Compensation Committees: A Look at Liability & Fiduciary Issues

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Housekeeping: About Anthony "Tony" Eppert

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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve the substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- At Andrews Kurth Kenyon LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:

Housekeeping: Upcoming 2017 Webinars

- Upcoming 2017 webinars:
  - Compensatory Arrangements within Partnerships and LLCs (4/13/2017)
  - Designing Equity Compensation Abroad (5/11/2017)
  - Expatriate & Secondment Agreements: Top 10 Issues to Consider (6/8/2017)
  - Pay Ratio Disclosure Rules: The A-Z Training Course (7/13/2017)
  - Trends in Designing Performance-Based Equity Awards (8/10/2017)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/2017)
  - How to Properly Design a Nonqualified Deferred Compensation Plan (10/12/2017)
  - Navigating Employee v. Independent Contractor Classifications (11/9/2017)
  - Sharing the Dream: M&A Transactions & Retaining Key Employees (12/14/2017)

- Upcoming 2018 webinars
  - To be determined
  - Suggestions welcomed!

Purpose of this Presentation

- The purpose of this presentation is to highlight certain compensatory issues that could result in liability to members of Compensation Committees (the "***Committee***") of Board of Directors (the "***Board***") of publicly-traded corporations

- To that end, this discussion covers:
  - Certain Rule 16b-3 developments,
  - ISS withhold (or against) votes on the re-election of members of the Committee or the Board,
  - ERISA fiduciary liability,
  - Grant limitations in equity plans,
  - Non-employee director share limits, and
  - Process relating to employment actions

Rule 16b-3 Development – Background

- As background, Section 16(b) is a provision of the Securities Exchange Act of 1934 (the "***Act***") that imposes reporting requirements and trading restrictions on "insiders" of publicly-traded corporations
  - For purposes of Section 16, the term "*insider*" includes:
    - A director;
    - An officer (defined as the president, principal financial officer, principal accounting officer, any VP in charge of a principle business unit/division/function, and any other person who performs a policy-making function for the company); and
    - Any 10% beneficial owner

- A purpose of Section 16 is to deter insiders from using confidential information for personal gain. To that end, Section 16(b) generally requires insiders to:
  - File public reports relating to the insider's transactions with equity of the company; and
  - Disgorge profits realized on "***short-swing transactions***" (*i.e.*, any purchase and sale, or vice versa, of company equity within a period of less than 6 months)
    - Generally, a purchase or sale occurs when the insider makes an irrevocable commitment
    - Interesting is that "less than 6 months" begins on the date of the transaction and ends 2 days prior to the end of the 6 month period
    - The disgorged "profits" is computed by matching the highest sales price to the lowest purchase price during the 6-month period, and so on, irrespective of the dates on which the transactions occurred
    - Therefore, it is possible to have a "profit" under Section 16(b) even though the transactions resulted in an actual net loss to the insider

Rule 16b-3 Development – Background (cont.)

- There are a few exemptions from Section 16(b). The one most often relied upon in the context of equity compensation is Rule 16b-3
  - This rule is available only to directors and officers who engage in a transaction with their company

- To satisfy Rule 16b-3, the plan/transaction must be approved by:
  - The company's Board,
  - A committee of the Board comprised solely of two or more independent non-employee directors (*e.g.*, the compensation committee), or
  - The company's stockholders

Rule 16b-3 Development – Recent Plaintiff Activity

- Forms 3, 4 and 5 are filed with the SEC and are publicly available
  - These forms are regularly monitored by plaintiffs (*i.e.*, those making a living out of threatening to file Section 16(b) suits)
  - A goal of the plaintiffs is to require the company to pay their attorney fees and expenses
- Recently, certain plaintiffs have sent demand letters claiming that net settlements and net exercises would not comply with Rule 16b-3 if they are elective on behalf of the insider, and as a result, such net settlement/exercise should be treated as a non-exempt sale subject to matching with any non-exempt purchases under the short-swing profit rules
  - The position of the plaintiffs is based upon an interpretation of C&DI 123.16
- In these demand letters, the plaintiffs are taking the position that Rule 16b-3 would not apply unless the net settlement/exercise is automatic with NO discretion on behalf of the participant

Rule 16b-3 Development – Recent Plaintiff Activity (cont.)

