified "no-fault" recovery. In addition, companies will have limited discretion as to whether to enforce the clawback policy. Unless recovery would be impracticable due to expense, or recovery would violate a home country rule, the policy must be enforced.

Our survey shows, however, that the voluntary policies currently in place at the Top 100 Companies are not uniform, and that their application varies as to the events that trigger recovery, culpability standards, the individuals covered, the types of compensation subject to recovery, the level of board discretion as to whether to seek enforcement, and the time period covered by the recovery policy. Once the rules under Dodd-Frank are finalized, most companies will need to either amend their current clawback policies or adopt a supplemental policy that conforms to the SEC's requirements.

Compensation Committee Requirements

Directors charged with sitting on a company's compensation committee must comply with the independence standards of the securities exchange or

association on which the company is listed. In addition, companies need to be aware of the “outside director” requirements of Section 162(m)² of the tax code, and the non-employee director requirements of Section 16 of the Exchange Act. The possibility exists that a compensation committee member will satisfy the independence requirements of the exchange, but will fail to be an “outside director” under Section 162(m) or a non-employee director under Section 16. Companies need to carefully monitor the activities and relationships of their board members to ensure they do not lose an expected deduction under 162(m), or inadvertently cause an insider to have to disgorge profits under Section 16.

Section 162(m)

Pursuant to Section 162(m) of the tax code, compensation payable to a company’s CEO and its three other highest paid officers (other than the CFO) is not deductible if it is in excess of \$1 million. An exception exists, however, for performance-based compensation that is approved by a compensation committee consisting entirely of two or more “outside directors.” An “outside director” is a director who:

1. is not a current employee of the company,
2. is not a former employee of the company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan),
3. is not a former officer of the company (regardless of whether he or she receives compensation for prior services), and
4. does not receive “remuneration” from the company, either directly or indirectly, in any capacity other than as a director.

Notwithstanding the fact that Treasury Reg. 1.162-27(e)(2)³ states that the committee must consist “solely of two or more outside directors,” the IRS has stated that these regulatory requirements will be met in the case of board action by unanimous written consent (so long as at least two members were outside directors), and actions by committees in which inside directors recuse themselves.⁴

² 26 U.S.C.A. § 162(m).

³ Treas. Reg. 1.162-27(e)(2).

⁴ Priv. Ltr. Rul. 9732007, 9811029, respectively.

Section 16(b)

Section 16(b) of the Exchange Act⁵ provides that a company insider, including a director, officer or 10 percent owner, is liable to the company for any profits resulting from his or her purchase and sale of the company's equity securities within any period of less than six months. To ensure that grants of equity compensation are exempt from this rule, the SEC promulgated Rule 16b-3 of the Exchange Act,⁶ which exempts transactions between an issuer and a director or officer that are approved by either the full board or a committee composed solely of two or more "non-employee directors."

To qualify as a non-employee director, the director cannot:

1. Be an officer or employee of the company;
2. Receive in excess of \$120,000 in compensation, either directly or indirectly, from the company (or from a parent or subsidiary) for services rendered as a consultant or in any capacity other than as a director; or
3. Have an interest in any "related party" transaction for which disclosure in the proxy statement would be required pursuant to Item 404(a)⁷ of Regulation S-K.

Although Exchange Act Rule 16b-3⁸ states that the committee must consist "solely of two or more non-employee directors," the SEC has stated that non-qualifying directors can abstain or recuse themselves from action on the transaction, or the committee can form a subcommittee composed of two or more non-employee directors to approve the transaction.⁹

Director Independence Requirements of the Securities Exchanges

With respect to the independence requirements of the securities exchanges, both the NYSE and NASDAQ require members of their listed companies'

⁵ 15 U.S.C.A. § 78p.

⁶ 17 C.F.R. § 240.16b-3.

⁷ 17 C.F.R. § 229.404(a).

⁸ 17 C.F.R. § 240.16b-3.

⁹ *American Society of Corporate Secretaries*, SEC No-Action Letter, Q.1(b) (Dec. 11, 1996).

compensation committees to be independent. One of the executive compensation provisions in Dodd-Frank requires the SEC to adopt rules directing the national securities exchanges and associations to prohibit the listing of any security of an issuer that does not comply with certain compensation committee (and compensation adviser) requirements. The exchanges and associations were charged with developing listing standards requiring each member of the compensation committee to be “independent.” The SEC finalized its requirements in June of 2012, and in January of 2013, approved the listing standards of each of the NYSE and NASDAQ.

