Top 10 questions for compensation committees in 2019.

With over a year to digest and implement changes made by the December 2017 tax legislation, compensation committees are faced with three important questions arising from the elimination of the performance-based exception to the $1 million cap on deductible compensation for certain executives. Further, questions that are expected to receive even more attention in 2019 include gender diversity and gender pay equity, the expanded scope of compensation committees, and the role of environmental, social and governance features in incentive awards and other decisions. Director pay litigation continues to be a concern for compensation committees while CEO evaluation is increasingly critical in today’s complex business climate. Finally, we see a further questioning of the rigor of annual performance targets and indications that the SEC sees the proper disclosure of perquisites as an enforcement priority.

1. What are the potential impacts of, and the planning for, the expanded definition of "covered employee" under IRC section 162(m) as amended by the 2017 Tax Cuts and Jobs Act?

An important change made by the 2017 Tax Cuts and Job Act (Act) was an expansion of the definition of a “covered employee” - i.e., an employee for whom the company’s annual deductible compensation is capped at $1 million. Here it is important to understand that the tax rules under IRC section 162(m) defining a “covered employee” differ somewhat from the SEC disclosure rules on identifying “named executive officers” (NEOs) for proxy statement disclosure purposes. In any case, there are four important components of the revised covered employee definition:

- first, a CFO is now a covered employee (finally correcting a technical glitch in the tax law);
- second, an individual is a covered employee if he/she was the CEO or CFO at any time during the taxable year (not limiting the definition to individuals who were the CEO or the CFO on the last day of the taxable year);
- third, a covered employee includes any of the company’s three highest compensated officers (other than a CEO or CFO) whose total compensation is required to be disclosed in its annual proxy statement; and
- fourth, if an employee was a covered employee for any taxable year beginning after 2016, he/she remains a covered employee throughout his/her employment and even for payments after cessation of employment.

A consequence of the new “once a covered employee, always a covered employee” rule is that it can be increasingly important for a company to pay more attention to which officers will be NEOs and included in the proxy statement. At some firms there may only be relatively small differences in total compensation among the top executive team, which could result in year-to-year changes in the composition of the company’s three highest-paid officers (other than the CEO and CFO). In such instances, a company may want to avoid having executives come in and out of the proxy because of items such as one-time compensation awards that are unlikely to be repeated in the future. In fact, the compensation committee may want to
proactively manage compensation for NEOs to ensure that it doesn’t trip over this new rule and unnecessarily add to the firm’s covered employee group.

If a company wishes to avoid creating one-time NEOs (who nevertheless would be treated for that year and all future years as covered employees), its compensation committee will need to be thoughtful regarding decisions on various one-time (or infrequent) compensation items, including: retention grants consisting of upfront equity awards, special bonuses, relocation expenses, and unusual changes in pension accruals. For retention incentives, the committee may want to take into account the timing of these awards and potentially split an award between two fiscal years.

In some situations, consideration might even be given to bumping-up the pay of an individual who already has covered employee status and who the firm ideally wants to position in the number five spot in the proxy, if that action would avoid another officer with similar total compensation becoming a covered employee. Of course, any such pay changes should be consistent with the employer’s overall compensation strategy and the desired market positioning for these executives. However, given the potential loss of a tax deduction for all future payments in excess of $1 million per year to or on behalf of a covered employee, this factor deserves consideration as an employer may seek to limit its group of covered employees subject to such deduction limitation.

2. What cautions and steps should be considered for preserving any available grandfathering of the performance-based compensation exception to the new strict $1 million cap on the deductibility of a covered employee's compensation?

If it hasn’t already done so, the compensation committee should make sure that it has a full inventory of compensation plans, programs, agreements, and awards (collectively “arrangements”) that may have been impacted by the 2017 tax legislation. This is a necessary first step in the process of determining whether, and to what extent, any such arrangements may qualify for grandfathering under an exception from the $1 million cap on deductible annual compensation for any covered employee.

Basically, the tax change included a limited grandfathering of arrangements that:

- were in effect on November 2, 2017, and
- are not modified in any material respect on or after that date.

Accordingly, companies and their compensation committees should carefully consider any proposed modification to an arrangement that otherwise might be grandfathered. These arrangements include an organization’s existing short- and long-term incentive programs, employment contracts, severance arrangements and other compensation awards that were in place on November 2, 2017. In determining whether any grandfathering might be available, the interim guidance provided last August by the IRS and Treasury in Notice 2018-68 should be examined.

