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Executive Compensation

New Year--New Stock Plan

BY MARK POERIO

It is conventional wisdom in investor relation circles: if you need a favorable shareholder vote, seek it when they are happy. On that scale, 2018 should be a smart year for proposing a new stock plan. Shareholders should be supportive given the stock market's run-up over the last decade -- accentuated in recent months.

Beyond market timing, there are many other reasons--discussed below--for amending, restating, or starting fresh with a new stock plan in 2018. Many possible improvements are unobjectionable to shareholders, yet valuable to those making award decisions. All of this adds up: think hard now about adopting a newer, smarter stock plan.

Eliminating Code Section 162(m) Limits It is commonplace for the stock plans of public companies to set forth maximum limits on individual awards. That enabled the income from stock option and SAR awards to be exempt from the $1,000,000 deduction limit that Section 162(m) of the Internal Revenue Code (Code) imposes with respect to certain executive officers of public companies. Last year's tax reform act eliminated that exemption, as part of eliminating § 162(m)'s general exemption for performance-based compensation (such as formula-based cash bonuses).

This means that, in 2018, stock award plans may now be cleaned-up through the deletion of extraneous § 162(m) provisions, with individual award limits now being unnecessary from a tax perspective. Shareholder approval is probably required--and is certainly advisable--before eliminating such limits. Otherwise, shareholders could assert that a plan's inclusion of individual award limits was material to past approval of a plan, and that shareholder must approve any change to them.

PRACTICE NOTE: Before removing individual limits, consider the likely reaction of proxy advisory firms such as ISS and Glass Lewis, and whether a negative voting recommendation from them would make it difficult to obtain shareholder approval for your new plan. The absence of individual limits is not per se problematic under 2017 ISS voting guidelines (see page 43).

Adding Director Compensation Limits Before the end of 2017, Delaware courts applied a ''meaningful limits'' test to shareholder derivative litigation alleging excessive director compensation. Under that test, courts would evaluate director conduct under the highly deferential business judgment rule if their compensation fell within shareholder-approved limits that were meaningful. Absent a shareholder-approved limit, director compensation needed to pass an ''entire fairness'' test demanding that boards show both a prudent process and reasonable decisions in order to defend how they set their own compensation.

In its Investors Bancorp decision (12/19/2017), Delaware's Supreme Court retreated from the meaningful limits test, by holding that the business judgment rule would only protect ''actual awards'' approved by stockholders. In other words, directors are not protected if--

1. they exercise discretion over their compensation or stock awards--even if done within the limits of a shareholder approved plan; and

2. a stockholder properly alleges that the directors breached their fiduciary duties by paying themselves excessive compensation.

In response to this litigation, it makes sense for boards to immediately consider two questions with respect to director compensation. First, does it make sense to establish a limit that receives shareholder approval? Second, what should board members be doing, from a process side, to build a record that justifies the discretion they exercise when setting their own compensation.

Shareholder-approved Limits. If a shareholder-approved plan establishes a self-executing (non-discretionary) formula for determining future director compensation, the direct benefit comes from securing review under the business judgment rule for so long as director compensation is determined by the approved formula.

Suppose, however, that directors decide to pay in excess of that formula at some future time. They may, of course, choose to return to stockholders for approval of the increase. They could instead decide to forego that

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approval, and instead position to defend the increase as being reasonable and defensible under the entire fairness standard. The risk of being sued for paying excessive compensation seems far less for increasing a shareholder-approved amount than it would be for defending the entire director compensation package.

Overall, board members should weigh two probabilities affecting their risk of becoming the target of claims that they have made self-interested decisions to pay themselves excessive compensation. On the one hand, several high profile Delaware decisions have allowed these shareholder derivative lawsuits to avoid early dismissal at the pleading stage. There seems little doubt that these cases will proliferate, and be aimed at directors who receive relatively high fees that shareholders have not specifically approved. On the other hand, it seems likely that a small percentage of companies will respond this year by seeking shareholder approval for a reasonable formula for director compensation. Such approval is possible, in a relatively inconspicuous way, by including a formula for director compensation within a new stock award plan. Overall, directors who take preventative action will sleep the best when headlines emerge about new lawsuits.

