Preparing for Next Proxy Season: Start Now

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Presented by:
Anthony J. Eppert
713.220.4276
AnthonyEppert@AndrewsKurth.com

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Housekeeping: About Anthony "Tony" Eppert

Anthony Eppert
Partner
Andrews Kurth LLP
Tel: +1.713.220.4276
Email: AnthonyEppert@AndrewsKurth.com

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

Housekeeping: Upcoming 2016 Webinars

- Upcoming 2016 webinars:
  - Energy Companies: Compensation Governance Survey/Trends (10/13/16)
  - Identifying and Solving Pitfalls in Equity Compensation Administration (11/10/16)
  - The Importance of Miscellaneous Contractual Provisions: A Drafter's Perspective (12/8/16)

- Upcoming 2017 webinars:
  - Compensation: ISS Concerns & Mandates (Annual Program) (1/12/2017)
  - Equity Plans & Award Agreements: The Training Course (2/9/2017)
  - Compensation Committees: A Look at Liability & Fiduciary Issues (3/9/2017)
  - Compensatory Arrangements within Partnerships and LLC (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)

Purpose of this Presentation

- The purpose of this presentation is to help issuers prepare for proxy season

- To that end, this presentation covers the following select topics:
  - Recap of the latest proxy season,
  - Cases impacting compensation design and/or process,
  - Amendments to the equity plan to allow for share withholding to cover taxes at the maximum applicable federal rate,
  - Re-approval requirements to comply with Section 162(m) and the performance-based deductibility exception to the $1mm deduction limit, and
  - Certain pay ratio employee counting issues

Recent Proxy Season: Select Data Points

- According to Alliance Advisors LLC, there were approximately 2,434 say-on-pay proposals on the proxy ballots, of which:
  - Approximately 1,920 ballots passed (or 98.4%),
  - Approximately 32 ballots failed (or 1.6%), and
  - Approximately 482 ballots were pending or undisclosed as of the Alliance data sweep
- According to the same data report, ISS recommended “Against” 207 of the 1,952 say-on-pay proposals that had voting results
  - This means that ISS recommended an “Against” approximately 10.6% of the time
  - This also means that ISS was successful in its recommendation approximately 15.5% of the time

Recent Proxy Season: Select Data Points (cont.)

- According to Alliance Advisors LLC, there were approximately 600 proposals to amend equity incentive plans on the proxy ballots, of which:
  - Approximately 438 ballots passed (or 99.1%),
  - Approximately 4 ballots failed (or 0.9%), and
  - Approximately 158 ballots were pending or undisclosed as of the Alliance data sweep

- According to the same data report, ISS recommended “Against” 136 of the 442 proposals that had voting results
  - This means that ISS recommended an “Against” approximately 31% of the time
  - This also means that ISS was successful in its recommendation approximately 2.9% of the time

- Caution
  - For those under the impression that the above statistics are not “all that bad,” keep in mind that a “no” recommendation from ISS generally results in 25% to 35% less shareholder support than issuers with “yes” recommendations

Cases Impacting Design and/or Process – *Calma*

- This case is important because it acts as a blue print for a board of directors on how to preserve the business judgment rule defense 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 the 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 doctrine (*i.e.*, the most exacting standard, and requires a judicial determination of whether the transaction in question was entirely fair to the stockholders)
  - However, if the director compensation decisions were "ratified" by the stockholders, then the business judgment rule defense would continue to apply
  - 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"

Cases Impacting Design and/or Process – *Calma* (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 of directors could not avail themselves of the business judgment rule defense as to the claims of breach of fiduciary duty and unjust enrichment)

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

Cases Impacting Design and/or Process – *Calma* (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
    - However, since "meaningful" is not quantifiable and could create litigation risk, consider whether it makes sense to avoid limits and instead provide a formula
    - The courts have held that decisions to grant equity awards to directors based upon a formula that was approved by the stockholders are protected by the business judgment rule (*see Steiner v. Meyerson* and *Cambridge Ret. Serv. V. Bosnjak*)
  - 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

Cases Impacting Design and/or Process – *Espinoza*

- *Espinoza v. Zuckerberg, et. al.*

- Similar to *Calma*:
  - The plaintiff brought claims for corporate waste, breach of fiduciary duty, and unjust enrichment
  - The board of directors asserted protection under the business judgment rule because the equity plan in question had been approved by the stockholders
  - However, the court concluded that the stockholders' ratification of the director compensation process did not comply with Section 228 of the Del. Gen. Corp. Law, and as a result, such ratification was not deemed to have occurred
  - Thus, the claims would have been viewed under the "entire fairness" doctrine except that the parties settled

- Under the settlement proposal, the parties agreed that the following reforms would be implemented for 5 years:
  - The Charter of the Compensation and Governance Committee would be amended to require annual review and assessment of compensation, and that such would hire an independent compensation consultant ;
  - The board of directors will conduct annual reviews of compensation paid to its non-employee directors; and
  - The company will include proposals for the stockholders to approve or deny on compensation it pays to its non-employee directors

Cases Impacting Design and/or Process – *Espinoza* (cont.)