Many incentive and other arrangements included a right for the compensation committee to exercise negative discretion in satisfying the now-repealed performance-based exception to the $1 million deduction limit. Each such arrangement should be examined to determine whether it allows for negative discretion by the committee in determining the amount to be paid. While it is hoped that forthcoming tax regulations may take a less restrictive position, under the Notice the mere existence of negative discretion generally would taint any otherwise available grandfathering unless the arrangement can be determined to be a binding written contract under applicable (generally state) law. Thus, in determining whether grandfathering is available regarding any arrangement that contains a negative discretion feature, legal counsel may need to be consulted.

In any case, a key take-away is to make sure not to inadvertently lose any potential grandfathering by making material changes before evaluating an arrangement’s qualification for, and the committee’s desire to utilize, the conditions of the exception.
3. Are public companies rebalancing CEO pay mixes and changing incentive plan metrics in view of the tax law changes (especially regarding IRC section 162(m))?  

When Congress enacted the 2017 Tax Cuts and Jobs Act (Act) that eliminated the “performance-based compensation” exception to the $1 million deduction limit of IRC section 162(m), there was speculation about whether many public companies would rebalance their CEO’s pay mix and/or incentive plan metrics (short- and/or long-term) now that companies no longer were able to obtain an income tax deduction by satisfying a series of tax law requirements. Following this change, most companies took a “wait and see” approach to gauge competitive market trends, investor preferences and proxy advisory firm implications.  

In the year since the Act became law, we have observed two trends – companies are not decreasing overall levels of CEO compensation to “makeup” for the loss of compensation-related tax deductions and there has been only a modest change to CEO pay mixes and incentive plan metrics. In reaching their decisions, we have observed a largely two-fold rationale:

- first, compensation committees understand that to attract, retain and motivate CEOs, they need to pay competitive market rates independent of the increased tax cost; and
- second, investors overwhelmingly prefer a pay-for-performance approach to CEO compensation. This includes emphasizing long-term compensation relative to other elements of pay and incorporating incentive plan metrics which are largely based on objective performance measurement that are intended to drive shareholder value creation.

One notable exception to these trends is Netflix, which is replacing its performance-based annual incentive (bonus) plan with higher base salaries for its executive team. Also, Institutional Shareholder Services recently addressed this issue in its U.S. Compensation Policies FAQs, taking the position that any shift away from performance-based compensation to discretionary or fixed pay elements will be viewed negatively.

That said, we have seen some companies implement targeted changes in light of the Act, but only when it makes sense in the context of the organization’s business, talent and compensation strategies. One fairly common potential targeted change includes the introduction of (or increased weighting of) non-financial incentive plan metrics such as operating objectives, strategic initiatives and individual performance. However, these conversations tend to focus on the “business case” for change rather than being driven by the change in tax law (since any changes will ultimately need to be publicly-disclosed and supported by shareholders).

While there is a no “one-size fits all” approach to decision-making around a CEO’s pay program, compensation committees should balance the aforementioned factors along with other critical inputs such as performance, retention and shareholder optics.

4. What further advancements are anticipated regarding gender pay equity and gender diversity?

Organizations and institutions continue to be scrutinized as both gender pay equity and gender diversity remain front-page news. This focus is not isolated, but part of a continuing movement towards establishing greater compensation equality and gender diversity in the work place.

Gender pay equity became a hot topic in 2018, with several states amending equal pay laws to supplement the 1963 Equal Pay Act which was intended to abolish wage disparity based on sex. Recent statutory activity has included the expansion of state and local laws that prohibit employers from asking applicants for salary history. California, Connecticut, Delaware, Massachusetts, Oregon, Puerto Rico, Vermont, and a handful of cities and counties have enacted bans on salary history inquiries. These jurisdictions recognize that using prior salary as a means of setting compensation can exacerbate historical inequities among the genders.

Boards of directors and company executives are heavily focused on promoting both equality and diversity initiatives as institutional investors have
incorporated board diversity and other environmental, social and governance (ESG) issues into their proxy voting guidelines. Several institutional investors have specifically pushed gender pay equity into the limelight by engaging companies and requesting that they disclose their gender pay statistics.

Institutional Shareholder Services (ISS) published updated voting guidelines in November 2018 which will be effective for meetings on or after February 1, 2019. While ISS addressed board diversity, it pushed its compliance deadline out another year, stating “For companies in the Russell 3000 or S&P 1500 indices, effective for meetings on or after Feb. 1, 2020, generally vote against or withhold from the chair of the nominating committee (or other directors on a case-by-case basis) at companies when there are no women on the company’s board.” Several sources are cited for ISS’ rationale, including investors’ desire for gender diverse boards, the positive correlation found in some studies between board gender diversity and company performance, and that gender diverse boards are now the market norm.