- Generically, we think that the plaintiffs are incorrect in their positions, and that net settlements/exercises should be treated as exempt under Rule 16b-3 so long as the award agreement that contains such provisions was previously approved by the Board or the Committee

- That said, until this plaintiff activity is resolved, we recommend that Board and Committees consider one or more of the following protective actions:
  - Do not allow Section 16 insiders to effectuate any net withholding or net exercises (not likely a viable alternative);
  - Insert in the award agreement that net withholding or net exercises, as applicable, is required (depending on the situation, could be doable);
  - Continue to allow for discretionary use of net withholding or net exercise provisions, but require that the implementation of any such netting shall be subject to approval by the Board or the Compensation Committee (doable); and
  - Educate Section 16 insiders on the disgorgement risks associated with any purchases of shares on the open market within the 6-month period immediately preceding and immediately following the implementation of a net withholding or net exercise (doable)

ISS – Voting Guidelines

- ISS can create liability for a Committee member in the form of a no vote (or against) recommendation with respect to his or her re-election to the Board

- That said, most no vote (or against) recommendations from ISS, if any, will start with the say-on-pay proposal
  - Which means that say-on-pay often acts as a temporary shield for Committee and Board members if the frequency of the say-on-pay vote is annually
  - For example, ISS voting guidelines recommend a vote against say-on-pay proposals if:
    - There is a misalignment between the CEO pay and performance of the company (*i.e.*, pay-for-performance),
    - The company maintains significant problematic pay practices, or
    - The Board exhibits poor communication and responsiveness to its shareholders

- Additionally, ISS voting guidelines recommend a vote against or withhold from members of the Committee (and possibly the full Board) if:
  - There is no say-on-pay vote on the ballot and an against vote would have otherwise been warranted due to any of the above,
  - The prior say-on-pay proposal received less than 70% support of the votes cast and the Board failed to adequately respond, or
  - The company has recently practiced or approved a problematic pay practice

ISS – Board Communications

- In evaluating an item on a ballot, ISS will consider the Board's responsiveness to investor input and engagement on compensation issues

- Bad facts include:
  - Failure to respond to a majority-supported shareholder proposal on executive pay;
  - Failure to "adequately" respond to a prior say-on-pay proposal that received less than 70% of the votes cast

- Addressing this latter point, ISS will evaluate:
  - The company's response, including:
    - Whether the company adequately addressed and disclosed engagement efforts with major institutional shareholders on issues giving rise to the low support,
    - Whether specific actions were taken to address the issue, and
    - Whether any other actions were taken by the Board
  - Whether the issues raised are recurring or isolated;
  - The company's ownership structure; and
  - Whether support was less than 50% (which would require the highest degree of responsiveness)

ISS – Problematic Pay Practices

- There are numerous problematic pay practices that ISS will evaluate on a case-by-case basis to determine whether such are contrary to a performance-based pay philosophy, including:
  - Multi-year guarantees of pay,
  - Excessive new-hire packages,
  - Incentives that motivate excessive risk-taking, examples of which include:
    - A single or common performance metric used for short- and long-term plans,
    - Mutli-year guaranteed bonuses,
    - Mega annual grants providing unlimited upside and no downside risk, and
    - High pay opportunities relative to industry peers
    - [Though ISS acknowledges that risky incentives could be mitigated with rigorous clawback provisions and robust stock ownership/holding guidelines]
  - Abnormally large bonus payouts without performance linkage or proper disclosure,
  - Excessive perquisites,
  - Excessive severance and/or change in control provisions (*e.g.*, single triggers, new or materially amended agreements containing excise tax gross-ups, etc.),
  - Dividends or dividend equivalents paid on unvested performance shares or units,
  - Internal pay disparity (*i.e.*, excessive differential between CEO total pay and that of the next highest paid NEO), and
  - Repricings without prior shareholder approval

ISS – Problematic Pay Practices (cont.)