- Take-away on "approval process" of equity plan design for non-employee directors
  - Consider *Calma* and adopting meaningful equity award limits;
  - Consider Calma and having such limits approved/ratified by the stockholders;
  - Consider amending applicable charters to require annual review of director compensation and require the engagement of an independent consultant to advise the directors
  - Consider benchmarking director compensation to the peer group

Cases Impacting Design and/or Process – *Yahoo!*

- *Amalgamated Bank v. Yahoo! Inc.* (2016)
  - This case has strong parallels to *In re Walt Disney Derivative Litigation*
  - The court made a Section 220 demand under the Del. Gen. Corp. Code against Yahoo! (which allows stockholders certain inspection rights)
  - The Section 220 request related to the investigation of compensation paid to the COO

- 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 Compensation 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

Cases Impacting Design and/or Process – *Yahoo!* (cont.)

- Take-aways:
  - There should be full documentation as to how the Compensation Committee was both engaged and informed during the hiring process
  - Tally sheets or wealth accumulation sheets should be used so that the Compensation 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 Compensation 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 act as proof that the director made an "informed" decision, even if after-the-fact he or she 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 Compensation Committee should require use of a tally sheet that shows 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.)

Actions/Amendments – Allow for Max Withholding

- The Financial Accounting Standards Board ("FASB") recently made changes that would allow employers to effectuate tax withholding of equity awards up to the maximum individual statutory rate WITHOUT triggering liability classification for accounting purposes
  - The new standards are applicable for fiscal years beginning on or after December 15, 2016 (for public companies) and after December 15, 2017 (for private companies), though a company could adopt the new standards sooner **IF** it adopts **ALL** of the standards
  - Under the current standards, stock-based awards withheld at or less than the minimum statutory rate would be classified as equity awards (*i.e.*, accounting expenses is measured at the date of grant), and stock-based awards withheld at a rate above the minimum statutory rate would be classified as liability awards (*i.e.*, accounting expense is re-measured each reporting period)

- Early adoption would require the company to also adopt:
  - Cash Flow Classification for Stock-for-Tax Netting,
  - Accounting for Equity Award Forfeitures,
  - Accounting for Excess Tax Benefits and Deficiencies Arising Out of Equity Awards, and
  - Determination of Expected Terms for Equity Awards with Service-Based Conditions (for private companies)

Actions/Amendments – Allow for Max Withholding (cont.)

- And too, NYSE has amended its compensation FAQs to provide that (*See* FAQ Question C-1):
  - An amendment to allow for the maximum tax withholding (as opposed to the minimum tax rate) would NOT be a "material amendment" requiring stockholder approval
  - Such is the result if the forfeited but unissued shares revert back to replenish the equity plan's share reserve (*i.e.*, the equity plan has liberal share counting)
  - However, if the amendment applies to issued and unvested shares, then the amendment would be permitted as a non-material amendment only if forfeited shares would be cancelled upon vesting (*i.e.*, no reversion to the equity plan)

- In sum, the change creates a real solution to the problem of holding illiquid stock (either because the company is privately traded or because the recipient has material non-public information at the time of vesting or exercise of stock options)
  - The minimum federal supplement withholding rate is 25%, and
  - The maximum federal individual tax rate is 39.6%

Actions/Amendments – Allow for Max Withholding (cont.)

- Consider whether to implement any amendment
  - Keep in mind that IRS Treasury remittance would be increased by incorporating the amendment, thus burdening the company with a larger cash drain
- Consider whether to early adopt
- Consider whether such an amendment would be "material" under NASDAQ listing rules, thus subject to the stockholder approval requirements
  - The risk is that if the equity plan allows for liberal share counting, and the shares that are forfeited return to the plan to increase the share reserve, then an amendment to allow for tax withholding at the maximum rate instead of the minimum rate could be deemed "material" because it would effectively increase the number of shares available for issuance under the equity plan
  - At least such is the argument that should be vetted

Actions/Amendments – Seek 162(m) Re-Approval

- According to the performance-based exception to the $1mm deduction limit under Section 162(m), the material terms of the plan must be disclosed to, and approved by, the stockholders before the compensation is paid. Such material terms include:
  - The eligible employees (by class or title),
  - The performance goals that may be used (*e.g.*, EBITDA, TSR, etc.), and
  - The maximum amount of compensation that could be payable during the specified period

- Generally, the Compensation Committee retains the authority to change the performance goals on an annual basis. In such cases:
  - The material terms of the plan must be re-approved by the stockholders by the first annual stockholder meeting that occurs in the fifth year after the year that the stockholders previously approved the performance goal

- For new public companies, the foregoing period is generally limited until the earlier of:
  - The first annual stockholders meeting at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs (for companies that became public due to an IPO)
  - The first annual stockholders meeting at which directors are to be elected that occurs after the close of the first calendar year following the calendar year that the corporation becomes publicly held (for companies that became public without an IPO)

