Wachtell, Lipton, Rosen & Katz

Compensation Committee Guide

April 2024

About This Compensation Committee Guide

This Guide provides an overview of the key rules applicable to compensation committees of listed U.S. companies and practices that compensation committees should consider in the current environment. This Guide:

- ***outlines a compensation committee member's responsibilities;***

- ***reviews the composition and procedures of the compensation committee;***

- ***considers important legal standards and regulations that govern compensation committees and their members; and***

- ***recommends specific practices to promote compensation committee effectiveness in designing appropriate compensation programs that advance corporate goals.***

Although generally geared towards directors who are members of a public company compensation committee, this Guide also is relevant to members of a compensation committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

This Guide also contains a sample compensation committee charter as an Exhibit. This Exhibit is intended to assist a compensation committee in performing its designated functions. However, it would be a mistake for any company to simply copy published models. The creation of charters requires experience and careful thought. It is not necessary that a company have every guideline and procedure that another company has to be "state of the art" in its governance practices. When taken too far, an overly broad or detailed committee charter can be counterproductive. For example, if a charter explicitly requires the compensation committee to review a particular type of compensation arrangement, meet a stated number of times each year or take other action, and the compensation committee has not taken that action, then the failure may be considered evidence of lack of due care. Therefore, we recommend that each company tailor its compensation committee charter and written procedures to those that are necessary and practical for the particular company.

Compensation Committee Guide

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Introduction

As we begin 2024, the role of the compensation committee continues to evolve. All aspects of executive compensation remain a central focus of the committee's responsibilities. This varied menu includes, among other things, designing and adopting incentive compensation programs that appropriately align pay with performance, implementing appropriate change in control and severance arrangements, overseeing executive compensation disclosure, and engaging with shareholders on compensation programs. In addition to this continuing mandate, the purview of the compensation committee at many companies has been expanded to include oversight of the company's policies and practices relating to broader human capital matters, such as gender pay equity and diversity and inclusion.

As we enter the 2024 proxy season, compensation committee members are participating more actively than ever in the process of disclosing executive compensation and soliciting shareholder feedback. The preparation of the annual proxy statement has evolved into a purpose-driven collaboration among management, the compensation committee, the compensation consultant, and external legal counsel in an effort to produce a document that serves as an executive compensation mission statement, state-of-the-union update on the performance of the business, catalogue of shareholder engagement efforts, and, last but not least, a detailed disclosure document that must comply with technical disclosure rules, the scope and breadth of which are constantly expanding.

Compensation committees are also called upon to address unexpected, high-priority compensation and governance matters that may arise, including executive transitions. The ability to recruit, motivate and retain highly qualified executives remains a core mandate of the compensation committee and is essential to the long-term success of a company. Given the increasing mobility of executive talent, companies need to act decisively to secure those with proven track records by entering into long-term arrangements. Succession planning is equally vital, and boards should periodically assess the leadership pipeline and prepare for unexpected succession events.

Compensation committees also play a significant role in corporate transactions, where directors are often called upon to approve appropriate retention and severance protections for their corporate leaders (affording more freedom for those leaders to advance the interests of the corporation and its shareholders).

As the role of the compensation committee expands and adapts, committee members can benefit now more than ever from having a working

knowledge of the key legal considerations surrounding the compensation committee's mandate. As in prior years, the primary objectives of this Guide are to review the responsibilities of public company compensation committee members and to provide information to enable these individuals to function most effectively. Because of the complexity surrounding executive compensation and other matters entrusted to the compensation committee, including with respect to tax, accounting, disclosure and governance issues, it would not be practical to expect compensation committee members to possess the technical expertise to identify and solve them all. This Guide is a resource to help orient compensation committee members to the relevant considerations and provides directors with the information necessary to enable them to ask the right questions of management and advisors in fulfilling their duties.

I.

Compensation Committee Membership

In enlisting qualified directors to sit as members on a compensation committee, attention must be paid to the various membership requirements imposed by the securities exchange on which the company is listed, Rule 16b-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and state law.

A. Independence Standards of the Major Securities Markets[1]

The New York Stock Exchange (the "NYSE") and the Nasdaq Stock Market ("Nasdaq") generally require that members of listed company compensation committees satisfy the general independence standards of the applicable exchange.

1. Independence Generally

Both the NYSE and Nasdaq have adopted rules as to who can qualify as an independent director. As a general matter, these independence rules ask whether the director is a non-management director free of any material business relationships with the company and its management in the past three years (other than owning stock and serving as a director). Both markets:

- require that the board of directors of a listed company makes an affirmative determination, which must be publicly disclosed, that each director designated as "independent" has no material relationship with the company that would impair the director's independence; and

- include in the applicable rules a specific list of relationships that disqualify a director from being considered independent. These disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. Note that ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude a board of directors from determining that a director is independent.

[1] For additional discussion of the NYSE and Nasdaq independence requirements, *see* Wachtell, Lipton, Rosen & Katz, *Nominating and Corporate Governance Committee Guide*.

The following relationships generally will bar a director from satisfying the independence standards of the NYSE or Nasdaq, as applicable:

- the director is, or has been within the last three years, an employee of the company or of any parent or subsidiary of the company,[2] *except* that former employment as an interim executive officer (which under the Nasdaq rules cannot last for more than one year)[3] does not, in and of itself, disqualify a director from being considered independent following such employment;

- an immediate family member[4] of the director is, or has been within the last three years, an executive officer of the company or of any parent or subsidiary of the company;

- the director is a current partner (or employee, under the NYSE rules) of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);

- an immediate family member of the director is a current partner of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);

- under the NYSE rules, an immediate family member of the director is a current employee of the company's internal or external auditor and personally works on the company's audit;

- the director or an immediate family member was, within the last three years, a partner or employee of a firm that is the company's external auditor (or internal auditor, under the NYSE rules) and personally worked on the company's audit at any time within that period;

- under the NYSE rules, the director or an immediate family member of the director is, or has been within the last three years, an executive officer of another company where any of the company's present

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[2] Both the NYSE and Nasdaq define "company" to include a parent or subsidiary in a consolidated group with the company.

[3] The Nasdaq rules stress, however, that the board still must consider whether such former employment and any compensation received would interfere with a director's exercise of independent judgment in carrying out the responsibilities of a director.

[4] General Commentary to Rule 303A.02(b) of the NYSE Listed Company Manual defines "immediate family member" as a person's spouse, parents, children, siblings, mothers—and fathers-in-law, sons—and daughters-in-law, brothers—and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. Nasdaq Rule 5605(a)(2) defines "family member" as a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.

executive officers at the same time serves or served on that other company's compensation committee;

- under the Nasdaq rules, the director or an immediate family member of the director is an executive officer of another entity where, at any time during the past three years, any of the executive officers of the company served on the compensation committee of such other entity;

- under the NYSE rules, the director is a current employee, or an immediate family member of the director is a current executive officer, of a company that has made payments to, or received payments from, the company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of $1 million or 2% of such other company's consolidated gross revenues;[5]

- under the Nasdaq rules, the director or an immediate family member of the director is a partner, controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year or $200,000, whichever is greater;[6]

- under the NYSE rules, the director or an immediate family member of the director has received during any 12-month period within the last three years more than $120,000 in direct compensation (*i.e.*, not investment income)[7] from the company, *except* for (1) director and committee fees and pension or other forms of deferred compensation for prior service (*provided* that such compensation is not contingent in any way on continued service), (2) compensation received by an immediate family member for service as a non-executive employee and (3) compensation received by a director for former service as an interim executive officer of the company;

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[5] The NYSE specifies that both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year of such other company. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

[6] The Nasdaq rules exclude from the calculation payments arising solely from investments in the company's securities and payments under nondiscretionary charitable contribution matching programs.

[7] In addition, the NYSE's focus on "direct" compensation means that *bona fide* and documented reimbursement of expenses also may be excluded. Note, however, that the NYSE considers payments to a director's solely owned business entity to be direct compensation.

- under the Nasdaq rules, the director or an immediate family member of the director received any compensation (*i.e.*, whether direct or indirect compensation)[8] from the company in excess of $120,000 during any 12-month period within the last three years, *except* for (1) director or committee fees, benefits under tax-qualified retirement plans or nondiscretionary compensation, (2) compensation paid to an immediate family member for service as a non-executive employee and (3) compensation received by a director for former service as an interim executive officer of the company for not longer than one year;[9] and

- under the Nasdaq rules, the director, while serving as an interim executive officer, participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

Independence determinations must be based on all relevant facts and circumstances. Thus, even if a director meets all the bright-line criteria set out above, the board is still required to make an affirmative determination that the director has no material relationship with the company.

In addition, under disclosure rules promulgated by the U.S. Securities and Exchange Commission (the "SEC"), for each director who is identified as independent, the company must describe, by specific category or type, any transactions, relationships or arrangements (other than transactions already disclosed as related-party transactions) that were considered by a board of directors under the company's applicable director independence standards (*e.g.*, the NYSE or Nasdaq independence rules).

2. Independence for Compensation Committee Members

The stock exchanges require listed companies to have a compensation committee, which must be composed entirely of independent directors.[10] When evaluating the independence of any director who will serve on the compensation committee, the NYSE rules require a board of directors to consider all relevant factors that could impair independent judgments about executive compensation, including, but not limited to: (1) the

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[8] For instance, Nasdaq provides that political contributions to the campaign of a director or an immediate family member of the director would be considered indirect compensation, and, as such, must be included for purposes of the $120,000 threshold.

[9] The Nasdaq rules stress, however, that the board must still consider whether such compensation would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director.

[10] NYSE Listed Company Manual, Rules 303A.05 and 303A.07; Nasdaq Listing Rules 5605(c)(2)(a) and 5605(d)(2)(a).

source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the company; and (2) whether the director is affiliated with the company or one of its subsidiaries or affiliates. The Nasdaq rules prohibit compensation committee members from accepting any consulting, advisory or other compensatory fees from the company or its subsidiaries (other than directors' fees).

In "exceptional and limited circumstances," Nasdaq permits one director who does not meet its independence rules to serve on the compensation committee without disqualifying the compensation committee from considering the compensation matters that ordinarily would be entrusted to it had it been fully independent. Specifically, if a compensation committee is composed of at least three members, one non-independent director (who is not a current officer or employee or a family member of an officer or employee) may be appointed to the compensation committee if the board of directors, under exceptional and limited circumstances, determines that such individual's membership on the compensation committee is required by the best interests of the company and its shareholders.[11] If the board of directors takes this approach, then it must disclose either on or through the company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its annual report on Form 10-K or Form 20-F) the nature of the relationship and the reasons for the determination. A member appointed under this exception may serve a maximum of two years. Since certain equity compensation arrangements that are exempted from the Nasdaq shareholder approval requirement must be approved by the company's independent compensation committee or a majority of its independent directors as a prerequisite to taking advantage of such exemption, a company with a non-independent member of the compensation committee would need to seek approval of a majority of the independent directors for this purpose.[12] The NYSE does not provide a similar exemption.

Separately, newly listed companies on the NYSE or Nasdaq need only have one independent member of the compensation committee at the time of the company's initial public offering, a majority of independent members within 90 days of listing, and a fully independent committee within one year of listing. If a newly listed Nasdaq company chooses not

[11] Nasdaq Listing Rule 5605(d)(2)(B).

[12] Nasdaq Listing Rules 5635(c)(2) and (c)(4). Under these Nasdaq rules, shareholder approval is required before the issuance of securities when an equity compensation plan is to be established or materially amended, except for, among other things, tax-qualified nondiscriminatory employee benefits plans that are approved by the company's compensation committee and certain "sign-on" equity compensation awards that are approved by the company's compensation committee.

to have a compensation committee and to have, instead, a majority of the independent directors discharge the duties otherwise associated with a compensation committee, then the company may rely on Nasdaq's phase-in of one year for its separate requirement that there be a majority of independent directors on the board of directors.

3. Non-Employee Director

Section 16(b) of the Exchange Act provides that a company insider, such as a director or officer, is liable to the company for any profits resulting from the company insider's purchase and sale of the company's equity securities within any period of less than six months. The statute and the rules promulgated thereunder are quite broad, such that, absent an exemption, the granting, exercise and settlement of equity compensation to an officer or director of the company may be subject to this prohibition and subject the officer or director to liability for short-swing profit if the officer or director has opposite-way transactions during a six-month period. In an effort to address this issue, the SEC adopted Rule 16b-3 under the Exchange Act, which exempts, among other things, grants and awards by the company of its securities to an officer or director if approved in advance and with specificity by a committee composed solely of two or more "non-employee directors."

Under Rule 16b-3, to qualify as a non-employee director, the director cannot: (1) be an officer or employee of the company (or of a parent or subsidiary 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) of Regulation S-K.

Disclosure under Item 404(a) is required for any "transaction" since the beginning of the company's last fiscal year or any currently proposed transaction in which the company is a participant, if the amount involved exceeds $120,000 and any "related person" had or will have a direct or indirect material interest in the transaction. Under the disclosure rules, the term "related person" means any person who was at any time during the relevant period: (1) a director or executive officer of the company; (2) any nominee for director (but only if the disclosure is being presented in a proxy or information statement relating to the election of that nominee for director); (3) an immediate family member of a director, executive officer or nominee for director (if the proxy or information statement in which the disclosure is being made relates to the election of that nominee for director) of the company; or (4) a beneficial owner of more than 5% of the company's voting securities or an immediate family member of such

owner. "Transaction" for purposes of the rule includes any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. Employment relationships and director compensation otherwise disclosed under Item 402 of Regulation S-K (*i.e.*, the executive compensation disclosure rules) need not be disclosed.

The SEC disclosure rules also make clear that, even if the company disclosed a relevant related-party transaction in the company's filings for the most recent fiscal year, such transaction will not disqualify the director under Rule 16b-3 if the transaction was terminated prior to the director's proposed service as a non-employee director.

B. Ensuring Compensation Committee Membership Compliance

It is possible that a compensation committee member will be independent under the NYSE or Nasdaq rules, but will not be a non-employee director under Rule 16b-3 under the Exchange Act. If the compensation committee has directors that are independent but are not non-employee directors, full compliance with Rule 16b-3 is still possible. As long as a compensation committee possesses at least two directors meeting the definitional requirements of non-employee directors, the compensation committee can create a subcommittee consisting solely of two or more non-employee directors and delegate responsibility with respect to matters falling within the ambit of Rule 16b-3 to the subcommittee.

C. Ensuring Independence under State Law

Transactions between a company and its directors are subjected to intense judicial scrutiny under state law because of the inherent conflict between the corporate insiders' personal financial interests and the insiders' fiduciary duty to a company and its shareholders. To avoid such heightened judicial scrutiny of compensation arrangements, compensation arrangements should be approved by, and negotiated with, directors who are disinterested with respect to the compensation decision at issue.

While Delaware courts have, in some instances, appeared receptive to arguments that economically independent directors were disqualified by alleged noneconomic conflicts of interest, the determination of independence under state law generally requires only economic independence based on a facts-and-circumstances analysis. In one opinion, the Delaware Supreme Court, addressing the independence of certain directors of Martha Stewart Living Omnimedia, Inc.,[13] specifically addressed claims that social connections and personal friendships can

[13] *Beam* v. *Martha Stewart Living Omnimedia, Inc.*, 845 A.2d 1040 (Del. 2004).

result in disqualification from a finding of independence. In deciding *Martha Stewart*, the Court held that allegations of a mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. The court also reiterated its rejection of the concept of "structural bias," the supposition that the professional and social relationships that naturally develop among members of a board of directors impede independent decision-making.[14]

No doubt, each case of alleged director conflict of interest is different. Nonetheless, the case law supports the presumption that non-management directors are independent, unless there is real evidence to the contrary.

[14] *Id.* at 1050–52.

II.

Key Responsibilities of Compensation Committee Members

The SEC, the NYSE and Nasdaq require a listed company to have a compensation committee that assumes a number of compensation-related responsibilities. It also is advisable for compensation committees to assume certain additional responsibilities. It is important, therefore, that a compensation committee understand what is expected of it, and that it be diligent in ensuring that it appropriately and faithfully fulfills its mandate.

A. Responsibilities Imposed by the Securities Markets and the Dodd-Frank Act

1. New York Stock Exchange Requirements

The NYSE requires that all listed companies subject to its corporate governance listing standards have a compensation committee composed entirely of independent directors with a written committee charter that addresses all of the duties described in this section, that is published and printable on the company's website. The NYSE further requires that the compensation committee carry out a number of minimum responsibilities. While the responsibilities of a compensation committee may be delegated to subcommittees, for most listed companies, each subcommittee still must be composed entirely of independent directors and also have a published and printable charter.[15]

Under NYSE rules, a compensation committee must, at a minimum, (1) review and approve goals and objectives relevant to the chief executive officer's ("CEO") compensation, (2) evaluate the CEO's performance in light of such goals and objectives, and (3) either as a committee or together with the other independent directors, determine and approve the CEO's compensation based upon such evaluation. In determining the long-term incentive component of CEO compensation, the NYSE suggests that a compensation committee consider (a) the company's performance and relative shareholder return, (b) the value of similar incentive awards to CEOs at comparable companies and (c) the awards given to the CEO in past years.[16] Compensation committee responsibilities regarding CEO

[15] A listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company (known as a "controlled company") is exempt from these requirements.

[16] The NYSE clarifies that a compensation committee is not precluded from approving awards so as to comply with applicable tax laws, with or without ratification by the full board.

compensation do not preclude discussion of CEO compensation with the board of directors generally.

In addition, under NYSE rules, a compensation committee must have direct responsibility under its charter either to recommend non-CEO executive officer compensation to the board of directors, or to approve the non-CEO executive officer compensation directly.[17] This requirement means that a listed company's compensation committee must recommend, or approve, the compensation of the president, the principal financial officer (the "PFO" or "CFO"), the principal accounting officer (or, if there is no principal accounting officer, then the controller), any vice president of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs a similar policy-making function. A compensation committee also is charged with recommending to the board of directors the approval of incentive and equity-based compensation plans that are subject to board of directors' approval.[18] Additionally, the NYSE reiterates and adopts the SEC requirement that a compensation committee produce a report on executive officer compensation required to be included in the listed company's annual proxy statement or annual report on Form 10-K.

Under NYSE listing standards adopted in response to the Dodd-Frank Act, the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor, and is directly responsible for the appointment, compensation and oversight of that advisor's work. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisor. Prior to retaining an advisor (other than in-house legal counsel or an advisor that consults on broad-based plans that do not discriminate in favor of executive officers or directors or provides non-customized information), the compensation committee must take into consideration all factors relevant to that advisor's independence from management, including (1) whether the advisor's firm provides other services to the company;

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[17] Section 303A.05(b)(i)(B) of the NYSE Listed Company Manual states that the written charter of the compensation committee must address the committee's direct responsibility to "make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval." This requirement is further clarified in the commentary to the rule, which states "[n]ote also that nothing in Section 303A.05(b)(i)(B) is intended to preclude the board from delegating its authority over such matters to the compensation committee." We read this rule, together with the commentary, to mean that the compensation committee may be given either approval authority or recommendation authority over the matters covered by Section 303A.05(b)(i)(B).

[18] See *id*.

(2) the amount of fees from the company received by the advisor's firm relative to the total revenue of the advisor's firm; (3) conflict-of-interest policies of the advisor's firm; (4) any business or personal relationships between the advisor and members of the compensation committee; (5) any stock of the company owned by the advisor; and (6) any relationships between the advisor or the advisor's firm and an executive officer of the company. These rules do not require the compensation committee to retain only independent advisors; rather, they mandate that the compensation committee consider the above six factors (and any other factors, if relevant) before selecting an advisor.

Lastly, a compensation committee must conduct an annual self-evaluation of its performance. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants also have established advisory services to assist a committee with the evaluation process. A compensation committee must decide how to conduct its evaluation. In making the decision, it is not required that the directors receive outside assistance, and no specific method of evaluation is prescribed. A compensation committee may elect to do the evaluation by discussions at meetings. Documents and minutes created as part of the evaluation process are not privileged, and care should be taken not to create ambiguous records that may be used in litigation against the company and its directors.[19]

2. Nasdaq Requirements

Under Nasdaq listing standards adopted in response to the Dodd-Frank Act, Nasdaq-listed companies are now required to have a compensation committee consisting of at least two independent directors. Nasdaq also requires the compensation committee to have a formal charter, as described in greater detail in Chapter X of this Guide.

Under the Nasdaq rules, the compensation committee is responsible for determining, or recommending to the board of directors for determination, the compensation of the CEO and all other executive officers of the company.[20] The CEO is prohibited from attending meetings while the compensation committee members are deliberating or voting on the CEO's compensation under the Nasdaq listing standards. Nasdaq places no such restriction on other executive officer attendance and does not prohibit the attendance of the CEO during compensation committee discussions concerning other executive officer compensation.

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[19] For a brief discussion of the factors a compensation committee should consider in its annual self-evaluation, *see* Wachtell, Lipton, Rosen & Katz, *Nominating and Corporate Governance Committee Guide*.

[20] *See* Nasdaq Listed Company Manual Section 5605(d).

In certain circumstances, the compensation committee may include one non-independent member, as described above in Chapter I.A.2 of this Guide.

As with NYSE rules, Nasdaq rules provide that the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor, and is directly responsible for the appointment, compensation and oversight of that advisor's work. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisor. Nasdaq rules require the compensation committee to consider the six factors described above in this Chapter II, but do not expressly require the compensation committee to take into consideration all of the factors relevant to an advisor's independence from management.

B. CEO and Executive Officer Compensation

While both the NYSE and Nasdaq only require that a compensation committee recommend to the full board of directors non-CEO executive officer compensation, vesting complete authority in the compensation committee for such individuals is advisable, given the requirements of the insider trading short-swing profit exemption of Rule 16b-3 under Section 16(b) of the Exchange Act and state law fiduciary duty jurisprudence, both of which provide substantial incentives for the compensation of executive officers to be determined by a committee of independent directors. A more detailed discussion of the requirements of Rule 16b-3 under the Exchange Act is set forth in Chapters I and V of this Guide.

In evaluating and setting executive officer compensation, a compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, then a compensation committee should discuss whether, and to what degree, the criteria have been satisfied. That said, in response to unforeseen circumstances, such as the economic dislocations of 2020 due to the emergence of the Covid-19 pandemic, a compensation committee may find it necessary to evaluate whether preset financial goals still provide a meaningful measure of company performance. If not, the compensation committee may need to exercise discretion and rely on subjective judgments regarding individual and company performance.

Furthermore, to help ensure that compensation and severance packages are justifiable, members of a compensation committee should fully understand the costs and benefits of the compensation arrangements that they are

considering. Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment, as well as the impact of a change in control of the company on equity incentives and other compensation arrangements. It may be useful for a compensation committee to utilize a tally sheet, which provides a concise breakdown of the various components of a given executive officer's compensation package in scenarios that include continued employment, termination of employment and change in control of the company. And, as discussed below, given the pressure for compensation committees to consider non-executive officer compensation when setting compensation for senior executives, it would be prudent for compensation committees to be better educated as to how executive compensation arrangements fit within the broader compensation structures of the company.

C. Non-Executive Officer Compensation and Broad-Based "ERISA" Plans

There is no particular allocation of responsibilities for the compensation and benefits of a company's employees that is appropriate for every company. Companies should consider whether the compensation committee will have responsibility for employee compensation beyond that of executive officers. In addition, companies should consider whether the compensation committee will have responsibility for risk oversight in incentive compensation plans for all employees, as discussed below in this Chapter II. Limiting a compensation committee's responsibility to executive officer compensation may make sense for many companies so that directors can concentrate their limited time and resources on establishing proper incentives for those employees who are most likely to influence company performance. However, companies should be mindful that due to increased focus on pay ratios and shareholder litigation surrounding compensation issues generally, it may be useful for compensation committees to increase their oversight of total compensation expenditures (*e.g.*, bonus compensation in financial institutions). Ultimately, the full board of directors is charged with allocating compensation responsibilities, but the compensation committee may be best equipped to make recommendations to the full board of directors concerning the compensation committee's scope of responsibility.

As noted in Chapter III of this Guide, a compensation committee also may have fiduciary responsibilities under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), for certain broad-based employee benefit plans, either as a result of language in plan documents or the compensation committee's own charter, or by virtue of actually exercising such responsibilities. It is possible for a plan to state that the full board of directors or the compensation committee is responsible for

administering ERISA plans or for managing the investment of their assets, either of which will implicate ERISA's fiduciary duty rules, which in most instances require that the fiduciary act exclusively for the benefit of the plan participants. It may or may not be appropriate for a compensation committee to assume such responsibilities—as with shareholder litigation surrounding compensation issues generally, it may be more useful to limit the responsibility of boards of directors and their committees with respect to employee benefit plans—but, in any event, companies should ensure that the documentation and actual exercise of fiduciary responsibilities are consistent, and that all who are ERISA fiduciaries are aware of that fact and understand the legal responsibilities it entails.

D. Development of Compensation Philosophy

A compensation committee must develop a compensation policy tailored to the company's specific business objectives in order to evaluate, determine and meet executive compensation goals. It should be noted that a compensation policy not only makes good business sense, but the SEC requirements for the Compensation Discussion & Analysis section of the annual proxy statement (the "CD&A") require discussion of such a policy.

E. Compensation-Related Disclosure Responsibilities

A compensation committee should oversee compliance with all compensation-related disclosure requirements. Such compliance presents a significant challenge in light of the comprehensive SEC rules regarding disclosure of executive officer and director compensation. Compensation committee members should request that management review with them (1) potential disclosures that may be required in connection with compensation-related actions, including the timing requirements for any such disclosure, and (2) the nature of the information to be disclosed in upcoming public filings, including information relating to the compensation committee members themselves. Importantly, under current SEC guidance, a company that receives an SEC comment letter due to noncompliance with executive compensation disclosure rules will have to amend any materially noncompliant filings. Set forth below are the principal components of the executive compensation disclosure required each year.