- However, the following problematic pay practices are deemed "significant," the presence of which will likely result in an adverse recommendation from ISS:
  - Repricing without shareholder approval,
  - Excessive perquisites or tax gross-ups,
  - New or extended executive agreements that provide for:
    - Change-in-control payments exceeding 3x (base + average/target/most recent bonus),
    - Single trigger or modified single trigger change-in-control severance payments (unless there was at least a substantial diminution of duties), and
    - Excise tax gross-ups for change-in-control payments

ERISA – Who Is a Fiduciary

- Under ERISA, a person is generally a fiduciary to the extent:
  - Such person is named in the 401(k) plan document and is provided discretionary authority or responsibility over the administration of the 401(k) plan (the "***Named Fiduciary***");
  - Such person exercises any discretionary authority or control respecting administration of the 401(k) plan; or
  - Such person exercises any authority or control respecting management or disposition of the assets of the 401(k) plan

- Qualified retirement plans generally have more than one fiduciary (*e.g.,* officers, human resources, etc.)

- An important point for a plan sponsor to keep in mind is that, with proper planning, fiduciary liability for a particular individual or group can be localized to certain acts
  - A person is a fiduciary ". . . only as to the activities which bring the person within the definition." *See Coleman v. National Life Ins. Co.,* 969 F.2d 54, 61 (4th Cir. 1992)
  - However, for example, if one or more persons have responsibility to approve recommendations made by others with respect to investment alternatives, then such persons will likely be considered fiduciaries with respect to investment decisions. *See Yeseta v. Baima,* 837 F.3d 380 (9th Cir. 1988)

ERISA – Limiting Fiduciary Liability

- Fiduciary obligations are among the highest known to law
- Fiduciaries are generally subject to the following standards (not an exhaustive list):
  - They must act for the exclusive benefit of providing benefits and defraying reasonable expenses of administering the 401(k) plan (*i.e.*, the duty of loyalty);
  - They must act with the care, skill, prudence and diligence under the circumstances that a prudent person with similar capacity would use (*i.e.*, the duty of prudence); and
  - They must act in accordance with the plan documents
- If an individual's powers are limited to appointing, retaining and removing a fiduciary, then such individual's fiduciary liability could be limited to only a failure-to-monitor claim
- As applied to members of the Board, and to help limit their liability, we typically have the Board delegate its authority with respect to the 401(k) plan to an individual (*e.g.*, the Director of HR), and then have that individual further delegate its authority to a Benefits Committee
  - Such should limit the Board's liability to a "failure to monitor" claim, if any; and
  - Insulate the Board from the determination of "who" should be on the Benefits Committee

ERISA – Limiting Fiduciary Liability (cont.)

- This slide should be of note for any company that offers employer stock within its 401(k) plan
- A question is whether the Form S-8 prospectus and the summary plan description for the 401(k) plan should be combined? The better answer is no
- As background, ERISA requires 401(k) plan sponsors to prepare and distribute summary plan descriptions (an "***SPD***") to 401(k) plan participants
  - The SPD is required to disclose eligibility, contributions, vesting, distributions, available investment choices, etc.
  - Many issuers have combined the SPD and the S-8 prospectus because much of the information is the same
- However, if an SPD incorporates the prospectus, then the SEC filings that are incorporated into the prospectus become incorporated into the SPD
  - If later, the SEC filing is found to be misleading or inaccurate, then the SPD will also have incorporated misleading or inaccurate information
  - The combination of the prospectus with the SPD allows plaintiff lawyers to expand the scope of their securities claims to include breaches of fiduciary duty under ERISA (*i.e.*, alleging that the plan fiduciary distributed ERISA documents to participants, that participants relied upon them to their detriment, and that the company's continued investment in the stock fund caused the breach)
  - Notwithstanding the above, the prospectus could incorporate the SPD since the prospectus is not an ERISA document (though we suggest avoiding combinations)

Grant Limitations in Equity Plans

- One of the requirements to qualify compensation for the performance-based deduction exception to the $1mm limit is to have the company's shareholders approve the maximum amount of compensation that could be paid to any covered employee

- To that end, equity incentive plans typically include:
  - For stock options and SARs, a maximum number of shares that could be made to any participant over a stated period and the exercise price cannot be less than FMV as of the date of grant;
  - For restricted stock, RSUs and Other Awards, a maximum number of shares that could be made to any participant over a stated period; and
  - For cash awards, a maximum dollar amount that could be made to any participant over a stated period

Grant Limitations in Equity Plans (cont.)