Gender pay equity was covered in ISS’ 2018 policy updates, including these considerations:

- The company’s current policies and disclosure related to both its diversity and inclusion policies and practices, its compensation philosophy and fair and equitable compensation practices;
- Whether the company has been the subject of recent controversy or litigation related to gender pay gap issues; and
- Whether the company’s reporting regarding gender pay gap policies or initiatives is lagging its peers.

We expect institutional shareholders and shareholder advocacy groups to continue to encourage organizations to voluntarily disclose statistics on diversity and gender pay gaps. As a result, companies should be able to assess gender pay gaps and understand how and why any pay disparity has occurred.

5. How and why are the role and responsibilities of the compensation committee expanding?

Driven in large part by social movements and concerns about the availability of future employee talent, the domain of the compensation committee is expanding at an accelerated pace. This enlarged role is changing compensation committee charters, meeting agendas and the profile of future committee candidates.

Companies cannot avoid dealing with social movements such as #MeToo, gender pay equity and diversity. Employees, shareholders and the general public expect companies to have positions and policies to address these movements due to their potential impact on business environments. At the same time, low unemployment numbers and demographic forecasts have boards worried about current and future workforces and leaders.

These external forces are, in large part, causing a convergence of pay strategy, leadership development and succession planning in meetings of the compensation committee. While continuing to address stakeholders’ pay levels and design issues, compensation committees are simultaneously pushing management on diversity efforts, retention of key talent, the development of future leaders and the ability to claw-back excess incentive payments.

Many compensation committees are changing their titles and charters to reflect these increased responsibilities. In addition, this broadened sphere of responsibilities is changing the profile of future compensation committee candidates, with human resources, public relations and diversity experience all being highly sought.

6. What ESG factors may see an increased role as metrics in incentive plans?

Environmental, social and governance (ESG) issues have received considerable attention in the press over the last several years and continued to be a focus of shareholder proposals during the 2018 proxy season, as well as receiving backing from various institutional investors and even activists (e.g., a policy statement by Trian Partners). The proxy advisory firms have also introduced ESG factors into their reports with
Glass Lewis utilizing information from Sustainalytics and ISS factoring ESG components into its overall quality score. In addition, the elimination of the performance-based exception to the $1 million cap on the deductibility of compensation under IRC section 162(m) may cause some compensation committees to provide more attention to non-financial factors such as the various activities covered by the broad ESG categories.

With this enhanced focus on ESG issues, we are seeing a few companies move towards basing a portion of incentive pay on one or more ESG factors. For example, Royal Dutch Shell announced that it will be linking executive pay of up to 1,200 senior employees to carbon emissions targets. Just like other performance metrics, the inclusion of ESG factors in an executive compensation program should not involve a “one size fits all” approach. Not only are the ESG factors impacting each industry often quite differently, compensation committees will need to evaluate whether the inclusion of one or more ESG factors is right for their company and what impact an executive’s actions may have on meeting the ESG goal. Communication of the performance goals and what is required of the executives also will be important, not only for the executives but also in company disclosures to ensure transparency with investors.

Whether a compensation committee might include an ESG component in an executive’s performance goals can require evaluation of several different factors and may include:

- Should the ESG goals be tied to short- or long-term incentives?
- How much of the executive’s incentive compensation will be linked to the achievement of the ESG goals?

Given the increased prominence that ESG factors have gained in recent years, compensation committees may decide to at least consider whether any ESG factors can or should be incorporated into executives’ incentive compensation programs.

### 7. What actions might compensation committees take to protect against litigation on the reasonableness of director pay?

Over the last several years an increasingly important concern for boards has been litigation regarding the compensation of non-employee directors. Directors set their own compensation (most commonly through action of the board’s compensation committee) which can lead to claims of self-dealing and unjust enrichment by directors resulting in excessive pay. Plaintiffs also may allege breaches of fiduciary duty and waste of corporate assets. After some procedural victories by plaintiffs, it has become increasingly clear that board members need to be concerned about any pay they receive that notably exceeds median levels at their peer group (or even one developed for use by plaintiffs’ counsel). While court decisions and reported settlements have been mixed, the resulting uncertainty has fueled concern among directors.