1. Compensation Discussion and Analysis

The CD&A provides investors with material information necessary for an understanding of a company's compensation policies and decisions regarding the named executive officers ("NEOs"), which generally include the CEO, the CFO and the three most highly compensated executive officers other than the CEO and the CFO. In particular, the CD&A must

explain the rationale behind all material elements of NEO compensation, including the overall objectives of the compensation programs and the rationale underlying and method of determining specific amounts for each element of compensation. Under the Dodd-Frank Act, a company also must address in its CD&A whether (and if so, then how) the company has considered the results of the most recent say on pay vote in determining compensation policies and decisions.

The CD&A is considered "filed" with the SEC; accordingly, misleading statements in the CD&A expose a company to liability under Section 18 of the Exchange Act. In addition, to the extent that the CD&A is included or incorporated by reference into a periodic report, the disclosure is covered by the CEO and CFO certifications required by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). If forward-looking information is included in the CD&A, a company may rely on the safe harbors for such information.

2. Compensation Committee Report

A company must include a Compensation Committee Report in its proxy statement and its annual report on Form 10-K (incorporation by reference into the Form 10-K from the proxy statement is permitted). The Compensation Committee Report is required to state whether a compensation committee has reviewed the CD&A, discussed it with management and recommended to the board of directors that it be included in the company's proxy statement and Form 10-K. The names of the compensation committee members must appear below the report. To help ensure the accuracy of the Compensation Committee Report, the compensation committee should have detailed discussions with management concerning the CD&A in advance of the filing deadline.

3. Additional Annual Disclosure Regarding NEO Compensation

The SEC rules require quantitative elements of executive compensation of NEOs to be disclosed in tabular format, together with narrative explanations and footnotes that describe the quantitative disclosure. The central component of the tabular disclosure is the Summary Compensation Table, which discloses, by category, all compensation earned by each NEO during the prior fiscal year, including compensation attributable to salary, bonus, equity awards, change in pension value, earnings on nonqualified deferred compensation and perquisites.

Other required tables provide detailed information regarding:

- equity awards and bonus award opportunities granted to NEOs during the last fiscal year;

- outstanding equity awards at the end of the last fiscal year, including vesting schedule and exercise price, to the extent applicable;

- stock options that NEOs have exercised during the last fiscal year and NEO stock awards that have vested during the last fiscal year;

- pension plan participation by NEOs, including accumulated benefits and any payments during the last fiscal year; and

- NEO participation in deferred compensation plans, including executive and company contributions, earnings, withdrawals, distributions, and the aggregate balance at the last fiscal year-end.

Finally, companies must describe the circumstances in which a NEO may be entitled to payments and/or benefits upon termination of employment and/or in connection with a change in control and quantify the value of those payments and benefits as of fiscal year-end.

4. Director Compensation Table

The SEC rules[21] also require disclosure of a Director Compensation Table setting forth director compensation during the prior fiscal year in a format that is comparable to the Summary Compensation Table for NEOs, including disclosure with respect to perquisites, consulting fees and payments or promises in connection with director legacy and charitable award programs. Additionally, the company must provide narrative disclosure of its processes and procedures for the determination of director compensation. We discuss the considerations as to the substance of the Director Compensation Table in more detail in Chapter X of this Guide.

5. Compensation Committee Governance

Narrative disclosure regarding the governance of a compensation committee is also required by SEC rules. The narrative disclosure must describe a company's processes for determining executive and director compensation, including the scope of authority of the compensation committee; the extent to which the compensation committee may delegate its authority; and any role of executive officers and/or compensation consultants in making determinations regarding executive and/or director compensation. If compensation consultants play a role in determining executive and/or director compensation, then a company must include the disclosure described immediately below.

[21] *See* Item 402(k) of Regulation S-K, 17 C.F.R. § 229.402(k) and related Instructions.

6. Compensation Consultants and Advisors

SEC rules require annual disclosure of the role of compensation consultants in determining or recommending executive and director compensation, including:

- the identity of the consultants engaged;
- whether the consultants were engaged directly by the compensation committee;
- the nature and scope of the assignment; and
- under certain circumstances, the aggregate fees for the services provided.

The Dodd-Frank Act added another layer of requirements relating to compensation consultants, and the SEC has adopted related rules. Under these rules, a company must disclose whether the work of a compensation consultant who played any role in determining or recommending the form or amount of executive and director compensation raised any conflicts of interest, the nature of any such conflicts, and how the conflicts are being addressed.

In response to these requirements, the NYSE and Nasdaq adopted listing standards allowing a compensation committee to obtain advice from any advisor it wishes, whether or not the committee determines the advisor is independent from company management. However, as discussed above in this Chapter II, the compensation committee is required by the listing standards to consider certain independence factors before receiving advice from the advisor of its choosing. The practical result of these rules is that, generally, compensation consultants and legal advisors providing advice to compensation committees deliver annual letters to such committees containing any relevant information relating to each factor, in order for compensation committees to comply with the listing requirements.

7. Risk and Broad-Based Compensation Programs

To the extent that risks arising from a company's compensation programs for employees generally (not just executives) are reasonably likely to have a material adverse effect on the company, the SEC rules require a discussion in the annual proxy statement of the company's compensation policies and practices as they relate to risk management and risk-taking incentives. The threshold under the rules—reasonably likely to have a material adverse effect—sets a high bar for disclosure. A company should engage in a systematic process involving participants from its human

resources, legal and finance departments in which it (1) identifies company incentive compensation plans, (2) assesses the plans to determine whether they create undesired or unintentional risk of a material nature, taking into account any mitigating factors, and (3) documents the process and conclusions. If a company concludes that its programs are not reasonably likely to have a material adverse effect, then no disclosure is required; however, as a practical matter, it may be advisable to provide such disclosure because the proxy advisory firm Institutional Shareholder Services ("ISS") has encouraged disclosure about the review process and the company's conclusions and, to the extent that no disclosure is provided, the SEC may seek confirmation from the company that the risk review was done and that the company determined that disclosure was not required.

While the compensation committee need not be involved in the evaluation of risk as applied to incentive compensation arrangements themselves, the committee should satisfy itself that management has designed and implemented appropriate processes to make such evaluations.

8. Dodd-Frank Act Disclosure Requirements

In 2022, 12 years after the Dodd-Frank Act was adopted, the SEC completed the rule-making process for the executive compensation-related provisions under the Dodd-Frank Act by adopting long-awaited final rules regarding annual disclosure of the relationship between compensation actually paid to executive officers of a listed company and the financial performance of such company (the so-called "pay versus performance" disclosure) and regarding the recoupment of executive compensation (the so-called "clawback rule," discussed in more detail in Chapter V of this Guide).

a. Dodd-Frank Act Pay Versus Performance Rules

The Dodd-Frank Act required that the SEC promulgate rules requiring most listed companies (foreign private issuers, registered investment companies and emerging growth companies are exempt) to disclose the relationship between compensation actually paid to executives and the financial performance of the company in the proxy or information statements in which executive compensation disclosure is required under applicable rules. In 2022, the SEC adopted final pay versus performance rules, which most companies complied with for the first time in 2023.[22]

[22] *See* Pay Versus Performance, 87 Fed. Reg. 55134 (Sept. 8, 2022) (amending 17 C.F.R. pts. 229, 232, and 240), available here.

The final rules require companies to disclose in a table the following information for each of the company's last five completed fiscal years (or three completed fiscal years, for smaller reporting companies):

- the total compensation reported in the Summary Compensation Table for the company's principal executive officer (the "PEO") and an average of the reported amounts for the remaining NEOs;

- the compensation "actually paid" to the PEO and the *average* compensation "actually paid" to the company's NEOs other than the PEO (calculated by starting with the Summary Compensation Table amounts and making certain adjustments to the amounts included for pensions and equity awards, discussed in more detail below);

- the company's cumulative total shareholder return ("TSR") on an annual basis, as well as the cumulative TSR on an annual basis, of the companies in the company's peer group (as identified by the company in its stock performance graph or in its CD&A) expressed as the dollar value of an initial $100 investment over the measurement period;

- the company's net income for each fiscal year; and

- an amount for each fiscal year attributable to an additional financial performance measure included in the tabular list described below, which in the company's assessment represents the most important financial measure (other than TSR and net income) used by the company to link compensation actually paid to the company's NEOs for the most recently completed fiscal year to company performance.

Using the information presented in the tables described above, companies must describe the relationship between the executive compensation "actually paid" and the company's (i) cumulative TSR, (ii) net income, and (iii) company-selected measure, in each case across the required measurement period. The description must also include a comparison of the company's cumulative TSR and the cumulative TSR of the peer group over the required measurement period. This disclosure may be described as a narrative, graphically or using a combination of the two.

In addition, companies are required to provide a "tabular list" of three to seven financial performance measures, which in the company's assessment represent the most important financial performance measures used by the company to link compensation actually paid to NEOs, for the most recently completed fiscal year, to company performance. Companies may provide a single list, two lists (one for the PEO and one for other NEOs) or a separate list for each NEO. A company may include non-financial measures in the tabular list if it determines that such measures

are among its three to seven most important performance measures, and it has disclosed its most important three financial performance measures.

As mentioned above, executive compensation "actually paid" is calculated using compensation that companies report in the Summary Compensation Table as a starting point, with adjustments relating to pension amounts and equity awards. The adjustments required to calculate the equity award component of compensation "actually paid" illustrate the complexity of this rule. This value must include:

- for awards granted in a covered fiscal year that are outstanding and unvested as of the end of such year, the fair value of the awards as of the end of the fiscal year;

- for awards granted in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year, the change in fair value as of the end of the covered fiscal year (from the end of the prior fiscal year);

- for awards granted in any prior fiscal year (or in the same fiscal year) that become vested as of the end of a covered fiscal year, the change in fair value as of the vesting date (from the end of the prior fiscal year);

- for awards granted in prior fiscal years that fail to vest, a deduction for the amount of fair value at the end of the prior fiscal year; and

- the dollar value of any dividends paid on any award in a covered fiscal year prior to the vesting date of the award that are not otherwise included in the total compensation for the covered fiscal year.

As noted above, this disclosure is required for the last five fiscal years (or three fiscal years for smaller reporting companies). However, a "phase in" regime currently in effect allowed companies, other than smaller reporting companies, to provide the information for three years in the first proxy or information statement in which they provided the disclosure, adding another year of disclosure in each of the two subsequent annual proxy filings that require this disclosure. Smaller reporting companies were initially permitted to provide the information for two years, adding an additional year in their subsequent annual proxy or information statement that requires this disclosure. The first year of experience under the new rules required significant effort for most companies, as compliance involves substantial assimilation of data and preparation of narrative and tabular disclosure.

b. Pay Ratio Disclosure

The Dodd-Frank Act requires that annual proxy statements include annual disclosure of the ratio between the CEO's annual total compensation and the median compensation of all other employees.

Under the rules implemented by the SEC pursuant to the Dodd-Frank Act requirement,[23] for purposes of calculating the pay ratio, companies are required to consider the annual total compensation of "all employees" (other than the CEO and contract/leased workers) as of a date selected by the company within the last three months of its most recently completed fiscal year in order to identify its "median employee" against whose compensation the CEO's will be compared. Fortunately, the rules provide companies with flexibility when identifying the median employee, including that companies may narrow the relevant employee population by using statistical sampling or other reasonable methods, may identify the median employee using either (1) annual total compensation or (2) any other compensation measure that is consistently applied to all employees included in the calculation, and may make certain cost-of-living and annualizing adjustments in identifying the median employee and annual total compensation. The SEC has also issued guidance regarding the use of statistical sampling and other reasonable methodologies that has been helpful in establishing market practices as to calculations and disclosure of the elements of the CEO pay ratio.[24]

Under the rules, companies may use the same median employee for three consecutive years, unless there has been a change in the employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the pay ratio disclosure. Note that a public company must briefly describe in its annual proxy statement the methodology it uses to identify the median employee, and, if a company changes the methodology, and if the effects of any such change are significant, then the company must briefly describe the change and the reasons for the change.

Once a company's median employee is identified, the median employee's and the CEO's annual total compensation is to be determined in accordance with the disclosure rules that prescribe the calculation of total compensation for the NEOs for purposes of the Summary Compensation Table included in the annual proxy statement. Several compensation consulting firms have created sophisticated pay ratio tracking systems, allowing companies to research the median and/or average pay ratios

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[23] *See* Item 402(u) of Regulation S-K, 17 C.F.R. § 229.402(u) and related Instructions.

[24] *See* SEC, *Division of Corporate Finance Guidance on Calculation of Pay Ratio Disclosure*.

within their industries.[25] Based on a sampling of 200 large public companies across a variety of industries, as of fall 2023, the median CEO pay ratio was 213:1 and the average CEO pay ratio was 328:1.[26]

c. Hedging Disclosure

An SEC rule issued pursuant to the Dodd-Frank Act requires companies to describe their policies regarding the hedging of company equity securities that are held, directly or indirectly, by employees (including officers) or directors or to state that they do not have any such policies.[27] The required disclosure covers equity securities (whether or not compensatory) of a company, its parent or subsidiary and any other subsidiary of its parent. A policy may be disclosed verbatim or in summary form. The rule does not define key terms such as "hedging" or "held, directly or indirectly," but the promulgating release makes clear that these phrases should be interpreted broadly. The rule covers emerging growth companies and smaller reporting companies, but does not apply to foreign private issuers.

It is worth highlighting that this rule only requires disclosure. It does not prohibit hedging transactions or mandate that a company adopt a hedging policy. That said, the requirement to disclose the presence of absence of a hedging policy appears to have created a general practice of adopting such a policy.

9. Current Reports on Form 8-K

A company must report certain material actions and events relating to (1) the appointment, retirement, resignation or termination of service of directors, NEOs, and other specified senior officers, or (2) the compensation of NEOs, in a Current Report on Form 8-K within four business days following the occurrence of the action or event.

Under applicable SEC guidance, the disclosure obligation relating to resignation or retirement is triggered by notice of a decision, whether or not in writing, but the question of whether communications represent discussion or consideration or an actual notice of a decision is a facts-and-circumstances determination. Given the timing requirements associated with Form 8-K, it is important that members of the compensation

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[25] *See, e.g.*, Farient Advisor's CEO Pay Ratio Tracker, which monitors the S&P 500 and Russell 3000 companies' CEO pay ratios, available here.

[26] *See* Meridian Compensation Partners LLC, *2023 Corporate Governance & Incentive Design Survey* (Fall 2023), available here.

[27] *See* Item 407(i) of Regulation S-K, 17 C.F.R. § 229.407(i) and related Instructions.

committee and other directors be mindful of this distinction when discussing potential officer departures, especially when the departures are a result of a determination by a board of directors to act swiftly, or if there is an unexpected resignation by a covered officer. The officers covered by this reporting requirement are broader than just NEOs, and are as follows: principal executive officer, principal financial officer, principal accounting officer, principal operating officer, any person performing a similar function as that of the foregoing, and any NEO not already identified in this list.

In addition, the adoption or material amendment of a material compensatory plan, contract or arrangement with the principal executive officer, principal financial officer or any NEO must be disclosed on Form 8-K. The determination of whether a Form 8-K is required in respect of a compensatory action for a particular officer is not always black-and-white and there are meaningful exceptions that may apply with respect to ordinary-course compensation decisions, including that an award that is materially consistent with the previously disclosed terms of a plan need not be disclosed on Form 8-K if it is disclosed when Item 402 of Regulation S-K requires such disclosure. The SEC has issued a variety of guidance on these questions to help listed companies ensure they comply with the Form 8-K disclosure rules.[28]

Form 8-K disclosure is also implicated when a company elects a new director, except by vote of security holders, and when a director retires, resigns, is removed, or refuses to stand for re-election (with substantial incremental disclosure required where any director has resigned or refuses to stand for re-election because of a disagreement with the registrant, known to an executive officer of the registrant, on any matter relating to the registrant's operations, policies or practices).

10. Conclusion

The importance of clear, thorough compensation disclosure that effectively conveys the business rationale for executive compensation decisions is greater than ever, due to the significant attention from the SEC, the media, shareholders and corporate governance activists and as a result of the heightened disclosure obligations due to the CEO pay ratio and pay versus performance rules. Companies should expect heightened scrutiny of and, accordingly, clearly explain the basis for, pay levels relative to total shareholder returns, termination and change in control payments, benchmarking practices, the existence and nature of

[28] *See* the Compliance and Disclosure Interpretations of the Corporate Finance Division of the SEC, available here.

compensation clawback policies and the relationship between particular compensation arrangements and risk.

F. Internal Controls

As part of the compensation committee's responsibility to oversee compliance with legal rules affecting compensation, it should oversee compensation disclosure procedures and the company's compensation-related internal controls. Companies should track and gather the information required under the compensation disclosure rules. Individuals to be included in the Summary Compensation Table must be determined by reference to total compensation (excluding the amounts included in the change in pension value and nonqualified deferred compensation columns).

Note that these individuals also constitute "covered employees" within the meaning of Section 162(m). As such, companies should make sure that they track all components of compensation for their executive officers, including the value of perquisites, tax gross-ups and amounts paid/accrued in connection with a termination of employment or a change in control. The expansion of Section 162(m) in 2017 to make "covered employee" status permanent—once a "covered employee," always a "covered employee"—compounds the importance of maintaining accurate records of this status, and a further expansion under the American Rescue Plan Act of 2021 that is slated to take effect in 2027 will increase the scope of the necessary tracking. Likewise, public companies must have clear rules and records regarding "specified employees," within the meaning of Section 409A of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), in order to ensure compliance with the required six-month delay of deferred compensation payments triggered by a separation from service.

G. Equity Compensation Grant Policy

Companies should review the manner in which equity compensation awards are granted to employees and directors, particularly in light of new SEC disclosure requirements that will soon take effect. While any given company's equity grant practices will be tailored to the company's particular business and administrative needs, each company should consider establishing a written equity award grant policy that complies with, and specifies that grants will be made in accordance with, applicable plan provisions, state law, the compensation committee charter and any applicable equity compensation plans. A comprehensive equity award grant policy will safeguard against the risk of ill-timed grants and preserve the flexibility to grant off-cycle awards under exceptional circumstances.

New Item 402(x) of Regulation S-K requires a registrant to discuss its policies and practices on the timing of option awards in relation to the disclosure of material nonpublic information, including how the board determines when to grant such awards; whether (and, if so, how) the board takes material nonpublic information into account when determining the timing and terms of such an award; and whether the registrant has timed the disclosure of material nonpublic information for the purpose of affecting the value of executive compensation.

If, during the last completed fiscal year, a registrant awarded options to a named executive officer in the period *beginning four business days before* the filing of a periodic report on Form 10-Q or Form 10-K, or the filing of a current report on Form 8-K that discloses material nonpublic information (MNPI), and ending one business day after the filing of such report, Item 402(x) requires the registrant to disclose the grant date, number of shares covered, per share exercise price, and grant date fair value of the award, as well as the percentage change in the closing price of the shares covered by the award between the trading day ending immediately prior to disclosure of the MNPI and the trading day beginning immediately following disclosure of the MNPI.

A registrant with a calendar year fiscal year must include these new disclosures in its Form 10-K or annual proxy statement filed in 2025. In order to avoid potentially difficult disclosures in the future, companies should evaluate their grant practices now.

H. Management Succession

Planning for succession of the CEO and other senior executives is critical for the long-term success and stability of any public corporation. The board should evaluate annually the status of future generations of company leadership. To the extent that a company has not given responsibility for executive succession to its nominating and governance committee, it should consider charging the compensation committee with responsibility for management development and succession strategy.

The smoothest successions involve planned transitions where there is time for a comprehensive board process and to prepare the communications rollout to key stakeholders. No two successions are exactly alike, but most involve similar work streams for a company and its advisors:

- negotiating exit terms with the outgoing executive and employment terms with the successor;

- preparing communications and SEC filings; and

- executing an effective communications rollout.

Managing a smooth board process is paramount. The board must understand the compensation costs, including any accounting impact, for both the outgoing and the incoming executive. A company that is unprepared for succession is vulnerable. And an uncertain situation can result in negative publicity, lack of focus, internal dysfunction, activist attack/criticism and unsolicited takeover offers.

Any succession strategy should include an emergency action plan, including:

- prior identification of an interim (or permanent) successor;
- having a protocol for calling emergency board meetings and preserving the record of such meetings;
- maintaining a list of key internal and external advisors, including public relations experts who can be relied upon to act quickly on the list of actions required;
- identifying and keeping track of key stakeholders—whether inside or outside of the organization—to whom prompt outreach may be important upon announcement of the leadership change;
- understanding disclosure obligations—both as to timing and substance of the departure of the officer and replacement thereof; and
- establishing a detailed timeline and clear chain of command.

It is not unusual for a board to learn on a Friday afternoon that it needs to announce a new CEO by Monday morning. Having an emergency plan in place will make things proceed as smoothly as possible.

I. The Role of the Compensation Committee in Risk Oversight of Incentive Compensation

As discussed above, the SEC has adopted disclosure rules that require discussion in proxy statements of the board of directors' role in overseeing risk and the relationship between a company's overall employee compensation policies and risk management. In addition, the regulatory framework applicable to financial institutions, as described in Chapter VI of this Guide, requires all financial institutions to evaluate incentive compensation and related risk management, controls and governance processes, and to address deficiencies or processes inconsistent with safety and soundness.

While the compensation committee cannot and should not be involved in actual day-to-day risk *management*, directors should, through their risk *oversight* role, satisfy themselves that management has designed and implemented risk-management processes that (1) evaluate the nature of the risks inherent in compensation programs, (2) are consistent with the company's corporate strategy, and (3) foster a culture of risk-aware and risk-adjusted decision-making throughout the organization.

In overseeing risk in incentive compensation programs, the compensation committee should take into account the company's overall risk-management system and tolerance for risk throughout the organization and should discuss with members of the committee charged with risk oversight the most material risks facing the business. The ability of the compensation committee to perform its oversight role effectively is, to a large extent, dependent upon the flow of information among the directors, senior management and the risk managers in the company. Compensation committee members need to receive sufficient information with respect to the material risk exposures affecting the company and the risk-management strategies, procedures and infrastructure designed to address them.

For instance, a non-exhaustive list of some of the features that may impact the risk profile of an incentive compensation program includes: the number of participants; whether metrics are risk-adjusted (*e.g.*, based on economic profit), and/or revenue- or transaction-based metrics; whether there are multiple metrics and whether those metrics are based on broader company or business unit performance or based on the individual's performance; and whether the compensation committee has discretion to adjust compensation up or down.

The measurement, determination and adjustment of payouts can also have an impact on the risk profile of an incentive compensation program, and can include the size of aggregate and individual payouts, whether goals and award levels are within narrower or broader ranges, and whether the awards are all-or-nothing v. tiered payouts. The maximum amount of potential revenue and potential losses or liabilities that could result from the businesses covered by the program and/or the plan also can have an impact.

If it is determined that a program has the potential to incentivize employees to assume excessive risks, then risk-mitigation techniques should be implemented to calibrate those programs to the risk profile of the organization. Potential mitigation tactics include lengthening performance periods, implementing clawbacks, deferring payment of earned performance awards, limiting the transferability of stock received in respect of equity awards, deleveraging payouts and applying downward

adjustments for adverse outcomes. Chapter VI of this Guide has a more detailed discussion of these strategies and others in the context of the proposed rules applicable to financial institutions, but the fundamental principles have universal relevance.

III.

Fiduciary Duties of Compensation Committee Members

A. Fiduciary Duties Generally

Decisions by members of compensation committees with respect to executive compensation are generally subject to the business judgment rule.[29] In addition, states such as Delaware have enacted laws to permit a company incorporated in the applicable state to, in its certificate of incorporation, either limit or eliminate the personal liability of a director to the company or its shareholders for monetary damages for breach of fiduciary duty, but such laws do not allow a company to limit or eliminate the liability of a director for, among other things, (1) breach of the director's duty of loyalty to the company and its shareholders, or (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law.[30] In order to ensure directors are protected from personal liability for exercising discretion on matters that come before them, many Delaware and other corporations have acted to limit or eliminate personal liability of directors to the extent permitted by such laws.

1. Business Judgment Rule

Under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Under this presumption, directors' decisions will not be disturbed unless a plaintiff is able to carry its burden of proof in showing that a board of directors has not met its duty of care or loyalty.

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[29] *See, e.g.*, *In re Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. 5215-VCG, 2011 Del. Ch. LEXIS 151, *45 (Del. Ch. Oct. 12, 2011); *Campbell* v. *Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 800 (6th Cir. 2001) ("evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts").

[30] *See, e.g.*, *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984). The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good-faith omissions. *Arnold* v. *Society for Sav. Bancorp, Inc*., 650 A.2d 1270, 1286–87 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

a. Duty of Care

The core of the duty of care is characterized as a director's obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of experts.[31] To show that a board of directors has not met its duty of care, a plaintiff must prove that director conduct has risen to the level of "gross negligence."[32] In addition, Delaware statutory law permits directors in exercising their duty of care to rely on certain materials and information.[33] Accordingly, directors charged with approving compensation arrangements should be familiar with the purpose of the arrangements and the nature of the benefits and should reasonably understand the costs; in so doing, directors may reasonably rely on the reports of their committees and advisors.

b. Duty of Loyalty

The duty of loyalty requires directors to act in the best interests of the company. Subsumed within this duty of loyalty is the directors' duty to act in good faith. In the landmark *Disney* case,[34] shareholders filed suit alleging that the board of directors did not act in good faith in approving the roughly $140 million employment and termination package of former Disney President, Michael Ovitz. The Court ruled that an appropriate measure for determining that a director has acted in good faith is whether there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities." Negligence—that is, a failure to use due care—should not result in personal liability unless the director failed to act in "good faith." The Court further ruled that a director fails to act in good faith when the director (1) "intentionally acts with a purpose other than that of advancing the best interests of the corporation," (2) "acts with the intent to violate applicable positive law," or (3) "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[35]

The *Disney* decision also made clear that, although directors are encouraged to employ evolving best practices of corporate governance, directors will not be held liable for failure to comply with "the aspirational

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[31] *Smith* v. *Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (holding that, in the context of a proposed merger, directors must avail themselves of all "information . . . reasonably available to [them] and relevant to their decision" to recommend the merger).