Although it does not define the term “independent,” Dodd-Frank does state that the exchanges must take into account certain “relevant factors” which include:

1. A director’s source of compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such directors, and
2. Whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of the issuer.

Although the NYSE and NASDAQ have different definitions of “independent,” both generally look to ensure that the directors have not, in the three previous years, been employees of the company, had a business relationship (other than stock ownership) with the company or familial relationship with employees of the company.

Although each exchange lists certain relationships that are a *per se* bar to independence, this list is non-exclusive and the board must examine each relationship and make an affirmative determination, considering all relevant facts and circumstances, as to a particular director’s independence. Further, to the extent a director has a relationship that the company reviewed before determining that the director was independent, this relationship will need to be disclosed in the company’s proxy statement pursuant to Item 404¹⁰ of Regulation S-K.

¹⁰ 17 C.F.R. § 229.404.

Compensation Committee: Best Governance Practices

The new disclosure requirements of Dodd-Frank, specifically say-on-pay, have led to a renewed focus on executive compensation and related corporate governance issues by shareholders and proxy advisory groups. At Shearman & Sterling LLP, we have actually rebranded our benefits and compensation group as Compensation, Governance & ERISA, in recognition of the challenge our clients face in balancing the need to attract and retain first-class talent with enhanced shareholder and regulatory scrutiny.

The most effective way a company can justify its pay practices to its shareholders—and avoid litigation—is through a rigorous focus on process. Compensation committees must consist of independent and informed directors. With respect to independence, companies should not limit their analysis to the requirements of the stock exchanges, tax code or securities laws. Companies that employ best practices with respect to committee member independence ensure that there are no connections between committee members and senior management that can create conflicts of interest. Further, committee members must be able to resign from the committee without any adverse personal financial impact.

In addition, compensation committees should follow a regular calendar for committee actions. A regular calendar is the best way to ensure that the members of the committee are able to properly implement the company's pay programs, and fully assess both the company's and the executive's performance before making decisions. A good calendar will also build in time for the committee members to engage in self-assessment, which should occur at least annually.

Finally, compensation committee members should be provided direct access to advisers and management. Compensation consultants assist committee members in establishing and analyzing the company's peer group for benchmarking purposes, and can help the committee understand complex performance measures. Counsel should be present at important meetings to document the committee's actions and provide advice at major inflection points in the compensation cycle, such as the hiring or

termination of an executive officer, or setting the strategy for addressing a negative say-on-pay vote.

Strategies for Addressing the Big Issues

Say-on-Pay

The attention paid to executive compensation programs as a result of “say-on-pay” has led to many companies adopting practices intended to ensure their shareholders understand and are comfortable with how the company’s senior management is compensated.

This year’s survey of the Top 100 Companies illustrates that one of the most effective and popular ways the Top 100 Companies address say-on-pay is through shareholder engagement. While forty-five companies disclosed shareholder engagement efforts in their 2013 proxies, seventy-seven did so in 2015, which represents a 71 percent increase. These efforts proved especially effective for those companies that received low approval ratings in 2014. Of the eight Top 100 Companies that received less than 80 percent approval in 2014, six disclosed shareholder engagement efforts in their 2015 proxy and, in 2015, received a greater than 80 percent approval rate (in many instances above 90 percent). With respect to the two companies that did not provide disclosure of shareholder engagement efforts, one failed its 2015 say-on-pay vote for the second year in a row, and the other had a nearly 22 percent decrease in its say-on-pay approval rating.

Effective shareholder engagement occurs throughout the year and is made to key investors or those institutional investors that hold a significant percentage of the company’s stock. A member of the compensation committee will often oversee or participate in the outreach. To avoid running afoul of the SEC’s rules against selective disclosure, those who engage in outreach typically work from a prescribed set of topics and do more listening than talking.

Disclosures

Further, the SEC’s required proxy compensation disclosures are, for many companies, not the most effective means to describe how their executives

are paid. Our survey shows that as a response to this issue, a majority of the Top 100 Companies provide additional disclosures in their proxy statements that are intended to provide a more accurate description of their compensation programs.

One type of additional disclosure is the inclusion of alternative pay disclosures and fifty-two Top 100 Companies employed this technique in their 2015 proxies. For example, while the SEC requires disclosure of total compensation, many companies are distinguishing this amount from *realizable* or *realized* pay. Although the precise meaning of these terms can vary from company to company, *realizable* pay generally means the pay that could actually be earned by an executive based on current performance and share price. *Realized* pay generally means an executive's actual take-home pay for the given year (including salary, bonus, option exercises and award settlements).