In claims relating to director pay, boards (and especially their compensation committee members) are “interested parties” in decisions on their own compensation; the result is that the otherwise applicable protection of the “business judgment rule” may not apply. Rather, directors’ decisions on their own compensation typically are subject to the “entire fairness” test, which considers the overall fairness of such pay decisions, and thus may be able to survive a motion to dismiss the case in its early stages. If a plaintiff’s lawsuit is allowed to go to trial, the monetary and other costs of litigation (including extensive discovery) may become significant, prompting a settlement even when the defendant
directors are likely to ultimately succeed on the merits.

In reaction to the first decisions that allowed director pay cases to proceed, boards and their advisors focused on imposing “meaningful limits” first on equity compensation and then on total director pay. Of course, what limit might be meaningful varied among companies and their advisors, but some cap on director compensation was thought to be helpful to avoid being targeted in, or to obtain dismissal of, an excessive pay lawsuit. The imposition by boards of limitations on director compensation became a common recommendation.

While it initially appeared that a shareholder-approved plan with “meaningful limits” would be sufficient to withstand attack from derivative shareholder strike suits, in a decision that surprised many, the important Delaware Supreme Court in the case of In Re Investors Bancorp, Inc. Stockholder Litigation (December 2017) basically held that the business judgment rule would not protect directors from claims regarding breaches of fiduciary duties for paying themselves excessive compensation where the directors exercised discretion over their own compensation. In such instances, the “entire fairness” test instead would apply, requiring a factual determination that the directors engaged in a prudent process in setting their compensation and made reasonable decisions on such pay.

As a direct result of the Investors Bancorp decision, the trend has been for boards to take further steps to prepare for any challenges to their compensation under the entire fairness test. This starts with a review of the company’s existing arrangements regarding director pay. A board might retain independent advisors for more frequent (preferably annual) director pay engagements that examine the reasonableness of equity awards and other components of director pay. In these studies, a peer review of director pay programs may be undertaken to show that the organization’s director compensation is in line with its peers and not an outlier (on the high side). Enhanced disclosure in proxy statements on the process and rationale used in setting director compensation also should be helpful.

Some advisors are counselling the adoption of a director compensation program that then is approved by shareholders and provides a fixed value, perhaps with a process that includes conditions for automatic adjustments following the annual shareholder meeting. Another approach involves shareholder approval of a director pay program that uses annual peer group benchmarking to set the components of director pay at median levels among such peers, subject to a process for adjustments in certain predetermined circumstances.

By now well-advised boards should understand that plaintiffs’ attorneys will be scrutinizing director pay disclosures in companies’ proxy statements, looking for instances where claims of excessive compensation may be viable. Accordingly, at a minimum, boards should consider possible steps to limit this vulnerability and become less attractive targets. Of course, the likely shareholder reaction to any actions should be considered before proceeding. Whatever approach is taken, it should be the result of a considered analysis of relevant facts and respective litigation risks.

8. Do we have an effective CEO evaluation protocol and process in place?

Both are critically important and many times overlooked. Far too often, a board will put together a somewhat generic set of questions for responses from the directors, then will ask the CEO for his/her self-evaluation against similar criteria. That may have been acceptable when the board was simply looking for a high-level assessment of the CEO’s past performance as a way to justify a pay adjustment – not to mention that many board chairs would just prefer to get this done and check the box. There are not many directors who are fond of providing feedback, particularly to their company’s CEO.

However, in the new era of relevance, where it is more pressing for boards to demonstrate a heightened degree of savviness about their company’s business and entire industry than ever before, two items have become critically important, namely: the criteria against which the CEO is measured must be relevant and purposeful and CEO evaluation is considered an
on-going process; not an annual event; with the company’s direction and strategy as the platform. Otherwise, why bother? Relevance has no patience for “check the box” activities.

Of course this begs for more upfront work by the committee, typically the compensation or HR committee that oversees this work. But after all, isn’t good stewardship of the CEO the board’s most important activity?

This process starts with clarification of the strategy – alignment across all directors regarding where the organization is headed and how the CEO is planning to take it there. While there are somewhat generic “buckets” of categories that are important in a CEO evaluation (e.g., management of the top team, fiscal soundness and organizational sustainability), what success looks like in each of these areas varies greatly from one organization to the next based on its strategy. The exercise of debating how to measure success in each not only serves the purpose of delivering relevant and meaningful feedback to the CEO against these criteria, but it also begs for the board overall to be clear on what the answers mean. Boards often stop short of defining success and move ahead based on assumptions.