- What happens if the limits are exceeded? The possibilities include:
  - The excess grant was made outside of the plan because it exceeded the limitations of the plan
  - The excess grant was made in violation of applicable listing rules since the shareholders did not approve such excess
  - The excess would not be covered by the performance-based exception to the $1mm deduction limit
  - Prior Form 4 disclosure would be incorrect
  - Proxy disclosure would be incorrect
  - The excess grant would not be protected by the Form S-8 registration statement and Rule 144 might apply

- Recognizing that these issues are typically caught well after the fact, possible resolutions could include:
  - If the resolutions of the Committee recited that the grant was made pursuant to the terms of the equity incentive plan, then a position could be taken that the entire grant (or at least the excess grant) is void;
  - Rely on the "bonus stock exemption;"
  - Make the employee whole at a later date; and
  - Conduct an internal investigation to determine whether adequate internal controls exist

Non-Employee Director Share Limits

- *Calma v. Templeton* (2015) is important because it acts as a blue print for a Boards on how to avoid the "entire fairness" doctrine when it acts on compensation decisions for non-employee directors. As background:
  - The business judgment rule defense acts to protect directors unless a plaintiff can prove that the decision of the directors had no rational business purpose (*i.e.*, the decisions of the directors will be presume to have been informed, made in good faith, and accomplished with the belief that such was in the best interests of the company)
  - Application of the business judgment rule makes it more difficult for a plaintiff to prove the directors breached their fiduciary duties and/or caused unjust enrichment
  - A plaintiff might be able to overcome the business judgment rule defense in the context of director compensation because such compensation decisions would likely be approved by interested directors. Such would result in a loss of the business judgment and instead subjects the court's review to the fairness standard (*i.e.*, the most exacting standard, and requires a judicial determination of whether the transaction in question was entirely fair to the stockholders)
  - But if the director compensation decisions were "ratified" by the stockholders, then the entire fairness standard would not apply
  - However, the *Calma* court concluded that large per-participant equity incentive plan limits were not "meaningful," and therefore, the stockholders' prior approval of the equity incentive plan did not constitute a valid "ratification"

Non-Employee Director Share Limits (cont.)

- Background on the case *Calma v. Templeton* (2015)
  - Over a 3-year period, non-employee directors received RSUs under the equity incentive plan of Citrix Systems, Inc.
  - The shareholder-approved equity plan had a customary 162(m) limit that limited equity awards to a maximum of 1mm shares for each participant in a calendar year
  - A plaintiff brought claims of breach of fiduciary duty, corporate waste, and unjust enrichment on the basis that the non-employee director compensation was excessive
  - On appeal, the claim for corporate waste was dismissed, but the claims for breach of fiduciary duty and unjust enrichment continued because the court could not conclude that the stockholders had ratified the equity awards to non-employee directors (*i.e.*, in other words, the Board's decision was subject to the entire fairness standard)

- A similar case can be found in *Seinfeld v. Slag*er (2012)

Non-Employee Director Share Limits (cont.)

- Take-away on "content" of equity plan design for non-employee directors
  - Consider whether to adopt a stand-alone, non-employee director compensation plan
  - Consider amending equity incentive plans to provide for a specific non-employee director compensation limit that is "meaningful," and then have such approved by the stockholders
  - Consider whether it is appropriate to hire compensation experts to establish what director compensation limits would constitute "meaningful" (*i.e.*, through peer studies)
  - Consider whether such limit should apply to both cash and equity compensation
  - Consider whether such limit should be specified in number of shares or a specified dollar amount (the latter addressed by using grant date fair value)
  - Consider whether the limit on equity compensation should be reduced proportionately by cash compensation otherwise paid to non-employee directors
  - Consider whether to seek ratification of prior compensation paid to non-employee directors under existing compensatory arrangements

Non-Employee Director Share Limits (cont.)