[32] *See Aronson*, 473 A.2d at 812 ("under the business judgment rule, director liability is predicated upon concepts of gross negligence").

[33] 8 Del. Code Ann. § 141(e).

[34] *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

[35] *Id*. at 755.

ideal of best practices." In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self-interest, and, in so doing, will not be subject to "*post hoc* penalties from a reviewing court using perfect hindsight."[36] As the Court noted, shareholder redress for failures that arise from faithful management "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."[37]

In the *Disney* case, the Delaware Court also rejected a claim that the Ovitz pay package amounted to corporate waste because the contract providing for his severance pay had a rational business purpose—that of attracting Mr. Ovitz to join Disney. The "rational business purpose" test is a high hurdle for claims based on waste. Nevertheless, the Delaware Court of Chancery refused to dismiss a corporate waste claim against the Citigroup board arising from the payment of $68 million to its retiring CEO, Charles Prince.[38] In return for the $68 million payment, Prince agreed to sign non-compete, non-disparagement, and non-solicitation agreements and a release of claims against Citigroup. The Chancellor's refusal to dismiss the waste claim was based on his desire to review information regarding the value of the various promises made by Prince relative to the payments he received.[39]

In October 2011, the Delaware Court of Chancery reaffirmed the traditional principles of the common law of executive compensation in dismissing a wide-ranging shareholder challenge to compensation practices at Goldman Sachs, which included claims based on waste and the board's failure to act in good faith, to be adequately informed and to monitor the company.[40] In particular, the Court noted that "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment,"[41] and, if the shareholders disagree with the board's judgment, their remedy is to then replace board members through directorial elections.[42]

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[36] *Id.* at 698.

[37] *Id*.

[38] *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009).

[39] *Id.*

[40] *In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG, 2011 Del. Ch. LEXIS 151 (Del. Ch. Oct. 12, 2011).

[41] *Id.* at 45.

[42] *Id.* at 46.

It should be noted that, in 2016, the Delaware Court of Chancery ordered YAHOO! Inc.[43] to produce certain books and records under Section 220 of the Delaware General Corporation Law to Amalgamated Bank, as trustee for certain stockholders, regarding the hiring and subsequent firing of YAHOO!'s Chief Operating Officer, Henrique de Castro. In its opinion, the Court found similarities to the *Disney* case: a CEO hiring a number-two executive, poor performance by the number-two executive and a no-fault termination that resulted in a large payment to the terminated executive (*i.e.*, approximately $60 million in cash and accelerated equity awards). According to the Court, based on publicly available information and certain information provided by YAHOO!, there was a credible basis to suspect wrongdoing, including possible breach of fiduciary duties, by the board and the CEO, and possible corporate waste.[44] Although the opinion does not represent a finding by the Court that there was in fact a breach of fiduciary duty or corporate waste, it highlights the importance of providing material information to a board of directors in executive compensation determinations and of facilitating a meaningful review and evaluation of such information before approval of compensation actions.

The protection of the business judgment rule is also important with regard to decisions about employment status of executive officers that have significant compensation consequences. In the 2023 dismissal of a stockholder complaint filed against the directors of McDonalds,[45] the Delaware Court of Chancery held that the business judgment rule protected a decision by directors to terminate the CEO without cause. Stockholders had alleged that company directors breached their fiduciary duties by terminating the employment of the company's CEO without cause in November 2019 after learning that the CEO had engaged in an inappropriate relationship with an employee. The plaintiffs alleged that the director defendants could have terminated the CEO for cause but acted in self-interest in approving a without-cause termination in order to avoid attracting litigation that would expose their own failures to address the Company's problems with sexual harassment and misconduct (the company had terminated another senior executive for cause during the same month it terminated the CEO's employment). The complaint also alleged that the directors committed corporate waste by allowing the CEO to keep millions of dollars in compensation while obtaining comparatively little for the company in return. The court found that the record showed that the director defendants had engaged meaningfully in assessing the

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[43] *Amalgamated Bank, Trustee for the Longview LargeCap 500 Index Fund and the LongView LargeCap 500 Index VEBA Fund* v. *YAHOO! Inc.*, 132 A.3d 752 (Del. Ch. Feb. 2, 2016).

[44] *Id.* at 783–84.

[45] *In re McDonald's Corp Stockholder Derivative Litigation*, C.A. 2021-0324-JTL (Del. Ch. Mar. 1, 2023).

termination and that the business judgment rule protected the decisions of the directors, noting "[r]reasonable minds can disagree about whether the Director Defendants made the right decision by opting initially to terminate the CEO without cause. Even if the Defendant Directors made an objectively wrong decision, the business judgment rule protects them for liability for a good faith error." With respect to the waste claim, the court found that although reasonable minds could disagree with the actions of the directors, the bargain was not so "out of whack" as to constitute waste.

2. Adopting or Amending Compensation Arrangements in the Context of Corporate Transactions; Conflicts of Interest Transactions

Adopting or amending compensation arrangements in the context of takeover activity or certain negotiated transactions can result in heightened judicial scrutiny. If the adoption or amendment of a compensation arrangement is deemed a defensive measure taken in response to an actual or threatened takeover, then the adoption will be subject to judicial review under an "enhanced scrutiny" standard,[46] which looks both to the board of directors' process and its action. That said, a compensation arrangement will not be subjected to enhanced scrutiny merely because a board of directors adopts a compensation arrangement in the face of a takeover threat; in order for enhanced scrutiny to apply, a board of directors must have entered into the compensation arrangement as a defensive measure.[47] If the arrangement was adopted as a defensive measure, the directors carry the burden of proving that their process and conduct satisfy a two-pronged test (known as the *Unocal* standard):[48]

- a board of directors must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," which may be shown by the directors' good-faith and reasonable investigation; and

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[46] *See, e.g.*, *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Gilbert* v. *El Paso Co.*, 575 A.2d 1131, 1143–44 (Del. 1990) (subjecting the "golden parachute" employment arrangement among target's defensive measures to enhanced scrutiny).

[47] *See, e.g.*, *Moore* v. *Wallace Computer Servs*., 907 F. Supp. 1545, 1556 (D. Del. 1995) ("In addition . . . the facts [sic] that such agreements are commonplace among chief executives of major companies and that Cronin's severance package was identical to that of his predecessor, persuade this Court that the adoption of the golden parachute agreement was not a defensive measure.").

[48] *Unocal*, 493 A.2d at 955.

- a board of directors must show that the defensive measure chosen was "reasonable in relation to the threat posed," which may be demonstrated by the objective reasonableness of the course chosen.[49]

If directors can establish both prongs of the *Unocal* test, their actions will receive the protections of the business judgment rule. While the *Unocal* standard still provides a board of directors reasonable latitude in adopting defensive measures,[50] executive compensation plans adopted in response to a takeover threat may result in a court more closely examining a board of directors' process and actions.[51] Therefore, adopting or amending change in control *employment* arrangements in advance of an actual or threatened takeover may be advisable whenever possible.[52]

When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the most exacting standard, the "entire fairness" review, which requires a judicial determination of whether a transaction is entirely fair to shareholders.[53] Such conflicts may arise in situations where directors (1) appear on both sides of a transaction, as in adoption of compensation arrangements for the directors themselves, or (2) derive a personal financial benefit that does not generally benefit the company and its shareholders.[54] In determining whether a transaction is entirely fair, "the court must consider the process itself that the board followed, the quality of the result it achieved and the

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[49] *Id*.

[50] *See, e.g.*, *Unitrin, Inc.* v. *American Gen. Corp*., 651 A.2d 1362, 1388 (Del. 1995).

[51] *See Gilbert*, 575 A.2d at 1143–44 (applying *Unocal* standard in reviewing defensive measures, including golden parachutes and ESOPs, where "everything that [defendant directors] did was in reaction to [the] tender offer"); *Int'l Ins. Co.* v. *Johns*, 874 F.2d 1447, 1459 (11th Cir. 1989) (stating that the intent of the company's board in enacting a golden parachute is determinative of the standard used; when enacted in response to a takeover threat, the *Unocal* enhanced scrutiny standard applies).

[52] *See Moore Corp. Ltd*. v. *Wallace Computer Servs., Inc*., 907 F. Supp. 1545, 1556 (D. Del. 1995) (refusing to apply *Unocal* scrutiny to golden parachutes negotiated before a tender offer, but applying *Unocal* enhanced scrutiny to the failure to redeem a poison pill); and *In re Western Nat'l Corp. S'holders Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000) (applying business judgment rule to board-approved employment agreement granting large severance payment and accelerated vesting of options because applicable employment agreement was adopted before potential acquirer was a shareholder and agreement was negotiated and recommended by disinterested directors).

[53] *See, e.g.*, *Weinberger* v. *UOP, Inc.*, 457 A.2d 701, 710–11 (Del. 1983), *aff'd*, 497 A.2d 792, Del. Supr., July 9, 1985.

[54] *See, e.g.*, *Ivanhoe Partners* v. *Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987).

quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide."[55]

In the context of director and executive compensation, entire fairness scrutiny is most likely to apply where directors have approved a compensation plan specifically for themselves. Even if the compensation arrangements directly benefit insider directors, their approval should be protected by the business judgment rule if approved by an independent committee or by the disinterested directors.[56] However, when directors who directly benefit from a proposed plan are delegated the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.[57]

Entire fairness scrutiny may also apply in the context of compensation awarded by a company to an officer who is also a controller of the company within the meaning of the applicable case law. A recent, high-profile example of this application arose in the stockholder derivative litigation relating to Elon Musk's 2018 performance-based stock option award from Tesla. The award had a grant date fair value of $2.6 billion and a maximum value of $55.8 billion, and consisted of 12 tranches of stock options, each representing 1% of Tesla's total shares outstanding. Vesting of each tranche required both an increase in Tesla's market cap by $50 billion and the achievement of certain revenue or EBITDA targets. In a 200-page opinion issued in January 2024,[58] the Delaware Court of Chancery ordered the rescission of the entire compensation award, concluding that (1) Musk was a controller of Tesla (although he only held 21.9% of the vote power) because he had transaction-specific control as to the decision to grant his compensation award, (2) the defendents bore the burden of proving that his compensation award was "entirely fair," unless the burden were shifted to the plaintiffs by demonstration of a "fully informed vote of the majority of the minority stockholders," (3) though the compensation award was approved by a majority of the minority, the stockholder vote was not fully informed because the proxy statement inaccurately described the board of directors as "independent" and omitted certain details about the process and therefore the defendents were unable to shift the burden to the plaintiffs, and (4) the defendants were not able to

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[55] *Cinerama, Inc.* v. *Technicolor*, 663 A.2d 1134, 1140 (Del. Ch. 1994).

[56] *See Tate & Lyle PLC* v. *Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, *20–21 (Del. Ch. May 9, 1988) (permitting outside directors to approve compensation for insider directors after conducting reasonable inquiry and obtaining full board of directors' approval).

[57] *See, e.g.*, *id.* at *20–22 (invalidating rabbi trusts covering both inside and outside directors due to conflict of interest).

[58] *Tornetta* v. *Musk*, C.A. No. 2018-0408-KSJM (Del. Ch. Jan. 30, 2024).

prove the compensation award was entirely fair (which requires both process and price to be proven to be fair). The full consequences of this recent decision remain to be seen, as it involved fairly uncommon facts and may still be appealed. While a comprehensive analysis of the Tesla litigation is beyond the scope of this Guide, the case serves as an important reminder that in compensation-related transactions with an actual or potential controller, great care should be taken, to the extent possible, to structure the transaction in a manner that avoids the directors bearing the burden of proving the entire fairness of the compensation arrangement to a court that will exercise its own judgment, and act with the benefit of hindsight, in evaluating the arrangement. Since what is required in that regard is uncertain under current case law, directors should consult with experienced outside advisors before commencing, and throughout the entirety of, the process of negotiating and approving a significant compensation award for a controller.

B. Fiduciary Duties under ERISA

ERISA is the federal law governing employee retirement and welfare benefit plans. Although its original enactment was spurred by a congressional concern for adequate funding of traditional defined benefit pension plans, ERISA has imposed from its inception a comprehensive set of requirements for many types of broad-based benefit plans, including retirement plans such as defined benefit pension plans (including cash balance plans), the well-known "401(k)" plan, employee stock ownership plans ("ESOPs"), and medical and other welfare plans. A key component of ERISA is the imposition of fiduciary duties and liabilities on individuals and entities that become fiduciaries in respect of such plans under ERISA. ERISA fiduciary duties are said to be the highest of such duties known to the law. It is critical, therefore, for compensation committee members to understand the extent to which they themselves may be liable as ERISA fiduciaries.

A person may become a fiduciary under ERISA by being specifically named as such in a plan document, by being identified as such under a procedure set forth in the plan document, or by exercising responsibilities that ERISA considers to be fiduciary in nature. Note that a named fiduciary may delegate fiduciary responsibilities to another person, who thereby becomes a fiduciary. However, a person who appoints a fiduciary is himself or herself a fiduciary with respect to that appointment. Compensation committees may, therefore, be considered ERISA fiduciaries for many reasons, including as a result of language in their charters or in plan documents, as a result of exercising administrative responsibilities for ERISA plans, by virtue of involvement in managing the assets funding ERISA plans, or because the compensation committees appoint plan fiduciaries (which may include employees of the company as

well as third-party institutions such as trust companies or investment managers).

The decision to adopt or terminate a particular compensatory arrangement, even if the arrangement is itself subject to ERISA, is generally considered a "settlor function" and is not subject to ERISA's fiduciary duty rules. However, once an ERISA plan is adopted, fiduciary duties may attach to determinations made pursuant to that plan. ERISA requires that fiduciaries exercise their fiduciary duties prudently and solely in the best interests of plan participants.

In general, fiduciary duties under ERISA fall under the statutorily mandated "prudent man standard of care." Such standard requires a fiduciary to act solely in the interest of the ERISA plan participants, for the exclusive purposes of providing benefits to the plan participants and of defraying reasonable expenses of administering the plan, all with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use.[59] A wide body of law has developed under this standard, which includes duties to disclose material information to plan participants, to operate ERISA plans in accordance with their terms and applicable law, and to avoid conflicts of interest. Consequently, while it is not impermissible for an individual or entity that acts as a plan fiduciary also to have another role that affects the plan, fiduciaries must be alert to the possibility that their ERISA duties and their responsibilities to the shareholders may conflict, presenting special legal issues that must be addressed.

Consider, for example, the common situation in which a person who has responsibility for selecting the investment choices to be offered to 401(k) plan participants—including company stock—learns, in his or her capacity as a member of a board of directors, of confidential information that may, when announced, cause a significant and long-term drop in the company's stock price: the individual's fiduciary duty under ERISA to offer only prudent investment choices to plan participants could come into conflict with the individual's duty under the federal securities laws not to use confidential information before it is made public and with a business strategy being pursued on behalf of shareholders generally. This type of fact pattern has generated many lawsuits against directors and executives with respect to actions taken in respect of ERISA plans, where an effective legal defense was oftentimes a judicially created presumption of prudence.[60] However, the U.S. Supreme Court has eliminated this presumption in favor of a fact-specific approach in the evaluation of such

[59] *See* 29 U.S.C. § 1104(a).

[60] *See, e.g.*, *Moench* v. *Robertson*, 62 F.3d 553 (3d Cir. 1995).

claims.[61] This fact-specific approach creates a high bar for claims involving nonpublic information, by requiring that (1) the complaint contain a plausible allegation that an alternative action could have been taken consistent with securities law and (2) a prudent fiduciary in like circumstance would not have viewed such alternative action as more likely to harm the fund than to help it. Most cases have failed to proceed under this newer standard, given the complex interplay between the securities laws and ERISA. Nonetheless, a recent stock drop case involving corporate officers serving as ERISA fiduciaries with insider knowledge of undisclosed losses at the company made its way to the U.S. Supreme Court.[62] Although the court did not rule on the merits, it remanded the case, and, of significance, directed the Second Circuit to determine whether to consider the views of the SEC regarding the conflict between the ERISA-based duty to disclose versus the objectives of corporate disclosure requirements and insider trading rules under federal securities laws. The parties ultimately settled through mediation and the Second Circuit made no ruling on the conflict between the duty to disclose and insider trading rules.

Many companies have chosen to have company employees and/or independent third parties, rather than members of their board of directors, serve as ERISA fiduciaries. In such cases, however, the responsibility to appoint those fiduciaries often rests with the full board of directors or the compensation committee. As noted above, those persons who appoint fiduciaries are themselves fiduciaries and, while such persons do not have the same breadth of ERISA fiduciary responsibility, they must still exercise their appointment powers prudently and solely in the best interests of plan participants (*e.g.*, the appointees must be qualified to serve as ERISA fiduciaries). This continued ERISA fiduciary responsibility also includes exercising some oversight over the performance of the appointees, generally through a duty to monitor the activities of the appointees.

The satisfaction of ERISA fiduciary duties relies heavily on "procedural prudence," so it is important for all ERISA fiduciaries to follow appropriate procedures, to have full access to all necessary information and expert advice pertaining to their duties, and to keep careful records of their deliberations, decisions and actions when acting in a fiduciary capacity. Boards of directors and compensation committees who have delegated ERISA fiduciary duties to qualified appointees also should receive periodic reports regarding the plans being administered by their appointees and satisfy themselves that the appointees are fulfilling their delegated functions. Obtaining and maintaining an appropriate level of

[61] *See Fifth Third Bancorp* v. *Dudenhoeffer*, 134 S. Ct. 2459 (2014).

[62] *See Retirement Plans Committee of IBM* v. *Jander*, 2020 WL 201024 (Jan. 14, 2020).

ERISA fiduciary insurance for all persons acting as fiduciaries is highly recommended. Although ERISA fiduciaries may not be indemnified using the assets of ERISA plans, companies may be permitted to further indemnify their ERISA fiduciaries through bylaws or corporate resolutions.

IV.

Methods of Compensation

A. Understanding and Pursuing Compensation Goals and Objectives

"Pay-for-performance" has been the mantra for "best practices" in executive compensation for decades. While compensation programs should be designed so that compensation increases as corporate or individual performance metrics are met or exceeded, the Covid-19 crisis has highlighted the importance and challenges of designing compensation programs that are responsive to unforeseen events while incentivizing behavior that preserves and enhances the long-term value of the company.

The highest priority for a company in designing a compensation program should be to create economic incentives and encourage particular behaviors. Companies should balance the need to retain employees and incentivize them in a manner that rewards growth and appropriate risk-taking with the need to preserve the business. With respect to performance-based compensation, companies should select performance criteria that reflect true measures of operating performance and long-term value creation, and a compensation committee may consider preserving some negative discretion to adjust award amounts downward in the event of anomalous results.

Careful thought should go into the structure and design of compensation programs to help ensure that they protect against the creation of short-term windfalls for employees that do not match long-term sustained benefits for shareholders. Moreover, a compensation committee should seek programs that it believes are in the best interests of shareholders generally, not programs that are merely intended to appease individual shareholder critics and the media at any given moment. These groups may have short-term interests that do not take into account the future well-being of the company and they may have interests that are inconsistent with the interests of shareholders generally.

The different types of compensation described below are not mutually exclusive alternatives. Companies can and should consider granting a mix of types of compensation based on their business needs. A compensation committee should determine, in its business judgment based on the particular needs of the business, the appropriate mix of fixed compensation (*e.g.*, annual base salary) and variable compensation (*i.e.*, short-term and long-term performance incentives), as well as the form of compensation (*e.g.*, stock options, restricted shares, restricted stock units or cash-based payments). No particular compensation vehicle should be

off the table simply because it has been criticized in the media or by shareholder activists, although committees should understand how awards will be considered by proxy advisory firms in connection with the "say on pay vote" recommendation.

Due to the 2017 elimination of the performance-based compensation deduction exemption under Section 162(m) (described in Chapter V of this Guide, below), incentive compensation awards can no longer be structured in a manner that ensures full tax deductibility under Section 162(m). While these changes have increased the after-tax cost of senior management compensation, they have also presented an opportunity for companies to take a fresh look at their compensation plan designs. From a corporate tax standpoint, the changes placed discretionary bonuses and service-based awards on equal footing with performance-based arrangements and provided companies with greater flexibility to address the impact on performance of unexpected events without compromising the deductibility of an award. Despite the elimination of the Section 162(m) performance-based compensation exception, sound incentive design and shareholder expectations have resulted in companies continuing to link pay to performance and there have not been dramatic design changes, although we have seen companies be more willing to exercise discretion to modify or adjust performance goals to address unexpected circumstances or events.

B. Equity Compensation

The manner in which most companies provide executives with equity compensation continues to evolve. We have set forth below the material characteristics of various types of equity compensation awards to aid committee members in understanding the issues involved in the design of equity compensation alternatives. To facilitate decision-making with respect to the granting of equity compensation awards, compensation committees should familiarize themselves with the economic, tax and accounting implications of granting different forms of equity compensation.[63]

The discussion below is limited to considerations regarding equity awards granted by U.S. corporations to U.S. taxpayers, but consideration should also be given to the securities and disclosure and tax implications of granting different forms of equity compensation in non-U.S. jurisdictions.

[63] The U.S. Internal Revenue Code provisions and the stock exchange rules referenced in this Chapter IV are outlined and discussed more fully in Chapter V of this Guide.

1. Stock Options

Despite their fall from grace over a decade ago, stock options can be a valuable tool to incentivize employees. Stock options provide employees with the opportunity to buy shares of company stock at a fixed price during a specified period of time, allowing the employee to benefit from appreciation in the value of company stock. Stock options typically have an exercise price equal to the fair market value of the underlying stock on the date of grant. Vesting of stock options generally is contingent upon an employee's continued employment for a specified period of time (service-based options) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based options) or may result in vesting at an earlier point in time (performance-accelerated stock options).

The principal benefits and drawbacks to granting stock options are as follows:

- ***Benefits***

    - Generally not subject to Section 409A of the Code if the following conditions are met: (1) the strike price is equal to or greater than fair market value on the grant date, (2) the option relates to "service recipient" stock, and (3) the stock option does not otherwise include any deferral feature.

    - Because stock options are not considered outstanding shares until exercised, they are not counted in the denominator for calculating earnings per share.

    - Optionees only realize a benefit from the award if the value of the stock exceeds the exercise price and do not realize any loss if the stock price never exceeds the exercise price, therefore encouraging stock option holders to pursue strategies to increase stock price, affording shareholders increased opportunities to recognize gains.

    - Because stock options generally are not taxable until exercise, optionees have a degree of control over when they incur taxes with respect to stock options.

- ***Drawbacks***

    - An accounting charge must be recognized following the grant even though no economic benefit may be derived by the optionee (although it is possible that the value ultimately achieved by the optionee will exceed the charge recognized).

- Because stock option holders receive a benefit if the stock price increases, but have no downside protection if the price decreases, there is a perception that stock option holders may be incentivized to pursue riskier strategies to cause stock prices to peak.

- Likely disconnect between amount of pay received by optionee and amount of expense to company.

- Because optionees typically have a long period during which to exercise their stock options, a well-timed exercise can result in significant gain even where the company's stock does not provide commensurate long-term gain for shareholders.

- The grant of stock options results in an increase of so-called "overhang," which ultimately can result in dilution of existing shareholders if the stock options are exercised. We note that institutional shareholders often measure dilution, taking into account outstanding stock options and/or even reserved option shares.

- In a falling stock market, underwater stock options may lose retentive value.

- Internal controls surrounding the grant of stock options have increased in complexity.

- ISS does not consider time-based stock options to be performance-based compensation for purposes of its "pay-for-performance" analysis.

2. Stock Appreciation Rights

Stock appreciation rights ("SARs") provide employees the right to receive an amount equal to the appreciation in value of company stock over a certain price during a specified period of time. Upon the exercise of a SAR, the company pays the employee cash, stock or a combination thereof equal to such net appreciation value.

The principal benefits and drawbacks of granting SARs generally are the same as granting stock options, except:

- ***Benefits***

  - SARs that may be settled only in cash are not considered equity compensation under NYSE and Nasdaq rules. Accordingly, no shareholder approval under such rules is required with respect to plans under which only these awards may be granted.

- The exercise of SARs does not require the holder to pay an exercise price for which he or she may need to borrow against the exercise proceeds or engage in a broker-assisted cashless exercise, either of which must be structured to comply with applicable securities laws and the company's policies regarding hedging and pledging and insider trading.

- SARs settled in cash instead of stock will not result in equity dilution.

- ***Drawbacks***

  - SARs settled in cash instead of stock will not increase the employee's holdings of company stock.

  - SARs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the SARs).

  - SARs settled in cash will require an outlay of cash by the company.

3. Restricted Stock

Restricted stock is a grant of shares of company stock subject to specified vesting provisions and limitations on transfer. Vesting of restricted stock typically is contingent upon an employee's continued employment for a specified period of time (service-based restricted stock) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based restricted stock) or may result in vesting at an earlier point in time (performance-accelerated restricted stock).

The principal benefits and drawbacks of using restricted stock are as follows:

- ***Benefits***

  - Holders of restricted stock share in both increases and decreases in the company's stock price, which directly aligns the interests of restricted shareholders with shareholders.

  - From the perspective of employees, restricted stock may represent a more tangible benefit than stock options.

  - Holders of restricted stock can vote and receive dividends.

- The ability of employees to make an election under Section 83(b) of the Code to recognize the value of the restricted stock at the time of grant may enable an employee to achieve a favorable tax result if the value of the restricted stock appreciates during the vesting period (although such elections are uncommon at public companies).

- Restricted stock generally is not subject to Section 409A of the Code.

- Holders of restricted stock will realize value even if the price of company stock decreases during or after the vesting period. Accordingly, restricted stock may have greater retentive value than stock options in a down market and may be less likely to encourage risky strategies than could be the case with stock options or SARs.

- ***Drawbacks***

  - Employees will receive some value from restricted stock even if the stock performs poorly.

  - ISS discourages the payment of dividends or dividend equivalents on unvested equity awards under its Equity Plan Scorecard (the "EPSC"); companies should be aware of this when granting restricted stock and may decide that dividends instead will accrue and not be paid unless and until the underlying shares become vested.