Once the criteria for evaluation are understood, the board can move ahead with the process. There are many ways to collect feedback, including a survey tool rating the CEO in each area with the opportunity for comments, interviews of each director that are summarized, or both. Whatever the methodology chosen, it’s important that all directors participate to the fullest. The CEO should also have an opportunity to rate his/her own performance against these criteria – as what the CEO thinks vis-à-vis the board is of critical importance.

Giving proper attention to the process is an essential component for the success of the overall exercise. With this robust data collected, the board now has information and insight on which to build a solid working relationship with the CEO. It is not only recommended that the board chair (and vice chair perhaps) meet regularly to create an on-going forum for discussion but also recommended that the board do a mid-term evaluation using the same process. This provides a convenient time for the full board to weigh in during the cycle, to not only provide useful insights but to potentially course-correct, if necessary.

Overall, the CEO evaluation is a perfect opportunity to build a solid and meaningful relationship with the CEO, while ensuring clarity around what success looks like for the company. It complements the CEO dashboard which has a more laser-like focus on discrete metrics but nonetheless a declaration of where and how the CEO should be spending his/her time. Together, these are powerful tools that, in these days of increasing complexity experienced across all industries, serve as ways to align and streamline CEOs’ organizational priorities and behavioral expectations.

9. Are our annual performance targets sufficiently rigorous?

This issue continues to be a priority as proxy advisory firms and many institutional shareholders increasingly focus on companies whose performance targets (as disclosed in the same proxy as the company’s performance results) are not viewed as appropriately challenging. Increasing scrutiny by shareholder advisory firms and institutional investors are forcing compensation committees to become more proactive. With new data-backed capabilities regarding performance targets, Institutional Shareholder Services (ISS) and others have become better positioned to challenge companies’ targets relative to industry and general market performance.

Historically, many companies have not disclosed forward-looking annual performance targets. However, looking ahead, as investors have more visibility into pay and more opportunities to critique executive compensation strategies, boards will need to up their involvement in disclosing their views of the business cycle, estimated market conditions, and other factors impacting how and why performance targets are set. The approach should be to proactively communicate whatever information is necessary to ensure stakeholders are comfortable with how annual performance objectives are established.
10. What do the SEC’s 2018 enforcement actions on insufficient and/or inaccurate perquisite disclosures portend for 2019 perquisite disclosures?

During 2018 the SEC brought two enforcement actions relating to inadequate or non-existent perquisite disclosures.

- In the first case, the SEC found that from 2011 to 2015 the company failed to disclose approximately $3 million in perquisites as “other compensation” to its CEO in its annual proxy statements filed in 2013 to 2016. Specifically, the firm failed to apply the SEC’s perquisites test - which requires the disclosure of personal benefits not widely available and not integrally and directly related to an executive’s job duties. Not only was the company fined $1.75 million, it also was ordered to retain a consultant for a year to review its policies, controls and training for perquisites.

- In the second action, the company’s founder and former CEO was charged with not disclosing over $10 million in personal loans, which were obtained from company vendors (allegedly for business contracts) and from a candidate for its board (who weeks later was appointed to the board). Further, the SEC complaint alleged that the executive did not disclose these loans and also that the company failed to disclose approximately $1 million in additional compensation over a five-year period related to perks. To settle the claims, the executive agreed to not hold a corporate officer position for five years and paid a penalty of $180,000. Additional penalties totaling $260,000 were assessed against a portfolio manager and his firm for hiding the loan to the executive and failing to disclose the plan to place the portfolio manager on the board.

Companies are required to report in the Summary Compensation Table of their annual proxy statement (as “All Other Compensation”) perquisites and personal benefits if the total amount exceeds $10,000, and to identify each such item by type in a footnote, regardless of the amount. Companies also must maintain and evaluate quarterly the effectiveness of a company’s disclosure controls and procedures (i.e., those controls and other procedures that are designed to ensure that information required to be disclosed in the company’s filings with the SEC is recorded, processed, summarized and reported). Additionally, disclosure controls and procedures need to ensure that information required to be disclosed is accumulated and communicated to management to allow timely decisions regarding required disclosure.

In both cases, it appears that inadequate controls and/or procedures resulted in the exclusion of executive perquisites from the Summary Compensation Table. Given the SEC’s apparent increased scrutiny of executive perquisite disclosures, a take-away for companies and their boards is that internal controls apply not only to financial data, but also to the compilation of supplemental information disclosed in filings with the SEC. We recommend companies and boards review their controls and procedures, as well as ensuring the individuals responsible for compiling and capturing the data are adequately trained regarding the SEC perquisite disclosure rules and requirements.

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