Another form of additional disclosure is the inclusion of a list of accomplishments, oftentimes in the form of a “what we do” and “what we don’t do” chart. Sixty-six of the Top 100 Companies cataloged their governance practices in this manner and the lists are often very similar from company to company. Common “we do” items include: share ownership and retention requirements, prohibitions on hedging and pledging, performance-based pay structures, and clawback policies. Common “we don’t” items include the absence of gross-ups, employment agreements, and single-trigger change in control equity vesting.

Golden Parachutes

Golden parachute arrangements have been heavily targeted by proxy advisory firms and shareholder activists. Further, Dodd-Frank now requires that any company seeking shareholder approval of a merger, acquisition, consolidation or disposition of substantially all of its assets must disclose any arrangements it has with its named executive officers (or the named executive officers of the acquiring issuer) concerning compensation that is based on or otherwise relates to the transaction. Included in this disclosure must be “the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.” The final rule promulgated by the SEC requires

that this disclosure be in both a tabular and narrative format and, in accordance with Dodd-Frank, that the arrangements between the company and its named executive officers be subject to a shareholder advisory vote.

Our survey of the Top 100 Companies shows that many companies are revisiting their change in control arrangements to ensure they withstand shareholder scrutiny. For example, in Fiscal Year 2014, none of the Top 100 Companies provided severance payments solely upon a change in control (without a subsequent termination of employment). In addition, the only company that provides for severance payments to executives that voluntarily resign following a change in control has eliminated that right for future agreements. Perhaps most interesting, with respect to time-vested equity, only twelve companies provide for single-trigger vesting upon a change in control. This represents a 40 percent decrease from the twenty companies that provided this benefit in 2014.

Not surprisingly, our survey of the Top 100 Companies also shows a significant decrease in the number of companies offering a full or modified gross-up for golden parachute excise taxes. In 2015, only thirteen companies provided a full or modified gross-up, which is a 28 percent decrease from 2014. In addition, of the four companies that provide full gross-ups, the full gross-ups are eliminated for new arrangements.

Recent Litigation

Director Compensation and Delaware Case Law

Director compensation has been in the spotlight recently as a result of some high-profile cases in Delaware. In *Calma v. Templeton*,¹¹ shareholders at Citrix Systems, Inc., claimed that the restricted stock units granted to non-employee directors in 2011, 2012, and 2013 were excessive. The Delaware Court of Chancery ruled that pre-filing demand on the board was not required, and the affirmative defense of shareholder ratification was not available to the board. The grants were made pursuant to an equity incentive plan that had been approved by shareholders in 2005.

¹¹ *Calma on Behalf of Citrix Systems, Inc. v. Templeton*, 114 A.3d 563 (Del. Ch. 2015).

The plan provided that no participant—which included employees, directors, consultants, and advisors—would be permitted to receive more than one million shares in any calendar year. The court held that, because the plan did not contain any specific or meaningful limits on non-employee director compensation, shareholder approval of the plan did not constitute approval of any action bearing specifically on the magnitude of compensation for the non-employee directors. As a result, because the directors approved their own compensation and could not rely on the affirmative defense of shareholder ratification, the transaction would be examined using the “entire fairness” standard rather than the “business judgment standard.” Under the business judgment standard, the burden is on the plaintiff to show that the directors’ decision cannot be attributed to any rational business purpose. This is a difficult hurdle for the plaintiff to overcome, and the majority of cases where this standard is applied are dismissed at the pleading stage. The “entire fairness” standard, however, shifts the burden to the defendant directors to show that their decision “was the product of both fair dealing *and* fair price.”¹² As a result, although the plaintiff needs to show some facts that can support an allegation that the transaction was not fair, most cases will survive a motion to dismiss. In *Calma*, because the plaintiffs raised meaningful questions as to whether the directors utilized the proper peer group for determining the compensation, the Chancery Court stated that it was possible that the awards were not “entirely fair” and the directors’ motion to dismiss the case was denied.

Next Steps

Going forward, public companies should engage compensation consultants to assist in the review of their director compensation programs. Companies need to first consider whether any shareholder-approved limits are meaningful. Companies that decide to retain maximum flexibility and not include meaningful or specific limits must ensure they will be able to defend the compensation if it is examined under the “entire fairness” standard. This will require working with consultants to develop a proper peer group for benchmarking, and granting director compensation that is reasonable in light of those benchmarks.