  - Shares of restricted stock are outstanding and are included in the denominator for computing diluted earnings per share.

4. Restricted Stock Units

A restricted stock unit ("RSU") is a contractual right to receive a share of company stock or cash equal to the value of a share of company stock. Settlement of RSUs (*i.e.*, delivery of the company shares or payment of cash) occurs on a fixed date or dates or upon the occurrence of a specified event or events. As is the case with restricted stock, vesting of RSUs may be service-based, performance-based and/or performance-accelerated.

The principal benefits and limitations of using RSUs as a means of compensation are the same as those of restricted stock, except:

- ***Benefits***

  - RSUs that can be settled only in cash are not equity compensation under NYSE and Nasdaq rules. Accordingly, no shareholder approval is required with respect to cash-based RSUs under such rules.

  - RSUs that can be settled only in cash are not equity securities under U.S. federal securities laws, and therefore no registration statement is required to be maintained with respect to such awards.

  - RSUs that are ultimately settled in cash instead of stock will not result in shareholder dilution.

  - Because RSUs are not "property" under Section 83 of the Code and merely represent a general unsecured promise to pay a future amount, an employee may postpone taxation beyond vesting (the company's deduction is similarly delayed) until such time as the RSUs are settled. Accordingly, RSUs can allow employees to retain an interest in company stock and, consequently, company performance for an extended period of time without triggering a tax liability.

  - RSUs could be structured (if done in advance) to delay delivery of stock to a future date post-termination of employment, which could help align executives' interests with shareholders and facilitate enforcement of clawbacks.

- ***Drawbacks***

  - If RSUs may be settled only in cash, or in stock or cash at the company's election, they are not reportable in the proxy statement beneficial ownership table.

  - RSUs settled in cash instead of stock require a cash outlay by the company, and unless such settlement could jeopardize the company as an ongoing concern (a high standard), Section 409A of the Code does not allow the company to delay payment even if such a cash outlay could significantly impair the company financially (*e.g.*, cause it to be in default under its credit facility).

  - RSUs settled in cash instead of stock will not increase the employee's holdings of company stock and typically do not count towards share ownership requirements.

- RSUs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the RSUs).

- RSUs that provide for the deferral of payment post-vesting may be subject to Section 409A of the Code, depending on their terms, which can limit a company's flexibility to modify such awards (*e.g.*, accelerate settlement, or further delay settlement, of previously vested RSUs).

- Because RSUs are not property, grantees cannot make an election under Section 83(b) of the Code to provide favorable tax treatment for post-grant appreciation.

C. Retirement Programs

In addition to the other compensation programs described above, compensation committees often provide executives with retirement benefits under either defined contribution plans (*e.g.*, 401(k) plans) or defined benefit plans (*e.g.*, pension plans that provide a fixed retirement benefit based on years of service and final pay). These arrangements can either be (1) "qualified plans," which provide the company with tax benefits, but generally, must be provided to a large portion of the employees and are subject to limitations on, among other things, the aggregate benefit payable to participants under the plans and complex rules under the Code and ERISA, or (2) "nonqualified plans," which may be limited to senior executives and provide them with additional retirement benefits that are not subject to the limitations imposed under the Code and ERISA.

Compensation committees should be sure to understand the applicable funding and contribution requirements of the company's tax-qualified retirement plans. The obligations under these plans, as well as the value of assets funding those obligations, are disclosed in a company's financial statements, although a company's management and compensation committee should be aware that the manner in which these obligations are calculated for accounting and reporting purposes differs from the manner in which these obligations are calculated under ERISA for purposes of determining funding obligations. And, as discussed in Chapter III of this Guide, boards of directors should understand the ERISA fiduciary law implications of maintaining qualified retirement plans.

Compensation committees should be sure to understand the cost of any nonqualified retirement plan arrangements, including any implications that increases in annual compensation may have on that cost. Moreover, Compensation Committees should be aware that, since these programs

generally represent an unsecured promise by the company to pay amounts to executives in the future, which constitute accrued liabilities that appear in a company's financial statements, they effectively result in executives being creditors of the company. As creditors of the company, executives with large nonqualified retirement benefits may be incentivized to act more conservatively with regard to risk-taking and capital investment, especially as they approach the stated retirement age when their benefits become payable.

D. Perquisites

Perquisites should be provided to executive officers only with full disclosure to the compensation committee. Any compensation or other benefit received by any officer from any affiliated entities (using a low threshold for the definition of an affiliated entity) should be carefully reviewed to confirm compliance with the company's code of business conduct and ethics and applicable law. Perquisite programs and company charitable donations to any organizations with which an executive is affiliated should be carefully scrutinized to make sure that they do not create any potential appearance of impropriety. As a reminder, perquisites provided to NEOs that in the aggregate are equal to $10,000 or more in any given year must be disclosed in the proxy statement.

Regulators and institutional shareholders are closely scrutinizing executive compensation in general and executive perquisites in particular. In response, many companies have modified or eliminated perquisite programs in recent years, in some cases replacing the value of such benefits with other forms of compensation that are subject to less scrutiny (such as base salary) or requiring that executives reimburse the company for the incremental value of the perquisites the company provides.

While the rhetoric may, in many cases, be overblown, procedure and disclosure are often as important as the substance of underlying compensation packages. And while criticism cannot always be avoided, actions taken by a well-informed and objective compensation committee, which are then appropriately disclosed to shareholders, will be shielded from liability.

V.

Laws and Rules Affecting Compensation

A. Section 162(m) of the Internal Revenue Code

1. General

Section 162(m) generally disallows a publicly traded company's federal income tax deduction for compensation paid to "covered employees" in excess of $1 million during a company's taxable year. This $1 million deduction limit covers all types of compensation, including cash, property and the spread on the exercise of options. For more than two decades following the enactment of Section 162(m) in 1993, public companies structured their executive compensation programs to take advantage of an exception to this deduction limitation for "performance-based compensation" keyed to a pre-established, objective, nondiscretionary goal and formula.[64] However, the 2017 Tax Reform Act eliminated this exception.

Accordingly, companies no longer need to structure their compensation programs to comply with the requirements of the "performance-based compensation" exception, including (1) subjecting their cash bonus plans to shareholder approval, (2) setting forth permissible performance goals in their equity plans, and (3) seeking shareholder approval of applicable performance goals every five years. Further, individual award limits are no longer necessary in equity plans from a tax planning perspective (other than for tax-qualified incentive stock options); however, proxy advisory firms such as ISS have issued statements making it clear that in their view companies should continue to use performance-based compensation structures and that plans should continue to contain individual award limits, even without the benefit of the performance-based compensation deduction exception under Section 162(m).

Elimination of the performance-based exception has resulted in a significant increase in disallowed tax deductions and other important consequences, which we discuss below. Nevertheless, to date, companies have accepted the lost deductions as a necessary consequence of the competitive marketplace for talent. And by now, most incentive compensation plans and arrangements and the manner in which they are administered have been modified as necessary to eliminate the framework

[64] Note that for financial institutions receiving government assistance under the Troubled Asset Relief Program (TARP) and for certain health insurance providers, the deduction limitation has been lowered from $1 million to $500,000 and there has been no exception for performance-based compensation for some time.

and limitations of the now-defunct performance-based exception. It is, however, important to ensure that the company is maintaining proper internal controls to ensure compliance with the broader limitations on deductible compensation.

2. Expansion of Impacted Companies and "Covered Employees"

Prior to the 2017 Tax Reform Act, Section 162(m) generally only applied to the compensation payable to "covered employees" of companies with publicly traded equity securities. The 2017 Tax Reform Act and the regulations thereunder expanded the scope of entities subject to Section 162(m) to include the potential coverage of foreign private issuers, companies with public debt, and partnerships, and also eliminated transition relief previously available to newly public companies. In a reversal of prior Internal Revenue Service ("IRS") guidance, the 2020 final regulations applied the Section 162(m) deduction limitation to a public company's distributive share of a deduction for compensation paid by a partnership to the company's covered employees, subject to certain grandfathered arrangements in effect on December 20, 2019.

The 2017 Tax Reform Act also substantially expanded the original definition of "covered employees" for purposes of Section 162(m). The definition had been limited to a company's principal executive officer and the three other most highly compensated executive officers who are required to be named in the company's executive compensation disclosure under SEC disclosure rules, but did not cover the company's principal financial officer. In addition to including principal financial officers, the 2017 Tax Reform Act definition imposed permanent "covered employee" status on any officer who was or is a "covered employee" for any tax year beginning after December 31, 2016. The final Section 162(m) regulations issued by the IRS in 2020 included an elaborate framework for determining when a public company must treat an individual as a covered employee by virtue of the person having been a covered employee of a predecessor of the public company. The rules vary based on transaction context, but generally sweep quite broadly.

These changes increased the number of active employees who can be "covered employees" in a given year and eliminate a corporation's ability to deduct amounts in excess of $1 million paid following a covered employee's termination of employment. Accordingly, companies should be mindful that individuals who appear in the Summary Compensation Table in the annual proxy statement for one year will be "covered employees," effectively forever.

The American Rescue Plan Act of 2021 further amended the definition of "covered employees" for tax years beginning after December 31, 2026 to include an additional five highest compensated employees, regardless of whether classified as executive officers (although employees covered only as a result of this expanded rule will not have permanent covered employee status). While the expanded definition does not become effective for several years, it is possible that companies will consider structuring incentive awards to individuals who might be covered by the expanded definition to vest and be paid in 2026 in order to avoid a lost tax deduction.

Overall, while companies could theoretically try to structure compensation so that there is limited turnover in the Summary Compensation Table population, we have found such planning to be uncommon, with virtually all companies concluding that the importance of making commercially appropriate compensation decisions outweighs such structuring considerations. Companies should, however, regularly review their list of executive officers and eliminate any individuals whose job functions do not warrant such classification. Also, as the covered employee population is backward-looking and therefore continually expanding, companies should maintain a list of all covered employees and update it annually.

The extension of "covered employee" status beyond termination of employment favors installment payments of deferred compensation and severance obligations over lump sum payments, in an effort to maximize the payments that fall below the $1 million limit in any given year. In most cases, however, we again have observed that design and business considerations trump tax structuring.

3. Continuation of Section 162(m) Compliance Procedures

Prior to the 2017 Tax Reform Act, the $1 million deduction limit did not apply to compensation payable solely on account of attaining one or more pre-established, nondiscretionary and objective performance goals established no later than 90 days after the beginning of the service period to which the goal relates and within the first 25% of such period, so long as establishment of the goals was determined by a compensation committee (or a subcommittee thereof) of the board of directors composed solely of two or more "outside" directors within the meaning of Section 162(m), and at the end of the period and before the compensation was paid, such committee of "outside" directors certified that the performance goals and any other material terms had been satisfied.

Given the 2017 elimination of the performance-based compensation deduction, public companies that no longer maintain any "grandfathered" arrangements are not required to ensure that compensation committee

members meet the requirements of "outside" directors under Section 162(m), and corresponding updates may be made to director and officer questionnaires, compensation committee charters, equity plan documents, and other arrangements that previously referenced the "outside" director requirements.

"Grandfathered" arrangements are, generally, written binding contracts in effect as of November 2, 2017, which are not materially modified (*i.e.*, amended to either increase compensation or accelerate the payment of compensation without a time-value discount) thereafter. The 2020 IRS final regulations construe narrowly the scope of this "grandfathering" rule.[65] Under these final regulations, the IRS clarified that arrangements permitting but not requiring the exercise of negative discretion when a compensation committee determines a bonus, do not constitute grandfathered arrangements for purposes of the performance-based compensation deduction exception. As of 2024, any remaining "grandfathered" arrangements are likely stock options, which do not require a certification by "outside" directors, and it has become increasingly uncommon for Section 162(m) to be relevant to compensation committee composition.

B. Section 409A of the Internal Revenue Code

Section 409A of the Code ("Section 409A") imposes penalties on participants in deferred compensation arrangements that do not comply with the strict requirements of the rules published under Section 409A. "Deferred compensation" for these purposes can, perhaps unexpectedly, include severance payments and reimbursement rights. Given the far-reaching impact of Section 409A, companies have rightly devoted, and continue to devote, a great deal of time and resources to implementing and operating programs to comply with Section 409A. While a compensation committee should satisfy itself that the company is aware of and is complying with the legislation, the committee need not spend inordinate amounts of time trying to understand the intricacies of the technical rules that have no impact on the arrangements' commercial terms.

C. Stock Exchange Rules Regarding Shareholder Approval of Equity Compensation Plans

1. General Rules

NYSE and Nasdaq listing standards require listed companies to obtain shareholder approval of most equity compensation plans. A compensation committee should be aware that these rules may require shareholder

[65] Treasury Regulations Section 1.162-33, 26 C.F.R. § 1.162-33.

approval of proposed plans and material plan amendments. NYSE and Nasdaq rules *exclude* the following types of plans from this shareholder approval requirement if all applicable requirements for the particular exclusion are met:

- arrangements under which employees receive cash payments based on the value of shares rather than actual shares (*e.g.*, cash-settled RSUs);

- arrangements that are made available to shareholders generally (such as a typical dividend reinvestment plan);

- arrangements that merely provide a convenient way for employees, directors or other service providers to purchase stock at fair market value;

- plans intended to qualify under Section 401(a) of the Code (qualified pension, profit-sharing and stock bonus plans) or Section 423 of the Code (employee stock purchase plans) (but note that shareholder approval for a Section 423 plan is separately required by the tax rules);

- "parallel excess plans," a narrowly defined category of excess benefit plans;

- equity grants made as a material inducement to an individual becoming an employee of the company or any of its subsidiaries;

- rollover of options and other equity awards in connection with a merger or acquisition; and

- post-acquisition grants to those who are not employees of the acquirer at the time of acquisition of shares remaining under a target plan that had been approved by the target's shareholders (although use of such share reserves in connection with the transaction will be counted by the NYSE and Nasdaq in determining whether the transaction must receive shareholder approval as an issuance of 20% or more of the company's outstanding common stock).

2. Material Revisions

The NYSE and Nasdaq rules provide the following examples of revisions to equity compensation plans that are considered "material" and therefore require shareholder approval:

- a material increase in the number of shares available under the plan, other than an increase solely to reflect a reorganization, stock split, merger, spin-off or similar transaction;

- an expansion of the types of awards available under the plan;
- a material expansion of the class of individuals eligible to participate in the plan;
- a material expansion of the term of the plan;
- a material change to the method of determining the strike price of options under the plan; and
- a deletion or limitation of any provision prohibiting repricing of options.

In light of the requirement that material amendments be approved by shareholders, a compensation committee should consider requesting that newly adopted plans be drafted to ensure maximum flexibility in the types of awards that can be granted and the terms and conditions thereof.

D. Compensation Clawback Rules

The 2010 Dodd-Frank Act charged the SEC with promulgating rules requiring NYSE- and Nasdaq-listed companies to adopt a policy mandating clawbacks of incentive compensation that was paid to a current or former executive officer during the three-year period preceding the date on which the company is required to prepare an accounting restatement as a result of material noncompliance with the securities laws, if the compensation is determined to have been based on erroneous data. The SEC was further required to direct the securities exchanges to prohibit the listing of companies that do not comply with those rules. After years of delay, proposed regulations, and discussion, the SEC in 2022 adopted final rules,[66] and in 2023 approved NYSE and Nasdaq listing standards implementing the rules,[67] which took effect on October 2, 2023, and required listed companies to adopt a policy no later than December 1, 2023. Accordingly, most public companies adopted new clawback policies in 2023.

The listing standards implementing the Dodd-Frank Act compensation clawback rules are, as was required by the Dodd-Frank Act, much broader than the pre-Dodd Frank statutory clawback rule set forth in Section 304 of Sarbanes-Oxley. Most significantly, the new listing standards: (1) require each listed company to adopt a written recovery policy,

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[66] *See* Listing Standards for Recovery of Erroneously Awarded Compensation, 87 Fed. Reg. 73076 (Nov. 28, 2022) (amending 17 C.F.R. pts. 229, 232, 240, 249, 270, and 274), available here.

[67] *See* NYSE Listed Company Manual, Rule 303A.14; Nasdaq Listing Rules 5608.

whereas the Sarbanes-Oxley clawback operates on its own as a matter of law; (2) do not require any misconduct for compensation to be subject to clawback, as does Sarbanes-Oxley; and (3) cover all current and former executive officers of a listed company, whereas Sarbanes-Oxley only covers the CEO and CFO.

Generally, the final SEC rules and the NYSE and Nasdaq listing standards address the key questions that should be considered when implementing a clawback policy:

- *Which companies are covered?* With limited exceptions, the SEC rules apply broadly to all companies with listed securities, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and issuers of listed debt whose stock is not also listed.

- *Which individuals are covered?* The recovery policy must apply to a company's current and former executive officers who served in that capacity at any time during the applicable look-back period. The term "executive officer" is defined expansively to include the company's president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function and any other person (including executive officers of a parent or subsidiary) who performs similar policy-making functions for the company.

- *What types of restatements trigger application of the recovery policy?* A restatement due to material noncompliance with any financial reporting requirement under the securities laws triggers application of the recovery policy. The determination regarding materiality is based on facts and circumstances and existing judicial and administrative interpretations.

- *How is the applicable look-back period determined?* Incentive-based compensation *received* during the three completed fiscal years immediately preceding the date that a restatement is required to correct a material error is subject to the recovery policy. Incentive-based compensation is deemed *received* in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs before or after that period.

- *What types of incentive-based compensation are covered?* Under the final rules and the listing standards, "incentive-based compensation" means any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting

measure. "Financial reporting measures" include measures that are determined and presented in accordance with the accounting principles used in a company's financial statements, as well as a company's stock price and total shareholder return. Importantly, stock options and other equity awards that vest exclusively on the basis of service, without any performance condition, and bonus awards that are discretionary or based on subjective goals or goals unrelated to financial reporting measures, do *not* constitute incentive-based compensation. Issuers should be mindful that board materials and proxy disclosures regarding pay programs could impact whether or not the applicable compensation is treated as incentive-based compensation for purposes of the final rules.

- *How is the recovery amount determined?* The recovery amount equals the amount, calculated on a *pre-tax* basis, of incentive-based compensation received in excess of what would have been paid to the executive officer upon a recalculation of such compensation based on the accounting restatement. For incentive-based compensation that is not subject to mathematical recalculation based on the information in an accounting restatement (*e.g.*, compensation based on stock price goals or total shareholder return), the recoverable amount must be determined based on a reasonable, documented estimate of the effect of the accounting restatement on the applicable measure.

  For equity awards that are incentive-based compensation, if the shares or options are still held at the time of recovery, then the recoverable amount is the number of shares or options received in excess of the number that should have been received after applying the restated financial reporting measure. If options have been exercised, but the underlying shares have not been sold, then the recoverable amount is the number of shares underlying the excess options applying the restated financial measure. If shares have been sold, then the recoverable amount is the sale proceeds received by the executive officer with respect to the excess number of shares.

- *Does the board have discretion over whether to seek recovery?* Board discretion is limited. A company is required to recover compensation in compliance with its recovery policy, *except* to the extent that pursuit of recovery would be impracticable because it would (1) impose undue costs on the company, (2) violate home country law based on an opinion of counsel or (3) cause a broad-based retirement plan to fail to meet the tax-qualification requirements. Before concluding that pursuit is not feasible, the company must first make a reasonable attempt to recover the incentive-based compensation. Finally, a board is required to apply any recovery policy consistently to executive

officers, and a company is prohibited from indemnifying any current or former executive officer for recovered compensation.

- *What additional disclosure requirements do the SEC rules impose?* A listed U.S. company is required to file its recovery policy as an exhibit to its Form 10-K. In addition, the final rules require disclosure in the company's annual proxy statement of the following items, among others, if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation was outstanding: (1) the names of individuals from whom the company declined to seek recovery, and the reasons for declining to do so, and (2) the name of, and amount due from, each person from whom excess incentive-based compensation had been outstanding for 180 days or longer.

Because most large public companies already maintained clawback policies prior to finalization of the listing standards, many companies faced a decision in 2023 as to whether to preserve such policies in addition to the newly required policy. While some companies superseded their existing policies with a new policy closely hewing to the new requirements, many companies have decided to maintain their existing policies in addition to adopting a new policy that complies with the new rules, or have integrated features of the old policies that are not required by law into the new policies. Companies that have chosen not merely to track the new requirements have generally desired the ability to impose clawbacks under circumstances that are broader than those covered by the new listing standards; common examples include a desire to be able to recoup compensation paid prior to the effective date of the new rules, to cover executives below the executive officer level, to be able to recoup service-vesting awards (which generally are not incentive-based under the new rules) or to be able to recoup compensation upon a termination for cause. Companies that elect to broaden the scope of their policies beyond the four corners of the listing standards may wish to provide that enforcement is discretionary in such cases, in order to preserve flexibility for the compensation committee or other administrator to exercise judgment As the new policies mature, we expect that companies will continue to evaluate and re-assess whether to include features beyond the legally required terms, and time will tell which approaches gain favor as companies adapt to the new rules.

Companies should take care to consider mechanisms for enforcing their clawback policies. Many companies require executives to acknowledge and consent to the terms of their clawback policy. A 2023 federal court decision against the Hertz Corporation illustrated the risks of not obtaining such a consent, as the court held that general employment agreement provisions about compliance with company policies were insufficient to

bind the executive to the clawback policy's punitive scheme.[68] Companies should carefully ensure that they establish a contractual basis with covered executives for enforcement.

Clawbacks may provide a number of benefits to a company, including enhancing shareholder confidence in executive accountability, promoting the accuracy of financial statements and aligning risks and rewards. At the same time, there are also countervailing considerations and risks. If inappropriately designed, clawback policies can result in unfair treatment of executives and require, or put pressure on, compensation committee members to enforce the policies, even where directors do not believe that it is appropriate to do so.

E. Human Capital Disclosure

In August 2020, the SEC adopted certain amendments to rules on the disclosure of human capital, expanding the information required to be described in annual reports on Form 10-K filed on and after November 9, 2020. Although the human capital disclosure may not fall expressly under a compensation committee's authority or responsibility as expressed in its current charter, boards of directors should consider whether the compensation committee is best suited to provide oversight of this disclosure, given that the topics that tend to be included in the disclosure—*e.g.*, diversity and inclusion, employee benefit programs, retention and succession—often have some overlap or connection with matters that are otherwise within the compensation committee's purview, including the determination of performance goals for incentive compensation programs.

In short, the disclosure rules require a company to discuss, to the extent material to an understanding of the company's business taken as a whole, the following: "the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)." Notably, the SEC rules do not define the term "human capital," choosing instead to defer to each company to determine the appropriate scope of disclosure in light of its "unique business, workforce, and facts and circumstances."[69]

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[68] *The Hertz Corp.* v. *Frissora*, unpublished opinion, 2023 WL 4173031 (D. N.J. June 26, 2023).

[69] *See Modernization of Regulation S-K Items 101, 103, and 105*, Release Nos. 33-10825; 34-89670 [85 Fed. Reg. 63726] (Aug. 26, 2020), available here.

In light of this disclosure standard, however, a compensation committee (particularly if such committee has been tasked with oversight of this disclosure) may wish to take the following steps as it makes decisions relating to the design of incentive compensation and other compensation programs: (1) consider whether human capital measures are already disclosed and are consistent with disclosed corporate goals; and (2) engage in a "bottom-up" approach to determine the relevant human capital factors, starting the discussion with business unit leaders and filtering their feedback through senior management. If the compensation committee is tasked with oversight of the human capital disclosure, in seeking to determine whether and how certain factors relating to human capital resources (*e.g.*, demographic data) and certain human capital measures and objectives should be included in the disclosure, then the compensation committee may wish to consider:

- whether selected factors, measures or objectives can be monitored and measured on a consistent basis year over year;

- how, on a long-term basis, the factors, measures or objectives could change or need to be modified;

- how the relevant factors, measures or objectives could impact incentive compensation programs; and

- how the public disclosure of the relevant factors, measures or objectives could be viewed by the company's various stakeholders.

A recent survey identified "diversity and inclusion, talent development, talent attraction and retention, and employee compensation and benefits" as "four of the five most frequently discussed topics" pursuant to these standards, "while quantitative talent development statistics, supplier diversity, community investment, and quantitative statistics on new hire diversity" are among the five least frequently covered topics.[70]

In reviewing human capital disclosure, a compensation committee may want to give careful consideration to whether the disclosure specifically and directly addresses the most material human capital management issues currently facing the company, with the goal of avoiding overly lengthy, boilerplate disclosures.

[70] *See* Gibson Dunn, *Form 10-K Human Capital Disclosures Continue to Evolve* (November 2023).

VI.

Change in Control Compensation Arrangements

A. Addressing Executive Uncertainty in a Deal Environment

As institutions face industry consolidation amid regulatory, competitive and business model challenges, employees are understandably anxious about the future should their employer be acquired by or merge with another entity—whether in a friendly, distressed or hostile deal. To offset these pressures and to permit successful recruitment and retention of executives, many companies have adopted arrangements containing change in control provisions. These typically include change in control severance or employment agreements providing enhanced severance, acceleration of equity compensation awards and accelerated payment and/or vesting of deferred compensation in the event of a qualifying termination in connection with a change in control. A 2023 study of executive change in control arrangements by Meridian Compensation Partners noted that 78% of the study group companies maintained some form of change in control arrangement providing for cash severance, and 93% of the study group companies provided for the "double trigger" (*i.e.*, a change in control plus a qualifying termination of employment) acceleration of vesting of outstanding equity awards in connection with a change in control, or "single trigger" vesting on the change in control, in the event that the successor in the transaction elects not to assume the outstanding equity awards.[71]

Change in control severance and other arrangements are not intended to deter combinations; rather, by reducing the personal uncertainty and anxiety arising from a merger, such arrangements can help to assure full and impartial consideration of takeover proposals by a company's management and aid a company in attracting and retaining key executives. These arrangements, prevalent at U.S. public companies, are both legal and proper, and widely recognized as effective retention and recruiting devices. Potential merger partners will likely have similar arrangements and be familiar with them from prior transactions. The costs associated with change in control arrangements are expected transaction expenses and there is no evidence that appropriately structured arrangements negatively impact shareholder value or are unacceptable to ISS, Glass Lewis or institutional shareholders generally.