Actions/Amendments – Pay Ratio

- The SEC will require a public company to disclose the ratio of:
  - The median total compensation of all employees of the company (excluding the CEO) and certain subsidiaries, and
  - The annual total compensation of the CEO
- For public companies with a fiscal year ending December 31, 2017, disclosure is required in 2018
- Companies should think about whether it makes sense to conduct an initial assessment of its pay ratio, so that it can effectuate applicable strategies

Actions/Amendments – Pay Ratio – Picking Employees

- Which employees are included?
- Step 1 – pick a measurement date. Generally, companies have the discretion to choose any measurement date (so long as it is within the 3 month period immediately preceding the end of the reported fiscal year)
  - The measurement date could be used to exclude certain seasonal or part-time employees
- Step 2 – as to the remainder, exclude certain independent contractors and leased employees
  - Such employees may be excluded only if they are employed by an unaffiliated third party, and
  - Their compensation is determined by such unaffiliated third party
- Step 3 – identify which subsidiaries are to be excluded
  - Only employees and its "consolidated subsidiaries" are included in the calculation
  - Consolidated subsidiaries is determined under applicable accounting rules and generally requires the company to own more than 50% of the outstanding shares of such entity
  - Thus, employees of unconsolidated subsidiaries are not counted

Actions/Amendments – Pay Ratio – Picking Employees (cont.)

- Step 4 – exclude employees due to foreign data privacy laws
  - For example, if the applicable jurisdiction prohibits the transfer of compensation data outside of its borders, this exclusion might be available
  - However, for this exclusion to apply, a company must generally
    - Seek an exemption from the data privacy laws from the applicable country;
    - If no exemption is received, then the company must attain a legal opinion that concludes any inclusion of such country employees in the pay ratio calculations would violate such countries data privacy laws;
    - Such legal opinion is filed as an exhibit to the SEC filing that contains the pay ratio calculation; and
    - The company discloses an approximate number of such countries employees that are excluded under this exemption

- Step 5 – exclude all non-U.S. based employees that constitute 5% or less of the company's workers
  - This calculation under Step 5 applies after the exclusions set forth in Steps 1-3. Thus, any individuals eliminated in Steps 1-3 would not be included in the calculation of 5%

- Step 6 – exclude non-U.S. employees up to 5% of the company's workers
  - If any employees of a particular jurisdiction are excluded under this Step 6, then the company must exclude all employees in that jurisdiction
  - Employees excluded under Step 4 must be counted towards the 5% in this Step 6

Actions/Amendments – Pay Ratio – Picking Employees (cont.)

- Step 7 – cost of living adjustments
  - The company is permitted to make cost of living adjustment in order to determine the median compensation of employees in all non-U.S. jurisdictions
  - The method of determining such would have to be disclosed

Don’t Forget Next Month’s Webinar

- Title:
  - Energy Companies: Compensation Governance Survey/Trends
- When:
  - 10:00 am to 11:00 am Central
  - October 13, 2016

Andrews Kurth Locations

AUSTIN
111 Congress Avenue
Suite 1700
Austin, Texas 78701
Phone: +1.512.320.9200
Fax: +1.512.320.9292

BEIJING
Room 2007, Capital Mansion
No. 6 Xin Yuan Nan Lu,
Chao Yang District
Beijing, China 100004
Phone: +86.10.8486.2699
Fax: +86.10.8486.8565

DALLAS
1717 Main Street
Suite 3700
Dallas, Texas 75201
Phone: +1.214.659.4400
Fax: +1.214.659.4401

DUBAI
Andrews Kurth (Middle East) DMCC
45th Floor
Mazaya Business Avenue, BB2
Jumeirah Lakes Towers
P.O. Box 118273
Dubai, UAE
Phone: +971.4.567.0767
Fax: +971.4.567.0768

HOUSTON
600 Travis Street
Suite 4200
Houston, Texas 77002
Phone: +1.713.220.4200
Fax: +1.713.220.4285

LONDON
Andrews Kurth (UK) LLP
16 Old Bailey
London EC4M 7EG
United Kingdom
Phone: +44.20.3053.8300
Fax: +44.20.3053.8299

NEW YORK
450 Lexington Avenue
New York, New York 10017
Phone: +1.212.850.2800
Fax: +1.212.850.2929

RESEARCH TRIANGLE PARK
4505 Emperor Boulevard
Suite 330
Durham, North Carolina 27703
Phone: +1.919.864.7200

THE WOODLANDS
Waterway Plaza Two
10001 Woodloch Forest Drive
Suite 200
The Woodlands, Texas 77380
Phone: +1.713.220.4800
Fax: +1.713.220.4815

WASHINGTON, DC
1350 I Street, NW
Suite 1100
Washington, DC 20005
Phone: +1.202.662.2700
Fax: +1.202.662.2739

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