¹² *Calma on Behalf of Citrix Systems, Inc.* 114 A.3d at 577 (italics in original).

A company that decides to amend its director compensation plan to include meaningful or specific limits on director compensation (whether the plan is a stand-alone plan or included in an omnibus plan) will also need to consider the costs and benefits of obtaining shareholder approval of the amendment. If it is determined that an amendment is preferable, the limit on director compensation should take the form of either a meaningful annual limit or, for maximum certainty, a specific formula for determining the compensation.

In light of the ruling in *Calma*, as well as a similar ruling in the 2012 case *Seinfeld v. Slager*,¹³ a growing number of companies are including director-specific stock award limits in their equity plans. According to a memo by Towers Watson, following *Seinfeld*, 22 percent of Fortune 500 Companies that put their stock award plans (with director participants) to a shareholder vote in 2013 included director-specific limits. Similarly, following *Calma*, 27 percent included limits in 2015. In each year, a small majority of these limits (55 percent in 2013 and 52 percent in 2015) were based on a fixed dollar value as opposed to a fixed number of shares.¹⁴

Conclusion

Those companies that are best able to withstand the intense shareholder and regulatory scrutiny of their executive compensation programs do so by engaging in corporate governance best practices. This includes ensuring that executive compensation decisions are made pursuant to an orderly process, and that the process and decisions are effectively communicated to the company's shareholders. Further, board members charged with planning and implementing their company's compensation program must be independent and fully apprised of the changing regulatory landscape. In addition, keeping abreast of compensation trends within the company's peer group is an excellent way to avoid having the company's compensation program raise flags with shareholders and shareholder activists.

¹³ *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. 2012).

¹⁴ Michael Bowie, *Executive Compensation Bulletin: Equity-Based Pay Continues to Push Increases in Outside Director Pay*, (Aug. 27, 2015), <https://www.towerswatson.com/en-US/Insights/Newsletters/Global/executive-pay-matters/2015/Executive-Compensation-Bulletin-Equity-Based-Pay-Continues-to-Push-Increases-Outside-Director-Pay>.

Key Takeaways

- Craft pay practices so they can be clearly justified to shareholders, following the disclosure requirements of Dodd-Frank. Employ a rigorous focus on process to effectively support pay practices to shareholders, as well as avoid litigation. Take every precaution to ensure the compensation committee is formed of independent and informed directors. Do not stop at the requirements of the stock exchanges, tax code or securities laws. Employ best practices that ensure there are no connections between committee members and senior management that can create conflicts of interest.
- Ensure compensation committee members have direct access to advisers and management. Retain compensation consultants to assist committee members in establishing and analyzing the company's peer group for benchmarking purposes, and understanding complex performance measures. Include lawyers to document the committee's actions and advise at crucial points, including hiring or terminating executive officers, or addressing a negative say-on-pay vote.
- Engage compensation consultants to assist in reviewing director compensation programs to ensure benchmarking is appropriate. Consider whether shareholder-approved compensation limits are meaningful when applied to non-employee directors. If you decide to retain maximum flexibility and not include meaningful or specific limits, take steps to ensure you are able to defend the compensation if it is examined under the "entire fairness" standard. Work with consultants to develop a proper peer group for benchmarking, and ensure that director compensation is reasonable in light of those benchmarks.
- Consider the costs and benefits of obtaining shareholder approval if you decide to amend your compensation plans related to non-employee directors to include meaningful or specific limits. If the decision is that an amendment is preferred, the limit can be established through setting a meaningful annual limit or a specific formula for determining the compensation.

Doreen E. Lilienfeld is a partner and the practice group leader of the Compensation, Governance and ERISA Group at Shearman & Sterling LLP. She has been involved

in a wide variety of compensation-related matters, including the design and implementation of retention and compensation plans, disclosure and regulatory compliance, and employment negotiations with senior executives. Ms. Lilienfeld has significant experience in compensation and benefits issues relating to private equity and other mergers and acquisitions transactions. She has advised both US and non-US issuers on corporate governance and regulatory requirements relating to compensation and benefits matters. Legal directories, such as Chambers, Legal 500 US, and Super Lawyers, have named Ms. Lilienfeld as a leader in her field.

For the past thirteen years, Ms. Lilienfeld has spearheaded the publication of the Shearman & Sterling LLP survey of the compensation-related corporate governance practices of the largest one hundred domestic issuers. She is an elected member of the firm's nine-member policy committee.

Acknowledgment: *I would like to acknowledge the assistance of Matthew Behrens in preparing this chapter.*



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