Compensation issues, such as the treatment of equity awards, severance protection and retention, continue to be of critical importance in

[71] *See* Meridian Compensation Partners, *2023 Study of Executive Change-in-Control Arrangements, December 2023*, available here.

transactions. Changes in compensation arrangements stemming from the influence of proxy advisors, including the trends of eliminating "golden parachute" excise tax gross-ups and single-trigger vesting, and the increasing prevalence of performance-based and deferred equity awards, require companies to understand and consider in careful detail the consequences and tax implications of a change in control. Attention must be paid to the applicable statutes and regulations to make sure that all tax and other technical concerns are understood and properly addressed in any arrangement. Severance and other change in control protections should be reevaluated periodically in light of the changes in a company's compensation programs from year to year. The importance of these arrangements, both the economics and procedural protections, was brought to light in the days following Elon Musk's acquisition of Twitter (now X Corp.) in late 2022, where Mr. Musk took the position that certain senior executives were fired for "cause" and therefore would receive no termination payments and benefits. In March 2024, following exhaustion of the administrative procedures under the applicable change of control severance program, several former Twitter executives sued Musk, X Corp. and others seeking payment of the severance benefits.

B. Forms of Compensatory Arrangements

1. Change in Control Protections

Many companies have adopted change in control protections for senior management. Typically, these protections include change in control severance or employment agreements or, increasingly, severance protection plans. A change in control employment or severance protection agreement or plan often becomes effective only upon a change in control or in the event of a termination of employment in anticipation of a change in control. A standard form of agreement or plan usually provides for a two- or three-year term after the change in control during which time the status quo is preserved for the executive in terms of duties, responsibilities, work location and certain levels of compensation and employee benefits. In general, if the status quo is not preserved and the executive resigns, or if the executive's employment is terminated by the company without cause, then the executive would be entitled to severance pay (typically, a multiple of base salary plus an annual bonus amount).

When implementing or reviewing a change in control arrangement, careful attention should be paid to the change in control triggering events. Getting the definition of "change in control" right is critical to the practical operation of change in control provisions, especially when it is uncertain whether a deal will be consummated in a timely manner (or possibly ever) due to regulatory, antitrust or other impediments to closing. Change in control definitions should not trigger upon an event prior to the

closing of a deal, such as the signing, public announcement, or shareholder approval of a merger agreement. These provisions not only create risks if a deal is not consummated, but also prevent the arrangements from fulfilling their intended purpose: to retain employees through the closing of a transaction. The events that give rise to a change in control should be objectively defined. Definitions that give a board of directors the ability to determine when an event does not constitute a change in control, while seemingly preserving flexibility, are likely to place the board in an untenable position both legally and practically. Deactivation provisions could also result in conflicts between the board and management at a particularly awkward and critical time. Cause definitions should be drafted narrowly to avoid creating a potential for acquiror abuse that would undermine the objective of the severance arrangements.

Severance benefits are generally expressed as a multiple (*e.g.*, three times) of pay. Less typically, they correspond to the term of the agreement such that the amount of severance declines for each day that the executive remains employed under the agreement during the term. Ultimately, the amount of severance payable is most relevant, and is dependent upon both the multiple of pay and the definition of "pay," which is typically expressed as the sum of base salary and bonus (which is commonly defined as target bonus or the higher of target bonus and average actual bonuses over the three prior years). In the change in control context, severance is almost universally paid in a lump sum because of the concern that an acquirer may cease to continue installment payments.

Most change in control employment or severance protection agreements and plans also contain provisions addressing the so-called "golden parachute" excise tax applicable under Sections 280G and 4999 of the Code. The federal golden parachute tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20% excise tax upon the recipient and the nondeductibility of such payments for U.S. federal income tax purposes by the paying company. Excess parachute payments result if the aggregate payments received by a "disqualified individual" that are "contingent on a change in control" equal or exceed three times the individual's "base amount" (the average annual taxable compensation of the individual for the five years preceding the year in which the change in control occurs). In such case, the excess parachute payments are equal to the excess of (1) such aggregate change in control payments over (2) the employee's base amount. In other words, the excise tax and nondeductibility rules apply not just to the excess over three times the base amount, but, once triggered, apply to the whole amount in excess of the base amount.

Three approaches generally are taken to dealing with golden parachute tax penalties in change in control agreements and plans:

- payments that are contingent on a change in control can be "cut back" to one dollar below three times the base amount, so that no payments are considered parachute payments;

- payments that are contingent on a change in control can be cut back to one dollar below three times the base amount, but only if the result is to give the employee a larger after-tax return than if the payment were not cut back (a so-called "better net after-tax" cutback); or

- payments can be "grossed-up" so that the employee is in the same after-tax position as if there were no excise tax.

After an analysis of the amounts involved, many companies historically adopted a "gross-up" provision in order to ensure that the excise tax would not undo the intended goals of the arrangement. In addition, gross-ups often were provided in order to ensure fair and uniform treatment because the excise tax punishes recently promoted and newly hired employees more harshly than longer-term employees, penalizes employees who do not exercise options more than those who do, and punishes employees who elect to defer compensation more than those who do not. Moreover, changes in the design of compensation programs (*e.g.*, including longer vesting periods, cliff vesting as opposed to installments, and a greater portion of performance-based compensation and mandatory deferrals) have exacerbated the impact of Section 280G on executives. For example, as a result of the manner in which the regulations under Section 280G value performance-based compensation for purposes of determining the amount of the payments contingent on a change in control, the tax is more likely to apply to employees who receive change in control acceleration of performance-based compensation than it is to those who receive acceleration of time-based awards.

Unfortunately for the affected officers, the now near-universal view of proxy advisors, such as ISS, is that the adoption of golden parachute excise tax gross-ups in new, extended or materially modified agreements, or executive change in control plans, is a "problematic" pay practice that is likely to result in a negative recommendation on a say on pay vote or, where there is no say on pay vote, or where concerns expressed by ISS on a say on pay vote are not addressed in the following year, a "withhold-the-vote" recommendation for the compensation committee members or even the entire board of directors. Companies that have implemented golden parachute excise tax gross-ups in preexisting agreements and plans and have determined that such gross-ups are in the best interests of the company and its shareholders need not eliminate them to avoid scrutiny by ISS, as ISS generally will make its recommendations regarding the periodic "say on pay" vote (but not the "golden parachute say on pay" vote) taking into account only agreements and plans that are new,

extended or materially amended. Those companies that wish to preserve such gross-ups should only amend the arrangements that contain the gross-ups with great care, as such amendments could de-grandfather the arrangements and result in ISS review. While an extension of an existing agreement will trigger ISS review, the automatic renewal of an agreement with an "evergreen" provision (itself a feature that ISS does not consider a "best practice") generally will not be deemed an "extension" for that purpose.[72]

In light of ISS's position on golden parachute excise tax gross-ups, many companies have elected to implement "better net after-tax" cutbacks. As the deductibility of compensation at the senior executive level is already limited due to the changes to Section 162(m), the lost deduction has become less relevant. In the past few years, there has been a trend for target companies to implement excise tax gross-ups in connection with the negotiation of a particular change in control transaction, particularly in circumstances (*e.g.*, transaction price provides a very high premium to market price) where executives would be harshly impacted by the excise tax even after applying all available mitigation alternatives.

2. Stock-Based Compensation Plans

In addition to employment and severance protection agreements and plans, companies should review the status of their stock-based compensation plans for change in control provisions. Plans often contain provisions for acceleration of stock options, lapse of restrictions on restricted stock and deemed achievement of performance goals on performance stock awards upon a change in control ("single-trigger" vesting) or upon a qualifying termination of employment thereafter ("double-trigger" vesting). Since performance goals may no longer be relevant or may not be measurable following a transaction, it is often advisable for award agreements to provide that performance goals are deemed achieved at the completion of the transaction at the greater of the target level and the level of actual performance (as measured immediately prior to the completion of the transaction), with the award then continuing as a time-vesting award. Stock plans also often provide an extended post-termination exercise period for stock options and SARs upon terminations of employment following a change in control (*e.g.*, the lesser of three years or the remainder of the original term). Since these provisions may result in parachute payments, plan amendments should be considered and implemented in the context of an overall review of change in control employment protections, and the associated costs should be analyzed in that context. While ISS encourages double-trigger change in control

[72] *See* Chapter VIII of this Guide for a more detailed discussion of say on pay votes and ISS and Glass Lewis.

vesting, single-trigger vesting provisions in an equity plan will not automatically result in a negative recommendation for the equity plan—for instance, where a plan provides for single-trigger vesting only when an acquirer declines to assume the outstanding equity awards. However, equity plans that include both single-trigger vesting and a liberal "change in control" definition are likely to receive a negative recommendation.

For purposes of evaluating equity plans, ISS in recent years modified its equity plan scorecard regarding change in control vesting features, from awarding or withholding points based on the actual vesting treatment of equity awards on a change in control, to awarding points based on the quality of disclosure of change in control vesting provisions. Full points for this factor under the EPSC will be given if the plan discloses with specificity the change in control treatment of both time-vesting and performance-based vesting awards. If there is no change in control provision in the plan, or if the plan allows discretionary vesting, then zero points will be earned for this factor.

In designing employee stock plans, as well as other types of benefit and compensation plans, companies should be sensitive to the need to retain key personnel through the closing of a transaction to help ensure that the board of directors is delivering to the acquirer an intact management team. It is also important to ensure that there is harmony between the terms of the equity plans and award agreements and any severance arrangements.

Despite the terms of the stock plan and award agreements, the treatment of equity awards in a transaction is often a negotiated point between the parties. Most equity plans contain flexible adjustment provisions to accommodate treatment that deviates from the default change in control provisions, as long as the negotiated treatment is not adverse to the award holders.

3. Separation Plans

In addition to change in control employment and severance protection agreements with, and/or plans covering, senior executives, many public companies have adopted change in control separation plans for less senior executives, sometimes covering the entire workforce. These separation plans either formalize existing practices or provide enhanced severance in the event of a layoff occurring within a limited period (such as one or two years) after a change in control. These plans generally provide for cash severance payments determined on the basis of seniority/position, pay and years of service or some combination of these factors, although a minimum and a maximum number of weeks of pay is usually specified, and may provide continuation of benefits with the company paying all or a portion of the expense and outplacement services. Severance usually is

payable following an involuntary termination without cause and sometimes due to a constructive termination, such as workplace relocation, decrease in base salary or wages, or material diminution in duties.

Due to the large numbers of people involved, separation plans should be adopted after a careful review of the estimated costs, including an analysis of the potential impact of golden parachute excise tax and deductibility provisions of the Code on the payments and benefits provided under the plan. Further, companies should be sensitive to the fact that in an in-market merger involving facility closings or similar reductions in force on both sides, harmonizing the target and acquiror's severance policies may make sense, so that similarly situated employees of the acquirer and target who are laid off are treated uniformly.

4. Deferred Compensation Plans

Due to the credit risk associated with the payment of deferred compensation and other unfunded nonqualified plan benefits, plans often provide for, or participants elect, an immediate lump-sum payment of the entire account balance upon a change in control. Any such election should be reviewed to ensure that it complies with Section 409A. The definition of "change in control" applicable to change in control distribution provisions in, or individual elections under, deferred compensation plans for employees and directors should be reviewed and understood prior to a transaction, since Section 409A imposes significant limitations on the ability to alter distribution provisions or elections after they are established. Although some companies may prefer the administrative ease of having only one change in control definition for all purposes, a change in control definition that mirrors the definition in Section 409A is not required for all change in control provisions in all compensation arrangements. In general, companies should use definitions that they believe indicate a true transfer of control of the company and should provide, only to the extent required by Section 409A, that the definition will be triggered if such event also constitutes a "change in control event" within the meaning of Section 409A.

5. Rabbi Trusts

A rabbi trust is a trust created for the purpose of setting aside assets that may be used to fund an employer's non-tax-qualified benefit obligations, such as traditional deferred compensation balances, although in a change in control situation, severance is sometimes also covered by the trust. In general, companies adopt rabbi trusts for two reasons: (1) to provide a way to set aside funds to meet future obligations to pay deferred compensation or unfunded retirement benefits; and (2) to reassure

employees that the assets to pay their compensation will be available and in the hands of a neutral third party. The latter concern is generally the primary motivation in establishing rabbi trusts that are only required to be funded upon a change in control. If there is a genuine concern that an acquirer may refuse to pay certain benefits after a change in control, a rabbi trust can be designed to allow payments to be made by the trustee in accordance with procedures designed to protect the employees against unfair treatment by the acquirer. Because an acquirer, especially in a friendly transaction, is rarely reluctant to pay severance following a change in control where the entitlement is clear, the rabbi trust's effectiveness in ensuring payment is rarely tested.

It should also be noted that under the U.S. tax rules pursuant to which rabbi trusts are able to exist, funds deposited into rabbi trusts remain general assets of the company, subject to the claims of unsecured creditors of the company in the event of a bankruptcy.

Finally, before implementing a rabbi trust, especially one containing a provision that requires full funding or makes the trust irrevocable on a change in control or imminent change in control, the compensation committee should consider the types of liabilities being funded and the timeline for the payment of such obligations, the costs involved in funding and maintaining the trust, and the costs of using the trustee as paying agent/administrator for the payment of benefits that are funded through the trust upon a change in control. The funding obligation and related costs may be large in relation to the benefits to participants.

6. Retention Programs

A retention program is a helpful tool to ensure that the employees who are necessary to the completion of a transaction and the transition following closing are retained and incentivized to stay focused and committed. Retention is an issue for both the seller and the buyer, with the seller often most concerned about retaining key employees through closing and the buyer focused on the transition beyond the closing. The specific terms of the retention program, such as total amount and general payment timing and terms, are negotiated in connection with a transaction by the management teams. Individual awards are usually made during the period between signing and closing. The impact of the excise tax under Section 280G of the Code and the application of Section 409A should be understood and considered when developing retention programs and allocating awards thereunder. Companies should understand the disclosure obligations relating to the adoption of a retention program and the grant of awards thereunder, which could require filing a current report on Form 8-K if named executive officers are participating.

7. Considerations in Mergers of Equals

The characteristics of "mergers of equals" or "MOEs" generally include a no or low premium deal, with social issues (*e.g.*, headquarters, name of combined company), governance matters (*e.g.*, the composition of the board and its committees, the designation of the chairman or lead independent director) and CEO succession addressed in greater detail than in other transactions. The succession, compensation and benefits issues in an MOE are complex, requiring a careful analysis of the existing arrangements of both parties to the transaction, as well as the tax implications under Sections 280G and 409A of the Code. In recent MOEs, new agreements (employment, consulting or both) are almost always entered into with the CEOs of each party to the transaction at the time the merger agreement is signed, with the view that establishing the ongoing executive leadership and any planned transitions are important aspects of the transaction. MOE parties usually seek a balanced and equitable approach to retention and compensation matters, recognizing that synergies are a critical aspect of most MOEs. As with most compensation and employee retention matters, there is not a one-size-fits-all approach.

VII.

Special Considerations Applicable to Financial Institutions

Executive compensation and broad-based incentive compensation matters at financial institutions continue to be sensitive subjects that are scrutinized by the media and shareholders, and the regulatory requirements and standards relating to the design and administration of compensation arrangements at financial institutions are complex. While much of the public attention has been focused on executive compensation that is deemed excessive in amount, there has also been a critical assessment of the interplay among compensation and governance policies, corporate risk-taking and short-termism. We note that the recent Silicon Valley Bank crisis may result in greater scrutiny by the regulators of the compensation design and performance goals at banking organizations, given the focus on the pay of Silicon Valley Bank's executives being based on goals that allegedly rewarded a riskier asset management strategy.

At this time, it is not clear whether, and if so when, the compensation-related regulations for financial institutions under Section 956 of the Dodd-Frank Act, last issued in 2016, will be finalized and implemented. Likely in response to the Silicon Valley Bank crisis, the SEC included Section 956 on its short-term rulemaking agenda in June 2023, but as of this writing, no further action has been taken.

Financial institutions should expect the continued focus of regulators on the structure of compensation throughout the organization. Large banking organizations are in regular dialogue with regulators regarding the implementation of supervisory expectations relating to compensation design, governance and controls. Outside of the United States, highly prescriptive EU regulations on incentive compensation, such as a cap on bonuses to bankers, has resulted in higher fixed compensation (generally through increased salary), as European financial institutions seek to remain competitive in retaining talent. Some EU financial institutions have applied the EU regulations to the compensation of key personnel operating at U.S. subsidiaries, resulting in compensation design that is not always aligned with that of similar U.S.-only peers.

In the pursuit of good corporate governance and risk management, and as strongly encouraged by regulatory guidance, design changes in compensation programs at financial institutions include longer deferral periods and vesting schedules—changes that result in ongoing and growing deferred compensation expenses, which at some point will need to be paid. Clawbacks remain a focus at large financial institutions and are a design change that has proven to have some teeth.

Set forth below is a brief summary of the final guidance on the safety and soundness of incentive compensation policies, the re-proposed final rule under Section 956 of the Dodd-Frank Act (though the SEC has previously indicated that it may be re-proposed, and the new proposal may deviate from the 2016 re-proposed rule) and the Federal Deposit Insurance Corporation's (the "FDIC") golden parachute limitations. This summary generally identifies where the compensation committee has a specific responsibility or obligation and notes the complexity of the regulatory framework surrounding the compensation arrangements of financial professionals, which has resulted in increased responsibilities and challenges for compensation committee members at financial institutions.

A. Safety and Soundness Guidance

In June 2010, the bank regulatory agencies jointly issued final guidance for financial institutions on incentive compensation. All banking organizations are expected to evaluate incentive compensation and related risk management, control and governance processes, and to address deficiencies or processes inconsistent with safety and soundness. This evaluation is to be done with a view to the three core principles described in the guidance—that incentive compensation should:

- provide employees incentives that appropriately balance risk and reward;
- be compatible with effective controls and risk management; and
- be supported by strong corporate governance, including active and effective oversight by the board of directors.[73]

The third principle is of primary importance to compensation committee members of banking organizations. The guidelines emphasize governance and board-level oversight and provide that the board of directors of an organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements ("ICAs") for all covered employees—not just senior executives—are appropriately balanced and do not jeopardize the safety and soundness of the organization. The guidance makes clear that the organization, composition and resources of the boards of directors of banking organizations should permit effective oversight of ICAs. In particular, the guidance requires that a compensation committee take the following actions with respect to a company's ICAs:

[73] As used in the proposed guidance, the term "board of directors" refers to the members of the board who have primary responsibility for overseeing the incentive compensation system of a banking organization and, for purposes of this discussion, it is assumed that the compensation committee serves this function.

- actively oversee ICAs and directly approve ICAs for senior executives;

- monitor the performance, and regularly review the design and function, of ICAs; and

- for banking organizations that are significant users of ICAs, review the arrangements on both a backward-looking and forward-looking basis.

The guidelines expressly call for the involvement of functions, such as compliance, internal audit and risk management in the incentive compensation process. It is, therefore, likely that both management and the compensation committee will need to evolve towards a more consultative and multidisciplinary approach, in particular during the adjustment period, as new compensation best practices evolve in response to the increased regulatory scrutiny on incentive compensation. The guidance also indicates that the compensation committee should have access to a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate to the nature, scope and complexity of the organization's activities.

The restructuring of ICAs has been an iterative process. At this stage, compensation committee members of financial institutions should be ensuring that management is implementing the final guidance and considering it when evaluating proposed compensation arrangements. To date, favored design changes have included:

- decreasing incentive compensation payout opportunities to 125% or 150% of target opportunity (previously, 200% was common);

- deferring a portion of the payout of incentive compensation, both cash and long-term incentives, over at least three years to better understand the risk outcomes, with payment of the deferred amounts to be contingent on achieving performance-based measures; and

- increasing the portion of incentive compensation paid in equity-based instruments, such as performance and restricted shares, with stock options disfavored other than in limited amounts.

These design changes generally contract the upside opportunity and provide for *ex post* adjustments to address negative tail risk. In addition, regulators expect companies to have a framework for the exercise of discretion in compensation matters so that discretionary decisions may be audited, and to have recoupment and clawback provisions in place for all forms of incentive compensation. Financial institutions have succeeded in

balancing regulatory expectations with the "pay-for-performance" demands of shareholders and the need to attract, retain and incentivize executives and key employees.

As the regulation of compensation arrangements at banking organizations increases, the duties of compensation committee members expand. It is important for compensation committee members to understand these duties and ensure that the organization has adequate resources to respond to the requests of the various regulators and implement compliant compensation programs. The consequences of failing to meet the standards of the compensation guidelines are not insignificant, as the guidelines provide that supervisory findings on incentive compensation will be included in exam reports and incorporated into supervisory ratings. In addition, supervisory or enforcement action may be taken if incentive compensation or related controls, risk management or governance pose a risk to safety and soundness, and acceptable curative measures are not underway.

B. Section 956 of Dodd-Frank Act

Section 956 of the Dodd-Frank Act prohibits incentive-based compensation arrangements at "covered financial institutions" with assets of $1 billion or more that provide excessive compensation or could expose the institutions to inappropriate risks that could lead to a material financial loss, and requires such covered financial institutions to report their incentive-based compensation arrangements. In April 2016, federal regulators (including the Federal Reserve, the FDIC and the SEC) re-proposed a rule regarding incentive-based compensation under Section 956 of the Dodd-Frank Act that was far more proscriptive for large financial institutions than the original proposed rule. The 2016 proposed rule under Section 956 of the Dodd-Frank Act would supplement existing rules and guidance of the bank regulatory agencies, imposing additional standards and reporting obligations that overlap, but are not entirely consistent with, existing requirements. Financial institutions covered by the rule would be required to comply no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. Any incentive-based compensation plan with a performance period that begins before such date would not be required to comply with the requirements of the proposed rule.

The comment period for the 2016 proposed rule ended in July 2016 and, other than being included on the SEC's short-term rulemaking agenda in June 2023, there has been no further formal action with respect to the proposed rule by the regulators as of the date of this Guide. Large financial institutions have likely already incorporated much of the process

and compensation design aspects of the proposed rule into their compensation programs, but the adoption of the proposed rule would require incremental changes, the necessity and benefits of which are unclear. Below is a summary of the 2016 proposed rule.

1. Covered Financial Institutions

The proposed rule applies to covered financial institutions that have $1 billion or more in average total consolidated assets. The definition of "covered financial institutions" includes depository institutions and their holding companies (including the U.S. operations of a foreign bank), broker-dealers registered under Section 15 of the Exchange Act, investment advisors under the Investment Advisors Act of 1940 (whether or not registered), credit unions, Fannie Mae, Freddie Mac and Federal Home Loan Banks. The methodology for determining total consolidated assets under the proposed rule varies depending upon the category of the institution and the applicable regulator, and for depository institutions that are not investment advisors, it is generally determined based on a rolling average.

The 2016 proposed rule introduced subcategories of covered financial institutions based on the amount of average total consolidated assets as follows: (1) Level 1 covered financial institutions would be covered financial institutions with average total consolidated assets of $250 billion or more and subsidiaries of such institutions that are themselves covered financial institutions; (2) Level 2 covered financial institutions would be covered financial institutions with average total consolidated assets of between $50 billion and $250 billion and subsidiaries of such institutions that are themselves covered financial institutions; and (3) Level 3 covered financial institutions would be covered financial institutions with average total consolidated assets of between $1 billion and $50 billion.

2. Covered Persons

The proposed rule applies to "covered persons," which include executive officers, employees, directors and principal shareholders. While all employees are potentially covered persons, the proposed rule is intended to apply to the incentive compensation arrangements for covered persons or groups of covered persons that could encourage inappropriate risk-taking to the detriment of the covered financial institution. The 2016 proposed rule also introduces additional limitations on the incentive compensation of "senior executive officers" and "significant risk-takers" of Level 1 and Level 2 covered financial institutions. The "executive officers" of a covered financial institution include any person who is a "senior executive officer" as defined in the proposed rule (*i.e.*, any person who holds the title or performs the function of one or more of the

following positions: president, CEO, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer or head of a major business line or control function and other individuals designated as executive officers by the covered financial institution). The proposed rule also provides guidance on who is considered a significant risk-taker, with the primary factor being whether the individual's incentive compensation is at least one-third of their total compensation.

3. Prohibitions under the Proposed Rule

Under the proposed rule, a covered financial institution would be prohibited from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by providing excessive compensation. "Incentive-based compensation arrangement" means any variable compensation arrangement that serves as an incentive for performance, including equity-based compensation. "Excessive compensation" means amounts that are unreasonable or disproportionate to the value of the services performed.

In evaluating whether compensation is excessive, the agencies will consider, among other factors, the following:

- the combined value of all compensation, fees or benefits provided to the covered person;
- the compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- the financial condition of the covered financial institution;
- compensation practices at comparable institutions;
- for post-employment benefits, the projected total cost and benefit to the covered financial institution; and
- any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the covered financial institution.

Accordingly, while the proposed rule would apply directly only to incentive-based compensation, regulators will consider all compensation and benefits arrangements in the evaluation of the incentive-based arrangements.

The proposed rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements that encourage a covered person to expose the institution to a material financial loss. To comply with this standard, an incentive-based compensation arrangement must balance risk and financial rewards (*e.g.*, through payment deferrals, risk adjustment of awards, and/or longer performance periods), be compatible with effective risk management and controls and be supported by effective corporate governance, namely through board of directors' oversight of incentive-based compensation arrangements.

4. Additional Requirements Applicable to Level 1 and Level 2 Covered Financial Institutions

Level 1 and Level 2 covered financial institutions would also be subject to several additional, prescriptive requirements with respect to incentive-based compensation arrangements, including, among others:

- *Maximum Opportunities (i.e., Caps on Incentive-Based Compensation).* Level 1 and Level 2 covered financial institutions would not be permitted to award incentive-based compensation to senior executive officers and significant risk-takers in excess of 125% and 150%, respectively, of the target amount for the incentive-based compensation.