- Some examples of companies that sought shareholder approval of non-employee sub-limits within the equity incentive plan include:
  - Approve an annual grant limit of 40,000 shares (covering stock options, RSAs and RSUs) to a non-employee director,
  - Approve an annual grant limit of $750,000 (cash and equity) to a non-employee director,
  - Approve an annual grant limit of 20,000 shares to a non-employee director, or if greater, such limitation not to exceed a grant date fair value (under ASC Topic 718) of $750,000,
  - Approve an annual share limitation not to exceed a grant date fair market value of $500,000 to a non-employee director, and
  - Approve an annual share limitation not to exceed a grant date fair market value of $300,000 to a non-employee director

Process Relating to Employment Actions

- *Amalgamated Bank v. Yahoo! Inc.* (2016)
  - This case has strong parallels to *In re Walt Disney Derivative Litigation*
- Short version of the facts:
  - The CEO recruited the COO, the two of which worked together at a prior employer
  - The COO was terminated without Cause within 15 months
  - The COO received payments approximating $60mm
  - Sound like *In re Walt Disney Derivative Litigation*?
- The issue or allegation is whether or not the Committee was fully informed at the time it made the compensatory offer to the COO, and whether it was fully informed at the time it made the decision to terminate the COO

Process Relating to Employment Actions (cont.)

- Take-aways:
  - There should be full documentation as to how the Committee was both engaged and informed during the hiring process
  - Tally sheets or wealth accumulation sheets should be used so that the Committee can better vet the financial analysis
  - Any conflicts should be fully disclosed (*e.g.*, the relationship between the CEO and the candidate)
  - In the context of a termination and prior to any such termination, provide a report to the Committee that addresses the executive's performance

- Tally sheets
  - Tally sheets can be instrumental to a director preserving his or her defense under the business judgment rule because tally sheets help to document that the director made an "informed" decision, even if after-the-fact it is shown that such director made the wrong decision
  - A tally sheet lists each component of an executive's compensation and tallies it up (*i.e.*, also called a "placemat")
  - Prior to making compensation decisions, a Committee should require use of a tally sheet to show the full range of potential payments in various alternative scenarios (*e.g.*, termination without Cause, for Good Reason, death, Disability, Change in Control, for Cause, etc.)
  - Tally sheets should be attached to the minutes

Don't Forget Next Month's Webinar

- Title:
  - Compensatory Arrangements within Partnerships and LLCs
- When:
  - 10:00 am to 11:00 am Central
  - April 13, 2017

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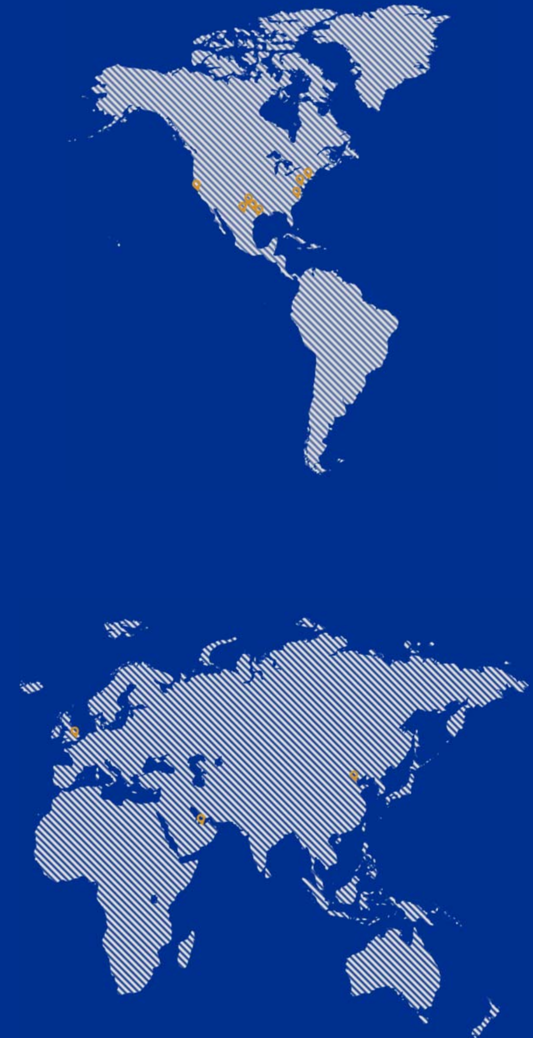

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