- *Relative Performance Measures.* Level 1 and Level 2 covered financial institutions would not be permitted to use incentive-based compensation performance measures that are solely based on industry peer performance comparisons.

- *Volume-Driven Measures.* Level 1 and Level 2 covered financial institutions would not be permitted to award incentive-based compensation to covered persons that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.

- *Minimum Deferral (Level 1).* Level 1 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (60% and 50% for senior executive officers and significant risk-takers, respectively) for each performance period for a minimum period of time (at least four years for short-term incentive compensation and at least two years for long-term incentive compensation). No more than 15% of a senior executive officer's or significant risk-taker's total incentive compensation awarded in stock options would count toward the deferral requirements.

- *Minimum Deferral (Level 2).* Level 2 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (50% and 40% for senior executive officers and significant risk-takers, respectively) for each performance period for a minimum period of time (at least three years for short-term incentive compensation and at least one year for long-term incentive compensation). The same limitation on options as described above for Level 1 covered financial institutions would also apply to Level 2 covered financial institutions.

- *Vesting During the Deferral Period.* During the deferral period described above, incentive-based compensation may not vest faster than on a pro rata annual basis beginning on the first anniversary of the end of the performance period for which the amount was awarded, and the vesting of the deferred incentive-based compensation may not be accelerated other than in the case of the death or disability of the covered person.

- *Downward Adjustment.* Deferred incentive-based compensation awarded to Level 1 and Level 2 senior executive officers and significant risk-takers would need to be subject to "downward adjustment" (*i.e.*, forfeiture) if any of the following adverse outcomes occurred at the covered financial institution: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered financial institution's policies and procedures; (2) inappropriate risk-taking, regardless of the impact on financial performance; (3) material risk management or control failures; (4) noncompliance with statutory, regulatory or supervisory standards that results in enforcement or legal action against the covered financial institution brought by a federal or state regulator or agency or a requirement that the covered financial institution report a restatement of a financial statement to correct a material error; and (5) other aspects of conduct or poor performance as defined by the covered financial institution.

- *Clawback.* Incentive-based compensation awarded to Level 1 and Level 2 senior executive officers and significant risk-takers would be subject to a minimum seven-year clawback period following the date on which the compensation vests. Events triggering clawback include: (1) misconduct that resulted in significant financial or reputational harm to the covered financial institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation. It is not clear how this provision would interact with the SEC's final compensation clawback rules discussed above.

- *No Hedging.* Level 1 and Level 2 covered financial institutions would not be permitted to engage in transactions on behalf of covered persons to hedge or offset any decrease in the value of the covered person's incentive-based compensation.

5. Policies and Procedures

To help ensure compliance with the proposed rule, covered financial institutions would be required to implement policies and procedures with respect to incentive-based compensation, including recordkeeping obligations for all covered institutions to ensure the ability to disclose records relating to the incentive arrangements to their primary regulator upon request. The 2016 proposed rule also incorporates several additional requirements for Level 1 and Level 2 covered financial institutions with respect to oversight, risk management, controls, and governance policies and procedures, including, among others, (1) recordkeeping requirements that mandate that the covered financial institution maintain detailed records with respect to its incentive-based compensation arrangements for senior executives and significant risk-takers for at least seven years in a manner that allows for an independent audit; (2) requirements that the compensation committee obtain annual written assessments with respect to the institution's incentive-based compensation program from both management and an independent third party; and (3) a requirement to develop and adopt a risk-management framework for its incentive-based compensation program that is independent of any line of business and includes an independent compliance program for internal controls, testing, monitoring and training.

C. FDIC Golden Parachute Regulations

Payments to executives of "troubled" financial institutions may be limited under the "golden parachute" rules of the FDIC. Subject to certain exceptions, the FDIC rules prohibit troubled insured depository institutions (or their holding companies) from making golden parachute payments to any "institution-affiliated party" ("IAP"), which includes the institution's directors, officers and employees, among others. The FDIC rules generally define "golden parachute payments" as compensatory payments (or agreements to make compensatory payments) to an IAP by a troubled insured depository institution that are contingent on, or payable after, the termination of the IAP's primary employment or affiliation with the institution, with exceptions for certain *bona fide* deferred compensation payments, qualified retirement plan payments, limited payments under nondiscriminatory severance pay arrangements and payments under certain employee welfare benefit plans. An institution subject to the FDIC's golden parachute rules may, subject to obtaining the written consent of the appropriate federal banking agency, make parachute

payments to IAPs under an agreement that provides for payment of a reasonable severance payment, not exceeding twelve months of salary, in the event of a change in control of the institution (other than an FDIC-assisted transaction or in connection with FDIC receivership or conservatorship).

VIII.

Shareholder Proposals, Relations and ESG Trends

Annual, mandatory say on pay shareholder advisory votes are for the most part an ordinary fact of life for public companies. Concern over say on pay support levels continues to influence company action, both in terms of compensation design and shareholder outreach strategy. This Chapter VIII discusses the evolution of say on pay, as well as other notable developments in the area of compensation-related shareholder proposals, the compensation policies of proxy advisory groups (notably, ISS) and executive compensation litigation.

A. Say on Pay

Since 2010, the Dodd-Frank Act has mandated three different types of nonbinding shareholder votes on compensation matters:

- No less frequently than once every three calendar years, each public company must submit the compensation of its NEOs to a nonbinding shareholder vote (the say on pay vote). Most public companies have opted for annual say on pay votes.

- No less frequently than once every six calendar years, each public company must submit for a nonbinding shareholder vote the question of whether the say on pay vote should be held annually, biennially or triennially (the say when on pay vote). As discussed below, this vote occurred most recently in 2023 for most companies.

- In any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets, a public company must submit all golden parachute arrangements covering any of its NEOs to a separate nonbinding shareholder vote, (the "golden parachute say on pay" vote), unless the arrangements have already been "subject to" a say on pay vote.

1. The Say on Pay Vote

The say on pay vote must cover the compensation of a company's NEOs, as disclosed in accordance with Item 402 of Regulation S-K, including the CD&A; it does not cover director compensation, nor does it cover the portion of the proxy statement disclosure related to compensation and risk with respect to broad-based programs. The vote is a single line item on the relevant compensation arrangements in their entirety. The SEC rules do not require companies to use specific language or a prescribed format

in "say on pay" resolutions, although they include a nonexclusive example of a resolution that would satisfy the applicable requirements. The proxy statement must include an explanation of the effect of the vote (*i.e.*, that it is nonbinding), and future proxy statements must address whether (and if so, how) the company has considered the results of the most recent vote in determining compensation policies and decisions.

The say on pay vote serves as an important barometer of shareholder views of a public company's compensation practices. As discussed below, ISS has indicated that it utilizes say on pay votes, where offered, as its primary vehicle for expressing dissatisfaction with compensation practices. While the say on pay vote is nonbinding, companies are quite focused on receiving a favorable outcome, and poor results have the potential to trigger significant investor pressure and even litigation.

In 2023, close to 98% of Russell 3000 companies that submitted a say on pay vote received majority support, with average support levels at approximately 90.0%, and with approximately 72% of such companies receiving more than 90% support. ISS recommended a vote against approximately 12.8% of Russell 3000 and 9.6% of S&P 500 company proposals (approximately 120 and 310 basis points lower, respectively, than the 2022 rates), so a favorable vote was achieved even in a significant majority of the cases where ISS had made a negative recommendation. However, an ISS negative recommendation correlated with lower support levels. Companies that received an ISS "against" recommendation achieved an average vote result of 26 percentage points lower, in the case of Russell 3000 companies.[74]

Despite generally positive year-over-year say on pay results, companies should approach each proxy season with a fresh perspective, as changes in company performance, company compensation programs, and investor guidelines can have significant impact. As discussed below, ISS engages in extra scrutiny of company responses to say on pay for those that did not achieve 70% support in the prior year's say on pay vote, and has indicated a willingness to more actively recommend withhold votes from members on compensation committees where there is a view that companies with low support are not sufficiently responsive to shareholder feedback received.

Each company's situation is unique, but, generally, the steps a company can take that will best position the company for a positive say on pay vote remain fairly constant from year to year, and include the following:

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[74] *See* Semler Brossy, *2023 Say on Pay & Proxy Results Report* (Jan. 19, 2024), available here.

- *Analyze Prior Year's Results and Monitor Shareholder Policies*. Companies should review the voting policies of major shareholders and understand the ways in which compensation practices may deviate from those policies. As part of that review, companies should revisit the prior year's vote results and proxy advisory firm recommendations in order to understand issues that may be particularly sensitive for the advisory firms and major shareholders. While companies should not make substantive compensation decisions that they do not believe are in the interests of long-term value increases to the company, merely in the hopes of increasing support for their say on pay proposals, changes may be appropriate where a company determines, upon reflection, that its compensation arrangements could be improved based on feedback from its shareholders and proxy advisors.

- *Communicate With Shareholders Through the CD&A*. The CD&A represents a critical communication tool in the effort to win say on pay votes. A company should use an executive summary to highlight key points and key developments since the prior year, shareholder-favored practices that the company maintains, and "hot button" practices that the company does not maintain. Given the large number of proxy statements that the typical institutional shareholder must review each proxy season, ease of readability is critical.

- *Directly Engage With Shareholders*. Whether or not a given company has received low support in the prior year, institutional investors and proxy advisors have come to expect companies—especially those that have reason to be concerned about low support at the next annual meeting (*e.g.*, its three-year TSR is low)—to be offering a direct dialogue not just immediately before ISS issues its report, but throughout the year, and before annual compensation goals and targets are set for an upcoming year. This is a process that requires careful consideration, and involves:

    - identifying significant shareholders that should be approached and, if available, their voting policies;

    - determining the person at each identified shareholder who should be contacted, with the goal being to gain the ear of a decision-maker and recognizing the delineation at most large institutions between the investment management team and the proxy voting team;

    - deciding who should make the approach to the identified shareholders, understanding that some shareholders prefer to meet with compensation committee members (particularly, the chair), while others prefer meeting with in-house subject matter experts in

the executive compensation, human resources or legal functions (but not the CEO, as the discussion is often about his or her own compensation) and outside advisors;

- figuring out the ideal time to approach the identified shareholders, with the understanding that telephone calls and meetings that occur outside of the proxy season are most likely to gain focused shareholder attention and also provide an opportunity for a second approach to the shareholders after the issuance of the ISS report if it is problematic; and

- crafting a section of the CD&A to describe the shareholder engagement process, including any changes in compensation programs based on shareholder feedback.

- *Respond to ISS's Recommendations*. As noted above and discussed below, ISS wields significant influence in the say on pay process.

  - ISS Corporate Solutions can be engaged, for a fee, to analyze, among other things, elements of equity plans being proposed for approval to shareholders, as well as compensation arrangements that may be up for approval in any say on pay advisory vote. The purpose of obtaining such a review in advance of a company filing its annual proxy is to allow companies to address any issues that ISS Corporate Solutions may identify as problematic, either through shareholder engagement, enhanced proxy disclosure, or both.

  - After the proxy statement has been filed, ISS will issue its report regarding the say on pay proposal. While at one time, ISS gave U.S. S&P 500 companies an opportunity to comment on ISS's report before it is finalized, ISS has discontinued this practice, although it will issue an "Alert" if it is notified of a factual error to update a previously issued proxy report. ISS has also advised that if "significant new information is publicly disclosed in a timely manner," ISS will issue an "Alert" only if (1) "warranted," as it determines it to be, and (2) if sufficient time is available before voting deadlines in that market for their institutional investor clients to review any changes in the Alert "(which could include a change to a previously issued vote recommendation)."

    The evolution of the ISS review process emphasizes how critical an ongoing annual shareholder outreach program is. Along with clear and complete disclosure, ongoing shareholder outreach will assist a company in being able to quickly and directly solicit and

obtain shareholder support of its compensation arrangements, despite a negative ISS say on pay recommendation.

2. The Say When on Pay Vote

The Dodd-Frank Act requires a nonbinding vote, at least once every six calendar years, to determine the frequency of say on pay votes. SEC rules require that shareholders receive the option to vote for one of four choices (annual, biennial, triennial or abstain). Thus, a company cannot offer a "yes" or "no" vote on its preferred option, although the company may make a vote recommendation.[75] In 2011, when most companies were required to first conduct a frequency vote, the annual option received the most support at approximately 80% of companies, the triennial option received support at approximately 19% and the biennial option received support at approximately 1%. In response, over 70% of Russell 3000 companies elected to conduct votes annually. Since this time, the overwhelming majority of companies conduct votes annually, due in no small part to both ISS and Glass Lewis announcing that they will generally recommend in favor of an annual vote for companies submitting a say-when-on-pay vote to shareholders. In fact, ISS will recommend an "against" or "withhold" vote on the entire board if a company implements a say on pay vote on a less frequent basis than the frequency of timing that received the majority or plurality of votes cast at the most recent shareholders meeting. Given the six-year cycle, most companies submitted to shareholders a proposal on say on pay frequency in the 2023 proxy season, and will next need to do so in the 2029 proxy season.

An annual say on pay vote offers many practical benefits. Providing shareholders with an annual say on pay vote gives shareholders an avenue other than director elections to express their dissatisfaction with pay practices at the company and, therefore, may save directors the embarrassment of receiving a significant number of "no" votes. In addition, holding an annual say on pay vote may help the company avoid antagonizing shareholders that favor an annual vote.

One note on disclosure: a company must disclose in a current report on Form 8-K its decision regarding the frequency of the say on pay vote in light of the results of the say when on pay vote. The Form 8-K must be filed no later than 150 calendar days after the date of the applicable meeting, and in any event no later than 60 calendar days prior to the

[75] Note that, under SEC rules, companies may vote uninstructed proxy cards in accordance with management's recommendation for the frequency vote *only* if the company (1) includes a recommendation for the frequency vote in the proxy statement, (2) permits abstention on the proxy card, and (3) includes language in bold regarding how uninstructed shares will be voted on the proxy card.

deadline for submission of shareholder proposals for the subsequent annual meeting. Companies must include in their proxy materials disclosure of the current frequency of say on pay votes and when the next scheduled say on pay vote will occur.

3. The Golden Parachute Say on Pay Vote

Under the Dodd-Frank Act, the golden parachute say on pay vote applies to any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets.

SEC rules require disclosure in a prescribed tabular format of all golden parachute compensation arrangements in connection with any such transaction. For this purpose, SEC rules define "golden parachute" fairly broadly to encompass all agreements and understandings between the target or the acquirer and each NEO of the target or the acquirer that relate to the transaction. However, *bona fide* new employment arrangements with the acquirer often can be excluded. If a company previously has submitted golden parachute arrangements to a say on pay vote and has not modified those arrangements, then the company will not be required to submit those arrangements to the golden parachute say on pay vote, so long as the company's disclosure for the prior say on pay vote satisfied the tabular disclosure and other requirements applicable to golden parachute say on pay votes.[76] Notwithstanding this exception, in our experience it is unusual that a target company is able to rely solely on its disclosure for the prior say on pay vote, so companies should expect full disclosure of their executive officers' arrangements in the merger proxy statement.

ISS's current policy on these votes is to make recommendations on a case-by-case basis on proposals to approve golden parachute compensation, consistent with policies on problematic pay practices related to severance. ISS's golden parachute say on pay analysis includes an evaluation of a company's existing arrangements, as well as any new ones. ISS's views on equity vesting provisions when making recommendations in connection with a "say on golden parachute" vote remain unchanged in its most recent updated voting guidelines: (1) maintaining existing criteria is a "good practice"; (2) pro rata vesting based on actual goal achievement for performance awards and/or based on partial completion of the vesting period is a "best practice"; (3) acceleration of awards granted shortly before a change in control is viewed as a greater windfall; and (4) auto-acceleration concerns are greater when awards make up the majority of

[76] Note that the rules applicable to annual proxy disclosure of termination and change in control arrangements, unlike the golden parachute say on pay rules, do not prescribe a mandatory tabular disclosure format.

NEOs' golden parachutes, or where accelerated awards granted in the cycle before the change in control are larger than in prior cycles.

Glass Lewis generally takes a hard line regarding golden parachute gross-ups:

> "Depending on the circumstances, the addition of new gross-ups around this excise tax particularly may lead to negative recommendations for a company's say-on-pay proposal, the chair of the compensation committee, or the entire committee, particularly in cases where a company had committed not to provide any such entitlements in the future. For situations in which the addition of new excise tax gross ups will be provided in connection with a specific change-in-control transaction, this policy may be applied to the say-on-pay proposal, the golden parachute proposal and recommendations related to the compensation committee for all involved corporate parties, as appropriate."

This last sentence could be construed as a caution to acquiring companies, as historically, the boards of directors of acquirors and their compensation committees have not been impacted by decisions of a target company's board of directors in connection with a transaction; to date, however, we are not aware of any situations where this guideline has been applied to trigger any adverse voting recommendation in respect of the acquiring company's compensation committee.

Against this backdrop, target companies should be aware of the possibility of an ISS or Glass Lewis recommendation against the say on golden parachute vote in circumstances where transaction-based compensation arrangements implicate the items covered by the ISS and Glass Lewis guidelines as summarized above. Importantly, however, even if the recommendation against leads to a failed say on golden parachute advisory vote, the vote results from the last several years do not appear to indicate any correlation between levels of support on the golden parachute advisory votes and levels of support on approval of the underlying transactions.

B. Shareholder Proposals

In recent years, shareholder activists have increasingly chosen to push their agendas through shareholder proposals, including compensation-related shareholder proposals from institutional investors such as union pension funds and faith-based investors. Many of the proposals received during the last proxy seasons have been industry-specific and/or had an ESG focus, with more significant proposals relating to climate change, as

well as pay equality and diversity. Of the ESG-related proposals made in 2023, 258 were based on social issues, and 106 were based on environmental issues. These proposals received lower support in 2023: 2% of social proposals and 2% of environmental proposals received more than 50% support, whereas in 2022 9% of social proposals and 22% of environmental proposals received more than 50% support.[77]

The appropriate course of action with respect to any particular proposal will depend upon the facts and circumstances. In some cases, it may be possible to exclude a proposal under applicable SEC rules. A company and its legal counsel will need to thoughtfully consider the possible impact of excluding compensation-related proposals and weigh the pros and cons of engaging in a dialogue with the proponent to encourage the proponent to withdraw its proposal. In other instances, it may make sense to implement a particular proposal, whether in whole or in part.

In formulating responses to shareholder proposals, companies should recognize that activists and shareholder advisory firms carefully monitor company action in this area and may shine a spotlight on those companies that they view as uncooperative. Ultimately, however, executive compensation is a core responsibility of the board, and directors must bear in mind that they are best positioned to establish optimal company-specific compensation programs.

C. The Rise of ESG-Related Goals and the Future of Executive Compensation

In recent years, investors have increasingly focused on ESG issues—notably, climate change, DEI, and human capital management—and have called on companies to disclose their ESG performance and targets.[78] As a consequence, company boards are finding it necessary to become more deeply engaged in the oversight and integration of ESG issues in business strategy and the monitoring of their companies' progress towards ESG targets.

Increasingly, companies are demonstrating their commitment to their ESG goals by tying certain ESG metrics to executive compensation. A recent survey by FW Cook[79] of the 250 companies in the S&P 500 with the

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[77] *See* Semler Brossy, *2023 Say on Pay & Proxy Results Report* (Jan. 19, 2024), available here, and Semler Brossy, *2022 Say on Pay & Proxy Results Report* (Jan. 12, 2023), available here.

[78] *See, e.g.*, World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation* (Jan. 2020).

[79] *See* FW Cook's *2023 Use of Environmental, Social, and Governance Metrics in Incentive Plans* (Aug. 2023), available here.

largest market cap found that, in 2023, 75% of these companies disclosed ESG metrics in their incentive plans (up from 74% in 2022). ESG use in incentive plans varied by industry and is most prevalent among companies in the energy, utilities, materials and real estate sectors (with over 80% of surveyed companies tying ESG metrics to compensation), while it is least prevalent among companies in the consumer discretionary (55% prevalence). The types of ESG metrics employed also varied by industry: environment & sustainability metrics are most common among the energy and materials sectors, while human capital and culture and DEI metrics were most common across other industries. This year saw a slight increase in the number of companies using diversity and inclusion metrics in incentive plans (59% in 2023 compared to 58% in 2022). Another recent study by Morgan Stanley[80] found that approximately 20% of the S&P 500 has tied short-term compensation to ESG goals. Among companies in the S&P 500 that link ESG to short-term compensation, around 70% disclosed some form of explicit weighting of ESG factors, with the average assigned weight being 17% of short-term incentive compensation.

Whether and how a company decides to address ESG in its compensation programs should be considered in the context of its broader ESG performance and the policies and processes it has in place to assure investors and other stakeholders of its commitment to carrying out its ESG ambitions, as well as the sector in which it operates, and evolving industry and market practices.

A preliminary analysis of considerations when tying compensation to ESG-related goals may include:

- which ESG issues are most relevant to the company, and whether key stakeholders agree on these priorities;

- determining whether the goals should be a stand-alone component of, a percentage of, or a basis to make an adjustment to, performance-based compensation;

- whether ESG metrics should feature in the company annual or long-term incentive plans;

- how progress on ESG issues will impact the company's financial bottom line over both the short term and long term (and whether this impact can be measured); and

[80] *See ESG-Linked Comp; Missing the Mark* (Jan. 2022) by Morgan Stanley Research.

- educating all constituencies regarding the relevance of the ESG issues and how the achievement of related goals benefits all stakeholders.

D. Shareholder Advisory Firms—Voting Guidelines

Over the last 10 years, the influence of shareholder advisory firms on executive compensation practices through their voting recommendations on executive compensation proposals cannot be overstated.[81] Below we discuss the influence firms like ISS and Glass Lewis have and continue to have on say on pay and equity plan proposals.

ISS—In General. The most influential of these firms is ISS. The compensation committee should regularly review updates regarding ISS's positions on pay practices, as a means of understanding the potential shareholder reaction to, and the best means of explaining, compensation decisions. We describe in Chapter VIII of this Guide some of ISS's positions on the say when on pay and golden parachute say on pay advisory votes.

The say on pay vote is the primary vehicle, although not the only vehicle, through which ISS will express its view on a company's pay practices. As in prior years, in 2024 ISS will evaluate, on a case-by-case basis, its recommendation regarding say on pay proposals and compensation committee member elections where a company's say on pay proposal in the previous year received the support of less than 70% of the votes cast. ISS's evaluation will be based on the company's response to the concerns expressed by shareholders in the previous year, including disclosed engagement efforts with major institutional investors and specific actions taken to address the issues that led to the lack of support. ISS has stated that cases where support was less than 50% will "warrant the highest degree of responsiveness." Given the low threshold of opposition votes triggering the more stringent review, companies may treat a say on pay vote with majority, but less than 70%, support as effectively a lost vote.

The ISS U.S. compensation policy proxy voting guidelines effective for meetings on or after February 1, 2024 are not different in any material respect to the guidelines issued for the prior proxy season.[82] ISS has advised the following regarding its recommendations:

- *If There is a Say on Pay Proposal on the Ballot*. ISS generally will recommend a vote against the proposal if (1) there is an unmitigated misalignment between CEO pay and company performance; (2) the

[81] *See* Chapter XI of this Guide for a discussion of ISS guidelines regarding non-employee director compensation.

[82] *See ISS United States Proxy Voting Guidelines* (published Jan. 2024), available here.

company maintains significant problematic pay practices; or (3) the board exhibits a significant level of poor communication and responsiveness to shareholders.

- *"Withhold" and "Against" Vote Recommendations on Compensation Committee Members.* In general, ISS will recommend a vote against or withhold from the compensation committee members or potentially the full board if ISS believes (1) the board has failed to respond adequately to a previous say on pay proposal that received less than 70% of votes cast; (2) the company has recently practiced or approved problematic pay practices, such as option repricing or option backdating; or (3) "[t]he situation is egregious."

ISS—Problematic Pay Practices.[83] The list of problematic pay practices has remained relatively constant over the last few years. Pay elements that are not directly based on performance are evaluated on a case-by-case basis, including whether executive perquisites or benefits are a poor use of company assets, which could have a detrimental effect on the company. For this reason, companies should remain aware of, and remain current on, the list of problematic pay practices. That list is long, and includes:

- "egregious" employment contracts containing multi-year guarantees for salary increases, non-performance-based bonuses and equity compensation;

- an "overly generous" new hire package for a CEO (*i.e.*, sign-on awards that are excessively large or insufficiently performance-based, problematic termination-related equity vesting provisions or any other "problematic pay practices" listed in ISS's policy);

- "abnormally large" bonus payouts without justifiable performance linkage or proper disclosure (*e.g.*, performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance, or payouts made despite failure to achieve pre-established threshold performance criteria);

- "egregious" pension or supplemental executive retirement plan payouts (*e.g.*, inclusion of additional years of service not worked that result in significant benefits provided in new arrangements, inclusion of performance-based equity awards in the pension calculation);

[83] *See ISS U.S. Compensation Policies Frequently Asked Questions* (Updated Feb. 2, 2024), available here.

- "excessive" perquisites (*e.g.*, perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft or other "inappropriate" arrangements, extraordinary relocation benefits, including home loss buyouts or "excessive" amounts of perquisites compensation);

- "problematic" severance and/or change in control provisions (*e.g.*, (1) change in control cash payments exceeding three times base salary plus target/average/most recent bonus or that include equity gains or other pay elements in the calculation; (2) new or materially modified arrangements that provide payments without loss of job or substantial diminution of job duties, including upon certain voluntary terminations; (3) new or materially modified arrangements that provide for an excise tax gross-up; (4) "excessive" payments upon an executive's termination in connection with performance failure or payments in connection with apparent voluntary resignation or retirement; (5) liberal definition of "change in control" where no actual change in control has occurred; and (6) a "problematic" definition of "good reason" that presents windfall risks, such as definitions triggered by performance failures);

- tax reimbursements;

- dividends or dividend equivalents paid on unvested performance shares or units;

- internal pay disparity—*i.e.*, an "excessive differential" between total pay of the CEO and that of the next-highest paid NEO;

- repricing or replacing underwater stock options or stock appreciation rights without prior shareholder approval;

- significant shifts away from performance-based compensation to discretionary or fixed pay elements; and

- other pay practices that may be deemed problematic in a given circumstance, but are not covered in the above categories.

In addition, although not identified as a "problematic" pay practice, ISS has said that it is unlikely to support large, front-loaded equity award grants that are intended to cover more than four years (*i.e.*, the grant year plus three future years). ISS's concern is that such grants may limit the board's ability to meaningfully adjust future pay opportunities in the event of unforeseen events or changes in either performance or strategic focus. If a front-loaded grant is made, any commitments not to grant new equity awards in the period covered by a front-loaded grant should be firm.

It is also worth noting that there is an ISS FAQ expressly requiring a company to identify in disclosure the type of termination of employment, and the provision by which severance payments were made under the relevant plan or agreement, in lieu of the less clear disclosure that an executive has "stepped down" or that the executive and board "mutually agreed" on a departure.

Note that engagement in a small number of these practices may not, in itself, result in an adverse recommendation from ISS. However, there is a list of pay practices that ISS deems most likely to result in an adverse recommendation. The list of these particularly problematic practices includes:

- repricing (including through cash buyouts) underwater options/stock appreciation rights without prior shareholder approval;

- "extraordinary" perquisites or tax gross-ups, potentially including gross-ups related to restricted stock vesting and home loss buyouts, and any lifetime perquisites;

- new or extended agreements that provide for:

    - excessive change in control payments (*i.e.*, that exceed three times salary plus target/average/most recent bonus);

    - change in control severance payments that do not require an involuntary job loss or substantial diminution of duties, or in connection with a problematic definition of "good reason";

    - problematic definition of "good reason" that presents windfall risks, such as a definition triggered by potential performance failures;

    - change in control payments with excise tax gross-ups (including "modified" gross-ups);

    - multi-year guaranteed awards or increases that are not at risk due to rigorous performance conditions; and

    - a liberal change in control definition combined with any single-trigger change in control benefits;

- insufficient executive compensation disclosure by externally-managed issuers ("EMIs") such that a reasonable assessment of pay programs and practices applicable to the EMI's executives is not possible;

- severance payments made when the termination is not clearly disclosed as involuntary (for example, a termination without cause or resignation for good reason); or

- any other provision or practice deemed egregious that presents a significant risk to investors.

As a reminder, ISS has advised that it will not consider a company's commitment to eliminate a problematic pay practice in the future as a way of preventing or reversing a negative vote recommendation.

ISS—Misalignment Between Pay and Performance. Given the importance of the pay-for-performance test and the focus by ISS on companies whose say on pay support falls below 70%, compensation committees will be well served by understanding this test, and may wish to consider having a "dry run" of it performed prior to proxy season in order to understand whether the vote might be at risk. Moreover, in the case of such a misalignment that is a result of a problematic equity compensation practice when there is an equity plan on the ballot, ISS may recommend voting against an equity plan proposal if it determines equity grant practices are driving the misalignment.

ISS has provided significant detail about how it runs its pay-for-performance test. If the results of a preliminary quantitative analysis indicate significant misalignment between CEO pay and shareholder returns and fundamental financial performance (both on an absolute basis and relative basis to a group of peers similar in size and industry), ISS will perform a more in-depth qualitative review of the programs.[84]

ISS—Equity Plan Proposals.[85] Under the ISS EPSC method of analyzing whether to recommend "For" or "Against" an equity plan proposal, recommendations on equity plan proposals are based on a combination of weighted factors related to: (1) plan costs based on a shareholder value transfer measurement; (2) plan features, such as share recycling and change in control equity award treatment; and (3) company grant practices, including a three-year average burn rate relative to peers, the proportion of CEO's equity awards subject to performance conditions, as well as clawback and holding requirements, with weighting by categories of companies. A score of 57 or higher (out of 100 points) for an S&P 500 company, 55 or higher for a Russell 3000 company and 53 or higher for

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[84] *See ISS U.S. Compensation Policies Frequently Asked Questions* (Updated Feb. 2, 2024), available here and *Pay-for-Performance Mechanics ISS' Quantitative and Qualitative Approach* (Updated Dec. 8, 2023), available here.

[85] *See ISS U.S. Equity Compensation Plans Frequently Asked Questions* (Updated Dec. 11, 2023), available here.

other companies is required to receive a favorable recommendation. In order for a company to receive points for a clawback policy, the policy should authorize recovery upon a financial restatement and cover all or most equity-based compensation for all NEOs. A company will not receive credit if the policy contains only the limited requirements under Sarbanes-Oxley, or if the company has disclosed that it plans to establish a policy after the finalization of applicable rules under the Dodd-Frank Act.

The current ISS list of "egregious" features that may result in an "Against" recommendation on any equity plan proposal, regardless of any EPSC score, is composed of the following items:

- a liberal change in control definition that could result in vesting of equity awards by any trigger other than a full double-trigger;

- repricing or cash (or stock award) buyouts of underwater options or SARs without shareholder approval;

- the plan is a vehicle for problematic pay practices or pay-for-performance misalignment;

- the plan is estimated to be excessively dilutive to shareholders' holdings (*i.e.*, the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (for S&P 500 companies) or 25% (for Russell 3000 companies)); or

- any other plan features or practices that are deemed detrimental to shareholders (*e.g.*, tax gross-ups on equity awards).

Director Equity Compensation Plans.[86] In response to the increased scrutiny of director compensation arrangements in recent years, ISS has added guidance regarding evaluations of director equity plans. Initially, ISS had clarified that stand-alone director equity compensation plans would not be evaluated under the EPSC or taken into account for purposes of determining the company's three-year burn rate for its employee equity compensation plans, unless the amount of director equity grants is larger than employee equity grants.

The current guidance regarding factors considered in ISS's qualitative review of director equity plan approval, when a stand-alone director equity plan exceeds the plan cost or burn rate benchmark, provides that in its review, ISS will examine:

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[86] *See ISS U.S. Compensation Policies Frequently Asked Questions* (Updated Feb. 2, 2024), available here and *ISS U.S. Equity Compensation Plans Frequently Asked Questions* (Updated Dec. 11, 2023), available here.

- the relative magnitude of director compensation as compared to companies with a similar profile;

- the presence of problematic pay practices relating to director compensation;

- the director stock ownership guidelines and holding requirements;

- the equity award vesting schedules;

- the mix of cash and equity-based compensation;

- the meaningful limits on director compensation;

- the availability of retirement benefits or perquisites; and

- the quality of disclosure surrounding director compensation.

ISS has also modified its policy regarding advisory shareholder votes to ratify non-employee director compensation to eliminate the specific list of factors it reviews (although they were similar to the factors used to review a stand-alone director equity plan, above). Instead, in evaluating director pay plans, ISS will consider pay composition, magnitude and other qualitative features, such as "meaningful" director stock ownership requirements (*i.e.*, at least four times annual cash retainer). ISS also views performance-vesting equity awards, retirement benefits and other perquisites as problematic pay practices for non-employee directors. Moreover, ISS views a "meaningful limit" on annual director pay as a "positive" feature.

Glass Lewis. Glass Lewis continues to apply a "highly nuanced approach" in analyzing say on pay advisory votes, reviewing such vote proposals on a case-by-case basis, both on a qualitative and quantitative basis, and may recommend against a say on pay vote if, generally, the company fails to demonstrably link compensation with performance (*i.e.*, if there are deficiencies in a company's compensation program's design, implementation or management). Glass Lewis grades each company's pay-for-performance on a school letter system (A, B, C, D or F), noting that a "C" in the Glass Lewis system indicates that the "company's percentile rank for pay is approximately aligned with its percentile rank for performance." Unlike ISS, Glass Lewis does not specifically disclose its methodology for weighting and scoring the factors used in its analysis.

Although not an exhaustive list, Glass Lewis may recommend voting "Against" a say on pay vote when the following issues are weighted together:

- inappropriate or outsized self-selected peer group and/or benchmarking issues, such as compensation targets set well above the median without adequate justification;
- "egregious or excessive" bonuses, equity awards or severance payments, including golden handshakes and golden parachutes;
- insufficient response to low shareholder support;
- problematic contractual payments, such as guaranteed bonuses;
- insufficiently challenging performance targets and/or high potential payout opportunities;
- performance targets lowered without justification;
- discretionary bonuses paid when short-term or long-term incentive plan targets were not met;
- executive pay that is high relative to peers and not justified by outstanding company performance; and
- "inappropriate" terms of the long-term incentive plans (as described in more detail in the voting guidelines).[87]

Additionally, Glass Lewis has noted that the following may "help to drive" a negative recommendation on a company's say on pay:

- excessively broad change in control triggers;
- inappropriate severance entitlements;
- inadequately explained or excessive sign-on arrangements;
- guaranteed bonuses (especially as a multiyear occurrence); and
- failure to address any concerning practices in amended employment agreements.

Beginning in 2023, Glass Lewis revised the threshold for the minimum percentage of the long-term incentive grant that should be performance

[87] *See Glass Lewis, 2024 Policy Guidelines (United States)*, available here.

based from 33% to 50%, and will raise concerns with executive pay programs where less than half of an executive's long-term incentive awards are subject to performance-based vesting conditions.

If a company receives 20% or greater shareholder opposition to a say on pay vote, Glass Lewis expects the board of directors to engage with its shareholders actively and respond to shareholder concerns, which may include implementing changes to its executive compensation program that directly address those concerns. In the absence of any evidence that the board is actively engaging shareholders on these issues and responding accordingly, Glass Lewis may recommend "holding compensation committee members accountable" for the failure to so respond, subject to the level of shareholder objection, severity and history of the company's compensation program.

Finally, in reviewing equity plan proposals, Glass Lewis utilizes a quantitative analysis to assess the plan's cost and the company's pace of granting equity awards, comparing plan limits relative to the peer group as chosen by Glass Lewis and taking into account dilution and projected annual cost relative to the company's financial performance and plans of peer companies, as well as comparing the plan cost against the company's operating metrics to determine whether the plan is excessive in light of company performance. Glass Lewis also utilizes a qualitative analysis, including plan and grant features and terms, and performance metrics, with a list of elements evaluated that are similar to those listed by ISS. Note also that Glass Lewis does not consider the CEO pay ratio a determinative factor in its voting recommendations.

Glass Lewis, like ISS, has also included a policy statement regarding director compensation, indicating that while it is generally supportive of competitive fees, excessive fees potentially compromise the independence of non-employee directors, and performance-based equity grants should not be granted to directors.

Conclusions. We recommend that compensation committees remain cognizant of the advisory firms' current policies and take them into account in structuring pay programs. However, because of the "one-size-fits-all" nature of their evaluation processes, in the final analysis, a compensation committee should make decisions that comport with its company's individual circumstances and needs.

E. The Rise of Institutional Investor Voting Guidelines

In recent years, we have seen institutional investors themselves issuing proxy voting guidelines, in response to both criticism of over-reliance on shareholder advisory firms and a shift to more targeted purpose-driven

investing. Below is a brief description of the topics covered by a few of the largest asset managers active in the U.S. market.

BlackRock Investment Stewardship Proxy Voting Guidelines.[88] BlackRock's guidelines for U.S. companies identifies, among other things, how BlackRock evaluates executive compensation arrangements when considering a say on pay vote, covering topics and positions similar to those of ISS. BlackRock's commentary on executive compensation leans heavily towards early and often engagement by a company's compensation committee. Note that BlackRock may choose to vote against members of a compensation committee if any of the following determinations are made:

- there is a misalignment over time between target pay and/or realizable compensation and company performance as reflected in financial and operational performance and/or shareholder returns;

- the company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation and incentive plan design;

- compensation is excessive relative to peers without appropriate rationale or explanation, including the appropriateness of the company's selected peers;

- there is an overreliance on discretion or extraordinary pay decisions to reward executives without clearly demonstrating how these decisions are aligned with shareholders' interests;

- company disclosure is insufficient to undertake BlackRock's pay analysis; and/or

- there is a lack of board responsiveness to significant investor concerns on executive compensation issues.

Note that BlackRock will also consider voting against members of a compensation committee during a period in which executive compensation appears excessive relative to performance and peers, when BlackRock believes either that the compensation committee has not already substantially addressed this issue, or when engagement with the compensation committee regarding a particular say on pay proposal is not expected to resolve BlackRock's concerns.

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[88] *See BlackRock Investment Stewardship, Proxy voting guidelines for U.S. securities* (Jan. 2024), available here and *Investment Stewardship's approach to executive compensation* (Mar. 2023), available here.

Vanguard.[89] Vanguard takes a principles-based approach to evaluating its portfolio of investments, with one of its four "Pillars" being its perspective on executive compensation, which is as follows:

> "Sound, performance-linked compensation programs drive long-term investment returns. We look for companies to provide clear disclosure about their compensation practices, the board's oversight of those practices, and how said practices are aligned with shareholders' long-term investment returns."[90]

Vanguard also advises that it does not take a "one size fits all" approach to executive compensation, but does identify the following "red flags" when evaluating a say on pay proposal:

- pay outcomes are significantly higher than those of peers but total shareholder return is well below that of peers;
- the long-term plan makes up less than 50% of total pay;
- the long-term plan has a performance period of less than three years;
- plan targets are reset, retested, or not rigorous; and
- the target for total pay is set above the peer-group median.

A Vanguard fund will also generally vote against compensation committee members when: (a) it has voted against the company's say on pay proposal in consecutive years, unless meaningful improvements have been made to executive compensation practices since the prior year; and/or (b) voting against an equity compensation plan that includes significantly problematic features (*e.g.*, "repricing," "evergreen," "reload," or similar features) or other egregious pay practices exist.

Fidelity.[91] Fidelity has advised that it will generally support say on pay votes, *unless* the compensation appears misaligned with shareholder interests or is otherwise problematic, taking into account the following:

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[89] *See Vanguard Proxy voting policy for U.S. portfolio companies* (Effective Feb. 2024), available here.

[90] *Vanguard Global investment stewardship program overview* (2023), available here.

[91] *See Fidelity Investments Proxy Voting Guidelines* (Jan. 2024), available here.

- the actions taken by the board or compensation committee in the previous year, including whether the company re-priced or exchanged outstanding stock options without shareholder approval; adopted or extended a "golden parachute"[92] without shareholder approval; or adequately addressed concerns communicated by Fidelity in the process of discussing executive compensation;

- the alignment of executive compensation and company performance relative to peers; and

- the structure of the compensation program, including factors such as whether incentive plan metrics are appropriate, rigorous and transparent; whether the long-term element of the compensation program is evaluated over at least a three-year period; the sensitivity of pay to below median performance; the amount and nature of non-performance-based compensation; the justification and rationale behind paying discretionary bonuses; the use of stock ownership guidelines and amount of executive stock ownership; and how well elements of compensation are disclosed.

Fidelity will also oppose the election of directors on the compensation committees if: (a) the company has not adequately addressed concerns communicated by Fidelity in the process of discussing executive compensation; (b) within the last year, and without shareholder approval, a company's board of directors or compensation committee has either: (1) repriced outstanding options, exchanged outstanding options for equity, or tendered cash for outstanding options, or (2) adopted or extended a golden parachute. Fidelity generally will oppose proposals to ratify golden parachutes where the arrangement includes an excise tax gross-up provision; single trigger for cash incentives; or may result in a lump sum payment of cash and acceleration of equity that may total more than three times annual compensation (salary and bonus) in the event of a termination following a change in control.

Conclusion: The principles and concerns stated in the foregoing asset management proxy voting guidelines are generally consistent with the guidelines issued by other large institutional investors. Compensation committees may be well-served by having an understanding of the proxy voting guidelines regarding say on pay and other compensation-related proposals of their top 10 institutional investors, if available, when considering actions to be taken on such topics, as these guidelines represent long-term investors' views on how executive compensation

[92] Note that Fidelity defines a "golden parachute" as "executive severance compensation and benefit arrangements resulting from a termination following a change in control."

programs should be structured to encourage and support long-term value creation at the companies in which they invest.

IX.

Compensation Committee Meetings

A. Meetings and Agenda

A compensation committee must meet with sufficient frequency to perform its duties, and should devote adequate time for planning the timing, agenda and attendees at its meetings. A compensation committee should schedule at least one of its meetings before the company's annual report and proxy statement are filed to provide an opportunity for the compensation committee to review and discuss the proposed CD&A and other compensation-related disclosures. The number of meetings a compensation committee should hold per year depends upon various factors, including the scope of the compensation committee's responsibilities, the size and business of the company, and the nature of the compensation arrangements implemented (or to be implemented) by the company. The SEC requires that companies disclose the number of compensation committee meetings held during the prior fiscal year in their annual proxy statements. Compensation committee meetings, like board of director meetings, should be sufficiently long to allot adequate time to carry out the duties of the compensation committee. Compensation committees should consider scheduling their meetings for the day before full board of director meetings to permit adequate time to consider and discuss agenda items.

A compensation committee should set aside sufficient time, without the presence of the CEO or other executive officers, to deliberate and determine the officers' compensation levels. For Nasdaq companies, the CEO may not be present during discussions of his or her compensation, but a similar requirement is not imposed for other executive officers. A compensation committee should have access to management as it deems appropriate.

A compensation committee should be active in setting its agendas for the year as well as for each compensation committee meeting. While management, rather than the board of directors, sets the strategic and business agendas for the company, including regulatory and compliance goals, directors should determine the bounds of their oversight and responsibilities. The compensation committee meetings and annual agendas should reflect an appropriate division of labor and should be distributed to the compensation committee members in advance. In light of the increased number of lawsuits regarding compensation matters, compensation committees should also ensure they receive materials regarding proposed compensation action in advance of their meetings, to provide the committee members sufficient time to review the materials.

B. Quorum Requirements

For a compensation committee to conduct official business at a compensation committee meeting, a quorum of its members must be legally present. Unless otherwise restricted in a company's charter, most states consider a director who participates via telephone or video conference to be legally present (as long as all those present at the compensation meeting can hear and speak to each other). A company's bylaws or a board of directors' resolution should set the minimum number of compensation committee members necessary to establish a quorum. If no minimum number is set by a company, then, absent a state law to the contrary, the default minimum quorum requirement for a compensation committee is a majority of its members. Similarly, the default quorum of the entire board of directors generally is a majority of its members. These principles flow from the general default rule that a committee of the board of directors is subject to the same corporate process requirements applicable to the entire board of directors.[93]

Neither the SEC nor the major securities markets have specific guidelines in this regard, although the SEC does require that the proxy statement disclose the number of compensation committee meetings held during the prior fiscal year, as well as the name of any director who attended fewer than 75% of the aggregate number of meetings of the full board of directors and the committees on which such director served.

Actions undertaken by a compensation committee in the absence of a quorum are voidable. Thus, the minutes should clearly reflect the presence of a quorum to protect valid decisions from attack. To help ensure that a quorum is present: (1) compensation committee meeting notices should be sent sufficiently in advance of a compensation committee meeting and responses promptly reviewed, and (2) the chairperson of the compensation committee should consult with the corporate secretary in advance of the compensation committee meeting. If a compensation committee meeting takes place without a quorum, it should be noted in the minutes.

C. Minutes

Typically, minutes are prepared for compensation committee meetings, but not for a compensation committee's executive sessions. It is common and prudent practice for such minutes to identify the topics discussed at compensation committee meetings rather than attempt to include detailed summaries. Enough information should be recorded, however, to establish

[93] *See, e.g.*, § 8.25(c) of the Model Business Corporation Act (2016 Revision) (Dec. 9, 2017).

that the compensation committee sought the information it deemed relevant, reviewed the information it received, understood each element of the compensation and otherwise engaged in whatever actions and discussions it deemed appropriate in light of the then-known facts and circumstances. The minutes also should indicate which directors attended, whether they attended in person or via telephone or video conference and whether individuals other than the compensation committee members were present.

A compensation committee should approve the minutes at the next compensation committee meeting following the meeting for which the minutes were prepared. The minutes should be attached to the agenda for such meeting and circulated in advance so that the compensation committee members have time to review them before they are approved. If the minutes have not been attached and adequately reviewed before the next compensation committee meeting, it may be advisable for the corporate secretary to read the minutes to the committee members before approval to ensure that they are aware of the actions that were taken at the last compensation committee meeting and approve of their characterization in the minutes. Unless otherwise required by state statute or a company's charter or bylaws, it is neither necessary for the minutes to identify the director presenting a motion or resolution nor to separately identify the directors voting for or against a motion or resolution. However, a dissenting or abstaining director should be identified if he or she so requests.

A compensation committee should consider providing a report or a copy of the minutes of each compensation committee meeting to the full board of directors. Directors who do not serve on the compensation committee should have the opportunity to ask the compensation committee questions relating to the compensation committee's charter or the topics covered at the compensation committee meetings.

D. Shareholder and Director Right of Inspection

Careful drafting of minutes is especially important because shareholders may inspect the books and records of the company, including committee meeting minutes. In Delaware, for instance, any shareholder may inspect board of director and committee minutes upon making a written demand under oath and stating a "proper purpose" for making the request. While the proper purpose requirement ensures that shareholders do not have *carte blanche*, activist shareholders are increasingly using this right, and a court's willingness to entertain such a demand cannot be foreclosed.[94]

[94] At least one Delaware Court of Chancery decision, *Polygon Global Opportunities Master Fund* v. *West Corp*., 2006 WL 2947486 (Del. Ch. Oct. 12, 2006), did announce

The Delaware Court of Chancery opinion in *Amalgamated Bank* v. *Yahoo! Inc.*,[95] discussed above in Chapter III of this Guide, demonstrates the utility of books and records demands in compensation-related claims. A 2005 Delaware Supreme Court order,[96] remanding a lower court decision allowing a company to demand confidential treatment before divulging sensitive information to dissident shareholders, illustrates the scrutiny companies may face when attempting to prevent public disclosure of even ostensibly confidential information. In its order, the Delaware Supreme Court held that the Court of Chancery must balance a company's interest in confidentiality against a shareholder's communication interest and establish that the confidentiality interest "outweigh[s]" the shareholder's interest.

In litigation, minutes carry added significance, given that both Delaware and New York accord corporate minutes a presumption of accuracy. Minutes have been cited in a number of high-profile cases as evidence of directors' alleged lack of care and/or good faith in exercising their fiduciary duties. It is especially important that minutes are carefully and thoughtfully drafted so that an ambiguous litigation record is not created. Courts and regulators reviewing a committee's actions often regard minutes as the most reliable contemporaneous evidence of what transpired at a meeting. In litigation concerning director-level conduct and decision-making, board and committee minutes are regularly used as evidence and can provide a guide to opposing counsel as to which directors to depose and what topics to cover in such depositions. It is therefore of vital importance that minutes be thoughtfully drafted to reflect the topics discussed at meetings and the substance of the committee's discussion.[97]

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several important limitations on the use of this tool in the transactional context and possibly beyond. In *West Corp*., an activist hedge fund (Polygon Global Opportunities Master Fund) demanded access to West Corporation's books and records after West Corporation announced its intention to undertake a going-private transaction. In denying Polygon Global Opportunities Master Fund's demand, the court held that, in certain circumstances, public information may be sufficient for the shareholder's stated purpose, the books-and-records statute "is not intended to supplant or circumvent discovery proceedings, nor should it be used to obtain that discovery in advance of the appraisal action itself" and Polygon Global Opportunities Master Fund's desire to investigate alleged board of director misconduct cannot be a proper purpose because Polygon Global Opportunities Master Fund would not have standing to pursue any claims (given that it purchased shares in West Corp. only after the announcement of the transaction). *Id.* at 16.

[95] *Amalgamated Bank, Trustee for the Longview LargeCap 500 Index Fund and the LongView LargeCap 500 Index VEBA Fund* v. *YAHOO! Inc.*, 132 A.3d 752 (Del. Ch. Feb. 2, 2016).

[96] *Disney* v. *Walt Disney Co.*, No. 380, 2004 (Del. Mar. 31, 2005) (ORDER).

[97] The need to document board actions with care was brought into sharp focus by the Delaware Supreme Court's ruling in *KT4 Partners LLC* v. *Palantir Techs. Inc.*, No. 281,

E. Access to Outside Advisors

Under stock exchange listing standards established pursuant to the Dodd-Frank Act, the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor (after considering factors described in Chapter II of this Guide). The rules require compensation committees to be directly responsible for the appointment, compensation and oversight of the advisors they retain and the company to provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisors. Additionally, the charter of a compensation committee must address these rights and responsibilities. As noted above, disclosure requirements mandate detailed disclosure of fees and services in respect of consultants who are not independent.

Notwithstanding this heavy emphasis on consultant independence, retention of separate advisors for each of the compensation committee and management when considering issues of executive compensation may not always serve the company's best interests. Such an approach can give rise to inefficiencies in compensation discussions, put a board of directors in the awkward position of receiving conflicting advice, and, perhaps most importantly, create an adversarial relationship between management and the board of directors. While directors should have full access to any consultants that are ultimately retained by the company and have the ability and time to ask focused questions of them, the use of consultants is not legally required, and a consultant's judgment should not be viewed as a substitute for a board of directors' exercise of judgment after careful and informed deliberation. As a matter of good corporate governance, a compensation committee should understand the nature and scope of services that consulting firms and their affiliates provide to the company to evaluate any actual or perceived conflicts of interest.

2018, 2019 WL 347934 (Del. Jan. 29, 2019), which involved a stockholder's books-and-records demand under Section 220 of the DGCL. The trial court permitted Palantir to exclude email from its production, but the Delaware Supreme Court reversed, holding that while a stockholder's inspection rights are generally properly limited to formal board-level materials such as meeting minutes, resolutions and presentations, Palantir's "history of not complying with required corporate formalities," including its failure to maintain any board-level documents responsive to the inspection demand, made necessary its production of responsive emails. *Id.* at *12. The decision makes clear that the diligent preparation and maintenance of minutes can help corporations avoid intrusive inspection requests from stockholders. *See also* Wachtell, Lipton, Rosen & Katz, Delaware Provides Guidance on Books-and-Records Inspection Rights (Jan. 31, 2019), available here.

F. Compensation Committee Chairperson

While each member of a compensation committee contributes to its effectiveness, the compensation committee chairperson has a unique role. The compensation committee chairperson is responsible for ensuring that compensation committee meetings run efficiently and that each agenda item receives the appropriate level of attention. The compensation committee chairperson also often serves as the key contact between the compensation committee and other directors and senior management.

Consequently, in choosing the compensation committee chairperson, a board of directors should seek to select a director with leadership skills, including the ability to forge productive working relationships among compensation committee members and with other directors and senior management. No matter who is appointed compensation committee chairperson, as part of the annual review of the compensation committee, the compensation committee and the board of directors should review the combination of talent, knowledge and experience of the compensation committee members to ensure that the compensation committee has the right mix of people.

The time commitment resulting from the current regulatory and shareholder activist environment may require additional compensation for directors, and this pressure is especially acute with respect to service on a compensation committee. Although some companies would prefer not to discriminate in compensation among directors, reasonable additional fees for compensation committee members are legal and may be appropriate. Additional compensation for committee chairs is another way to give fair compensation for those members most burdened with responsibilities.

X.

Compensation Committee Charters

Under the SEC's executive compensation disclosure rules, a public company must disclose whether or not it has adopted a compensation committee charter, and any such compensation committee charter must be made publicly available on the company's website or attached to the proxy or information statement at least once every three years. In addition, as described below, the NYSE and Nasdaq require a listed company to adopt a compensation committee charter that must include specified provisions. In light of these requirements, the compensation committee of a publicly held company should have a charter that complies with applicable regulations and securities market requirements rules. In addition, it has become common in recent years to add to compensation committee charters the responsibility for company-wide oversight of human capital management generally, including diversity and inclusion, and in some cases to change the name of the committee to reflect this expanded role.[98] That said, any such compensation committee charter should not over-engineer the operation of the compensation committee. If a compensation committee charter requires review or other action and the board of directors or compensation committee has not taken that action, the failure may be considered evidence of lack of due care. To avoid inadvertent charter violations, companies should be thoughtful about the obligations specified in the charter and then ensure that all such obligations are covered when preparing the annual meeting calendar and agendas. The creation of compensation committee charters is an art that requires experience and careful thought; it is a mistake to copy blindly the published models.

Each company should tailor its compensation committee charter to address the company's particular needs and circumstances, limiting the charter to what is truly necessary and what is feasible to accomplish in actual practice. To be state of the art, it is not necessary that a company have everything other companies have. A compensation committee charter should carefully be reviewed each year to prune unnecessary items and to add only those items that will, in fact, help the compensation committee members in discharging their duties.

Exhibit A to this Guide is a model compensation committee charter. This compensation committee charter is only an example intended to reflect required and recommended provisions for a compensation committee

[98] Compensation Committees & Human Capital Management, Harvard Law School Forum on Corporate Governance available here.

charter. Companies should customize a charter to address their particular needs and circumstances.

A. NYSE-Listed Company Charter Requirements

The compensation committee of a company listed on the NYSE must have a written compensation committee charter that, at a minimum, contains the required provisions specified by the NYSE listing standards.[99] The compensation committee charter must be approved and adopted by the board of directors and should provide:

- a description of the compensation committee's purpose. In this regard, the compensation committee charter should indicate that the compensation committee is appointed by the board of directors to discharge the responsibilities of the board of directors relating to compensation of the company's CEO, as well as the other executive officers (including making recommendations to the board of directors regarding such compensation). In addition, as applicable, it should indicate that the compensation committee is charged with overall responsibility for approving and evaluating all compensation plans, policies and programs of the company as they affect the CEO and other executive officers;

- that the compensation committee annually will review and approve corporate goals and objectives relevant to CEO compensation, evaluate CEO performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. It also should be noted that, in determining the long-term incentive component of CEO compensation, the compensation committee will consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years;

- that the compensation committee will review and discuss with management the CD&A and, based on this review and analysis, determine whether or not to recommend to the board of directors the CD&A's inclusion in the company's proxy statement and annual report on Form 10-K;

- that the compensation committee shall furnish the compensation committee report required by the SEC;

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[99] *See* NYSE Listed Company Manual Section 303A.05. A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

- that the compensation committee may, in its sole discretion, retain advisors only after taking into consideration all factors relevant to advisor independence, including the six factors set forth in Section 303A.05(c) of the NYSE Listed Company Manual and will be directly responsible for the appointment, compensation and oversight of the advisor;

- that the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any advisors retained by the compensation committee;

- the compensation committee's membership requirements, including the need for member independence;

- how compensation committee members are appointed and removed;

- the compensation committee's structure and operations, including authority to delegate to subcommittees;

- the procedures for compensation committee reporting to the board of directors; and

- that the compensation committee will perform an annual self-evaluation of its performance.

B. Nasdaq-Listed Company Charter Requirements

The Nasdaq rules require the compensation committee of a Nasdaq-listed company to have a formal written charter. On an annual basis, the compensation committee must review and reassess the adequacy of the charter. The charter must specify:

- the scope of the compensation committee's authority and responsibilities, and how it carries out those responsibilities, including structure, process and membership requirements;

- the compensation committee's responsibility for determining, or recommending to the board of directors for approval, the compensation of the CEO and all other executive officers;

- that the CEO may not be present during voting or deliberations on his or her compensation;

- that the compensation committee may, in its sole discretion, retain advisors only after taking into consideration factors relevant to advisor

independence set forth in Nasdaq Listing Rule 5605(d)(3) and will be directly responsible for the appointment, compensation and oversight of the advisor; and

- that the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any advisors retained by the committee.

C. Other Potential Items for Inclusion in Compensation Committee Charters

In addition to the provisions required by the NYSE and Nasdaq rules to be included in the compensation committee charter, it may also be advisable for the charter to provide:

- that the compensation committee will, at least annually, review and approve the annual base salaries and annual incentive opportunities of the CEO and other executive officers;

- the compensation committee will review and approve the following as they affect the CEO and other executive officers: (1) all non-annual incentive awards and opportunities, including both cash-based and equity-based awards and opportunities, (2) any employment agreements and severance arrangements, (3) any change in control agreements and change in control provisions affecting any elements of compensation and benefits, and (4) any special or supplemental compensation or benefits, including supplemental retirement benefits and perquisites provided during and after employment; and

- that the compensation committee will review and reassess the adequacy of the compensation committee charter annually and recommend any proposed changes to the board of directors for approval.

However, because every company is different, a board of directors, in conjunction with the compensation committee, should carefully consider whether inclusion of any provision is helpful in furthering the performance of the compensation committee's duties.

XI.

Director Compensation, Indemnification and Directors and Officers Insurance

A. Director Compensation

Director compensation is one of the more difficult issues on the corporate governance agenda and has been the subject of increased attention in recent years. On the one hand, more is expected of directors today in terms of time commitment, responsibility, exposure to public scrutiny and potential liability. On the other hand, the higher a director's pay, the greater the likelihood that such pay can be used against the director as evidence of a lack of true independence, or can be used to make claims of excessive director compensation.

1. Responsibility for Determining Director Compensation

The NYSE and Nasdaq rules do not specify that responsibility for director compensation must be assigned to any particular committee. However, it should be made the responsibility of either a committee of the board of directors or the full board of directors. Since director compensation is typically determined by either the Compensation Committee or the Nominating and Governance Committee, we have included this Chapter regarding the issues of publicly disclosed compensation at public companies generally.

As discussed in Chapter II of this Guide, when directors who would directly benefit from a proposed plan are delegated the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.[100] Care also should be taken that, under normal circumstances, the compensation and benefits of management are not increased at the same time as that of directors, lest doubt be cast on the validity of both actions.[101]

2. Considerations for Determining Director Compensation

In General. While directors are not employees and compensation is not the main motivating factor for public company directors, given the importance of board composition and the competition for the best

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[100] *See, e.g.*, *Tate & Lyle PLC* v. *Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, at *20–22 (Del. Ch. May 9, 1988) (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

[101] *See id.*

candidates, it is important to evaluate whether director compensation programs are appropriate to the company's needs. Accordingly, as boards go through their self-evaluations, it is worthwhile to evaluate whether such programs are adequate to secure and retain best-in-class directors, or whether the programs need adjustment consistent with the increased demands of board service.

Meeting Fees and Retainers. Companies also should give careful thought to the mix between individual meeting fees and retainers. Business and regulatory demands have deepened director involvement and technology has changed the way directors meet. In view of these developments, many companies have de-emphasized per-meeting fees and instead increased retainers. Such an approach offers the dual benefits of simplifying director pay and avoiding issues that arise from electronic forms of communication and frequent, short telephonic meetings. As companies move away from per-meeting fees to retainer structures, they should consider whether additional retainer pay is appropriate for directors serving on committees that impose substantial extra demands. It is both legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time. It is also appropriate to consider the level of time commitment required outside of meetings, including for members of audit and compensation committees who must frequently review substantial written material to be properly prepared for their meetings.

Additional Director Responsibilities. The increased responsibility imposed on directors generally is especially pronounced for non-executive board chairs, lead directors and committee chairs. Accordingly, particular attention should be paid to whether these individuals are being fairly compensated for their efforts and contributions. We expect the pay of non-executive board chairs and lead directors to increase as pay practices catch up to the demands of the responsibilities of these positions.

Determining Compensation. The board of directors, a compensation committee, a nominating committee or other responsible board of director committee, as applicable, should determine the form and amount of director compensation to be paid, with appropriate benchmarking of such compensation against that of peer companies. Additionally, as with executive officers, any perquisites or other forms of compensation that may be provided to directors should be carefully considered, especially in light of the positions taken by shareholder advisory firms, such as ISS, in certain circumstances.[102] Boards of directors may also wish to consider

[102] *See* Chapter VIII of this Guide for a discussion of ISS views on director equity compensation plans.

including within the applicable equity incentive plan an annual limit on non-employee director equity-based awards or total compensation, to help avoid and defend against nuisance litigations that we have seen arise in the last few years.

In our experience, most compensation consultants can provide assistance in such benchmarking exercises, as well as in the design of director compensation programs. Survey data will prove useful in considering appropriate director compensation, and in light of ISS guidelines regarding how it determines "excessive" director compensation, has almost become an imperative when setting director compensation.[103]

Finally, the committee tasked with determining director compensation should also consider the stock ownership guidelines applicable to the directors, both in terms of the number of shares and the period of time over which a new director is required to serve in order to achieve the guideline requirement. Compensation consultants can also be useful in providing survey data as to ownership requirements—both as to level, type and period of time required to meet these requirements—at peer companies.

In all instances, the importance of collegiality to the proper functioning of a board of directors must be kept in mind; director compensation should not promote factionalism on the board. Differences in compensation among directors should be fair and reasonable and reflect real differences in demands placed on particular directors.

Note on Disclosure. As discussed in Chapter II of this Guide, the SEC's compensation disclosure rules require tabular and narrative disclosure of all director compensation. The required tabular disclosure is comparable to the extensive disclosure that is required for executive officer compensation, except that only information concerning the last fiscal year needs to be disclosed. The narrative disclosure requires a description of the company's processes and procedures for the consideration and determination of director compensation.

3. Shareholder Advisory Firm Guidance

ISS and Glass Lewis have issued guidance regarding director compensation:

- *ISS*. ISS may issue an adverse vote recommendation for board members approving non-employee director pay if there is a "recurring

[103] For a recent survey of director compensation arrangements, *see F.W. Cook & Co., Inc. 2023 Director Compensation Report* (Oct. 2023), available here.

pattern of excessive non-employee director pay magnitude without disclosure of compelling rationale," where the pattern is identified in two or more consecutive years, or without other "mitigating factors." ISS has indicated that it may consider director pay excessive if it exceeds pay received by the top 2% of directors within the same index and sector.

ISS has indicated that it would view any of the following circumstances, if within reason and adequately explained, as mitigating an excessive pay concern: (1) one-time onboarding grants that are clearly identified as such; (2) payments related to corporate transactions or special circumstances (such as special committees service, requirements related to extraordinary need, or transition payments to a former executive for a limited period); and (3) payments made in consideration of specialized scientific expertise. High non-employee director pay that arises from general performance of duties, consulting agreements with an indefinite term, and problematic payments (*e.g.*, performance-based awards, perquisites and retirement benefits) will generally not qualify as pay that arises from mitigating circumstances.

As a reminder, ISS considers non-employee director pay an "outlier" if above the top 2% of all comparable directors within the same index and sector, recognizing that board chair and lead independent director pay is often at a premium and should be compared as a separate category.

- *Glass Lewis*. Glass Lewis's guidance is less specific than ISS's, providing generally that it will be supportive of fees that are competitive and that reasonably compensate directors for their time and effort without imposing an excessive financial cost on the company. However, Glass Lewis believes that, for directors to serve as a check on imprudent risk-taking in executive compensation, directors should not be compensated in the same manner as executives and that directors should not be granted performance-based equity awards.

B. Director Compensation Litigation

In recent years, plaintiffs have focused on director compensation arrangements, and have achieved some limited successes in the Delaware courts. However, it remains the case that properly designed director compensation arrangements approved after appropriate consideration should not prove vulnerable to challenge. But the relatively recent decisions summarized below provide a strong reminder of the need for

directors to apply the highest level of care when setting their own compensation.

In April 2015, the Delaware Chancery Court in *Calma* v. *Templeton* allowed a claim that Citrix Systems' board of directors had breached its fiduciary duties in awarding compensation to its outside directors under a compensation plan that had been approved by shareholders to proceed.[104] The suit challenged awards under the existing equity incentive plan, which had been approved by a majority of shareholders a few years earlier. Potential participants in the shareholder-approved plan included all employees, directors, and officers of Citrix; the plan contained a general limit of 1,000,000 shares per participant per year (worth over $55 million at the time of the litigation), but no sublimit for directors.

The Court determined that the entire fairness standard of review (less deferential than the usual business judgment standard) was applicable because the awards to the outside directors were made by the recipient directors themselves: "[D]irector self-compensation decisions are conflicted transactions that 'lie outside the business judgment rule's presumptive protection.'"[105] The directors' primary defense was that the equity plan had been ratified by shareholders; however, in light of the lack of meaningful limits or specific guidelines for awards to non-employee directors, the Court held that shareholder approval of the plan as a whole did not constitute approval of the specific decision of the board to make the grants in question.[106]

The *Calma* decision built on a 2012 Delaware Chancery Court decision, *Seinfeld* v. *Slager*,[107] involving director equity awards under a plan with an individual share limit (worth approximately $30 million at the time of the litigation). The *Seinfeld* Court held that "there must be some *meaningful* limit imposed by the stockholders on the Board for the plan to . . . receive the blessing of the business judgment rule. . . . A stockholder-approved *carte blanche* to the directors is insufficient."[108]

In 2016, Facebook settled a shareholder derivative complaint alleging breach of fiduciary duty, waste and unjust enrichment in connection with the board's approval of an annual cash and equity compensation program for non-employee directors in 2013 by committing to several governance steps, most notably an agreement to submit various elements of its director

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[104] *Calma* v. *Templeton*, 114 A.3d 563 (Del. Ch. Apr. 30, 2015).

[105] *Id.* at 578 n.54 (citation omitted).

[106] *Id.* at 587–89.

[107] 2012 Del. Ch. LEXIS 139 (Del. Ch. June 29, 2012).

[108] *Id.* at 41.

compensation program to a shareholder vote that would not otherwise be required, and by agreeing to pay the plaintiff's legal fees reported to be $525,000. Most practitioners are of the view that the Facebook plaintiffs would not have succeeded on the merits, and presume that Facebook settled to avoid the cost and distraction of litigation. Nonetheless, the case serves as a cautionary example of the desirability of taking steps to decrease the likelihood of attracting claims related to director compensation, particularly because the size of the attorney's fees may inspire further such claims.[109]

In late 2017, the Delaware Supreme Court overruled a lower court regarding the standard of review that is required when a challenge is made to director compensation awards granted under shareholder-approved equity incentive plans.[110] In *Investors Bancorp*, the Delaware Court of Chancery concluded that because the company's shareholder-approved equity incentive plan contained a "meaningful limit" on the number of shares that could be granted to directors, though the grants that the company's directors made to themselves were large they fell within these plan limits, and, therefore, the company could properly invoke a defense that the shareholders had effectively ratified these grants.[111] The Delaware Supreme Court reversed this decision, holding that the grants were subject to an "entire fairness" standard of review, which is a higher standard than the typical "business judgment" standard of review that applies to most director actions.[112]

In 2019, the Delaware Court of Chancery allowed a challenge to director compensation at Goldman Sachs to proceed under the entire fairness standard.[113] While casting doubt on the merits of the plaintiffs' allegations, the court rejected the company's position that an equity plan provision that by its terms provided that directors could not be found liable for actions taken in good faith obviated the need for application of entire fairness review.

Directors and company executives of Delaware corporations may wish to consider including, in new or amended equity incentive plans otherwise being put to a shareholder vote, realistic limits on director awards, specifying the amount and form of individual grants to directors or a meaningful and reasonable director-specific individual award limit, and also consider including overall limits on director compensation. While

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[109] *Espinoza* v. *Zuckerberg*, 124 A.3d 47 (Del. Ch. 2015).

[110] *In re Inv'rs Bancorp, Inc. Stockholder Litig.*, C.A. No. 169, 2017, 2017 Del. LEXIS 517 (Del. Dec. 13, 2017), *rev'g* 2017 Del. Ch. LEXIS 53 (Del. Ch. Apr. 5, 2017).

[111] *Id.* at *13 (discussing the Court of Chancery's decision).

[112] *Id.* at *30.

[113] *Stein* v. *Blankfein et al.*, C.A. No. 2017-0354-SG (Del. Ch. May 31, 2019).

these limits are not required under any rule, and while some commentators have questioned their value in defense litigation in light of *Stein*, we continue to believe that they may help to deter, or bolster a defense against, claims challenging the amount or form of director compensation.

Moreover, in light of recent proxy advisory firm guidance and continued litigation pressures, it is as prudent as ever for a board to rely on a compensation consultant to assist in constructing the appropriate peer group for benchmarks and to advise on the amount and design of any proposed director compensation, as this may also assist in the protection against claims attacking director compensation.

C. Indemnification and Directors and Officers Insurance

A directors should be fully indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest coverage permitted by law. Directors also can continue to rely on their exculpation for personal liability for breaches of the duty of care under charter provisions put in place pursuant to state law.

Directors and Officers ("D&O") insurance coverage, of course, provides a key protection to directors. D&O policies are not strictly form documents; they can and should be negotiated. Careful attention should be paid to retentions, exclusions, and the scope of coverage. Care also should be given to the potential effect of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, companies should purchase separate supplemental insurance policies covering only directors and officers, but not the company (so-called Side-A coverage), in addition to the policies that cover both the company and the directors and officers individually.

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This Guide is not intended as legal advice, cannot take into account particular facts and circumstances (including the extent to which certain federal fiduciary laws may apply to a given compensation committee), and generally does not address individual state or non-U.S. corporate laws. Applicability of the information contained herein to specific situations

should be determined through consultation with legal, tax and accounting advisors.

EXHIBIT A

COMPENSATION [AND MANAGEMENT DEVELOPMENT] COMMITTEE CHARTER

Purposes

The primary purposes of the Compensation [and Management Development][114] Committee (the "Committee") of the Board of Directors (the "Board") of **[Name of Company]** (the "Company") are to:

- discharge the Board's responsibilities relating to the compensation of the Company's Chief Executive Officer (the "CEO") and other officers subject to Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") (collectively, including the CEO, the "Executive Officers");

- provide oversight of the Company's executive compensation plans, policies and programs as they affect the Executive Officers;

- [review, assess, and make reports and recommendations to the Board as appropriate on succession planning with respect to the Executive Officers;][115] and

- [assist with Board oversight of the Company's culture and strategies relating to human capital management.][116]

This charter (this "Charter") sets forth the authority and responsibilities of the Committee in fulfilling its purpose.

Membership

The Committee will consist of no fewer than [two][117] members, with the exact number determined by the Board.

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[114] Consider the Committee's name and desired scope of responsibilities.

[115] It is not unusual for succession planning to be under the purview of the Nominating and Corporate Governance Committee rather than the Compensation Committee. Consider the desired division and scope of responsibilities relating to succession planning.

[116] It is not unusual for responsibility for human capital management to be under the purview of either the Compensation Committee or the Nominating and Corporate Governance Committee. Consider the desired division and scope of responsibilities relating to human capital management.

[117] Nasdaq requires a minimum of two members on the Compensation Committee, or a minimum of three members if one of those members is not an independent director. NYSE requires that all members of the Compensation Committee be independent.

The members of the Committee will be appointed annually by the Board on the recommendation of the Nominating & Governance Committee and will serve at the Board's discretion. Committee members may be replaced or removed from the Committee by the Board at any time, with or without cause, and any vacancies will be filled through appointment by the Board on the recommendation of the Nominating & Governance Committee. Resignation or removal of a director from the Board will automatically constitute resignation or removal, as applicable, of such director from the Committee.

The Board will appoint one member of the Committee as its Chairperson (the "Committee Chair").

All members of the Committee will meet the independence requirements of the listing standards of the securities exchange on which the Company's securities are listed and any other applicable laws, rules or regulations (including the rules and regulations of the U.S. Securities and Exchange Commission) or other qualifications as are established by the Board from time to time. At least two members of the Committee will also qualify as a "non-employee" director within the meaning of Rule 16b-3 under the Exchange Act.

[Notwithstanding the foregoing, the Company may avail itself of any phase-in rules and interpretations applicable to newly listed companies in connection with an initial public offering.][118]

Meetings and Actions Without a Meeting

The Committee will meet as often as it determines necessary to carry out its responsibilities. The Committee Chair will preside at each meeting. If the Committee Chair is not present at a meeting, the Committee members present at that meeting will designate one of its members as the acting chair of such meeting. The Committee may also act by unanimous written consent in lieu of a meeting in accordance with the Company's Bylaws.

Authority and Responsibilities

The principal responsibilities of the Committee are set forth below. The Committee may perform such other functions as are consistent with its purpose and applicable laws, rules and regulations and as the Board may request or as the Committee deems necessary or appropriate consistent with its purpose.

The Committee will:

[118] If applicable.

Compensation and Benefit Programs

1. Periodically review and approve the Company's compensation strategy and practices with respect to the Executive Officers.

2. Annually review and approve corporate goals and objectives relevant to the CEO's compensation, evaluate the CEO's performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. [In determining the long-term incentive component of the CEO's compensation, the Committee may consider any number of factors, including the Company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the CEO in past years.][119] [The CEO may not be present during voting or deliberations on his or her own compensation.][120]

3. At least annually review and approve (and, if desired, make recommendations to the Board for approval of) the compensation of the Executive Officers, including annual base salaries, short- and long-term (including cash-based and equity-based) incentive awards and opportunities, and perquisites or other personal benefits, except to the extent such benefit policies or programs apply to Company employees generally.

4. Periodically and as and when appropriate, review and approve the following as they affect the Executive Officers:

   (a) any employment and severance arrangements;

   (b) any change in control agreements and change in control provisions affecting any elements of compensation and benefits; and

   (c) any special or supplemental compensation and benefits for the Executive Officers and individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

5. Perform such duties and responsibilities as may be assigned to the Committee under the terms of any equity-based plan or other compensation plan.

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[119] Bracketed language lists considerations that the NYSE Listed Company Manual states the Committee should consider when determining the long-term incentive component of CEO compensation.

[120] This statement is required for Nasdaq-listed companies.

Compliance and Governance

6. Review and discuss with management the Compensation Discussion and Analysis required to be included in the Company's proxy statement and annual report on Form 10-K and prepare the annual Compensation Committee Report for inclusion in the Company's proxy statement.

7. Consider the results of advisory votes on executive compensation and the frequency of such votes.

8. Receive periodic reports on the Company's compensation programs as they affect all employees and consider related risks.

Management Development and Culture[121]

9. [Review annually with the Board an evaluation of the performance of the CEO and other Executive Officers.]

10. [Periodically review and discuss with the Board and, as the Committee deems appropriate, the Nominating and Corporate Governance Committee, the corporate succession plan for Executive Officers.] [Periodically review [and approve] a written talent management program that provides for development, recruitment, and succession of Executive Officers, review diversity programs, and make recommendations to the Board regarding Executive Officers.][122]

11. [Review and assess reports from management and make reports and recommendations to the Board as appropriate, on the Company's culture and strategies relating to human capital management, including talent development, performance against talent and diversity goals, significant conduct issues, and any related employee actions (including, but not limited to, compensation actions), in each case, at the highest management levels.]

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[121] Consider including Items 9–11 if the Committee will have broad authority for management development and culture generally.

[122] Succession planning is often primarily allocated to the Nominating and Corporate Governance Committee. Consider the desired division and scope of responsibilities relating to succession planning.

Assessment

12. [At least annually, review and evaluate the performance of the Committee.][123]

13. [Annually review and reassess the adequacy of this Charter and recommend any proposed changes to the Board for approval.][124]

Advisors

The Committee may, in its sole discretion, retain or obtain the advice of compensation consultants, outside legal counsel, or other advisors. The Committee will have sole authority to approve the advisor's fees (the expense of which will be borne by the Company) and other terms and conditions of the advisor's retention.

To the extent required by the rules of the securities exchange on which the Company's securities are listed, prior to selecting or receiving advice from an advisor, the Committee will conduct an independence assessment, taking into consideration the factors set forth in such rules and any other factors the Committee deems relevant to the advisor's independence from management.

Meetings and Reports

The Committee will maintain written minutes of its meetings and copies of its actions by written consent, and will file such minutes and copies of written consents with the minutes of the meetings of the Board.

The Committee will report periodically to the Board, generally at the next regularly scheduled Board meeting following a Committee meeting, on actions taken and significant matters reviewed by the Committee.

Delegation of Authority

The Committee may from time to time as it deems appropriate, and to the extent permitted by applicable laws, rules and regulations, form and delegate authority to subcommittees consisting of one or more members when appropriate.

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[123] An annual performance evaluation is required by the NYSE.

[124] The Nasdaq rules require the charter to be reviewed annually.