Procedural Diligence. In its *Investors Bancorp* decision, Delaware's Supreme Court permitted the litigation to proceed because: ''The plaintiffs have alleged facts leading to a pleading stage reasonable inference that the directors breached their fiduciary duties in making unfair and excessive discretionary awards to themselves after stockholder approval of the EIP. ''*[Author note: EIP abbreviates Equity Incentive Plan.]*

What gave rise to that ''reasonable inference''? The court highlighted a few allegations, supported by data drawn from the complaint. Notably, peer data showed that Investors Bancorp made new stock awards that jumped director pay to a level 23 times the median paid by similarly-situated companies. Those stock awards also increased the annual compensation of directors to high multiples of their past annual compensation levels. Although directors had held four meetings and considered peer data, the complaint alleged that the board relied on peer data that itself was arbitrarily selected and ''driven by self-selection bias.'' Interestingly, the data came from a law firm serving as corporate counsel -- rather than from an independent consultant.

PRACTICE NOTE: The complaint against Investors Bancorp's directors seems to have been grounded in far more than conclusory allegations of excessive compensation. That gave the litigation legs. Directors should respond by following a well-documented process that involves independent advice, and decisions that are readily justifiable based on an examination of relevant peer data.

Plan Improvement Checklist Although there may be knee-jerk appeal to a super-simple stock plan, it is almost always better for a company to have its plan include provisions that provide broad levels of discretion for decision-makers, as well as protections against litigation by award holders. The items listed below fall generally into those categories, and reflect recent changes in applicable corporate governance, securities, tax, and accounting rules. Although companies may amend (or restate) existing stock plans in order to incorporate some or all of these changes, it is usually preferable to seek shareholder approval for a new plan that covers the entire spectrum of desired improvements, globalization of the workforce, e-delivery innovations, and governance practices responsive to the concerns of shareholders and the standards enunciated by proxy advisory firms such as ISS and Glass Lewis.

- Increasing the Share Reserve – It is generally wise to assure that a stock plan reserves a number of shares sufficient to cover anticipated needs for at least a three to five year period. Attention is warranted for evergreen or other plan counting and replenishment provisions.

- Forfeitures for Competition and Other Breached Covenants – By having a plan authorize deferred share awards (DSUs), companies may ''hold back'' vested awards for settlement after employment terminates, thereby creating golden handcuffs that encourage select executives to honor their employment-related covenants relating to non-competition, non-solicitation, and the non-disclosure of trade secrets.

PRACTICE NOTE: A company's plan and award agreements could be structured to fall within the scope of ERISA, and thereby preempt otherwise applicable state non-compete laws.

- Claw-back and Forfeiture Rights – Employers never regret having a broad arsenal of remedies available to them when they face bad actors. This is the case whether the problem involves workplace harassment or misconduct, breaches of employer policies, the theft of trade secrets, or the violation of post-employment restrictive covenants (such as those described above). Step one involves assuring that ''just cause'' definitions are state-of-the-art and vetted for consistency between plans and agreements. Step two involves making forfeiture and claw-back rights ironclad – and broadly applicable.

PRACTICE NOTE: Employers may seek to apply toughened plan terms to outstanding awards, but that generally required the consent of award holders, supported by contractual consideration. A cash payment could serve as lawful consideration, but it is often cleaner to incorporate an amendment to outstanding awards within a new award agreement that fully discloses what is being amended and agreed to through execution of the award.

- Underwater Stock Option Options – It makes sense to allow the company sponsoring a plan to unilaterally cancel certain underwater stock options (mainly to avoid SEC tender offer rules and similar blue sky issues that could get triggered if the consent of affected optionees is necessary to re-price, cancel, or replace underwater awards).

- Awards outside the U.S. – Companies headquartered in the United States tend to maintain U.S.-centric plans that can easily be crafted to reflect a global workforce, if awards are made internationally. At a minimum, those companies should revise their stock plans (or award agreements) to position for compliance with applicable data privacy rules.

- Plan and Award Amendments – Many plans unnecessarily restrict the power of the board of directors to make desired plan amendments without shareholder approval. Those provisions may often be relaxed, with a common practice being to authorize a designated company officer or officers to make plan changes that are immaterial or required by law or applicable rule (such as a stock exchange listing

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requirement).

Claims-related Provisions. The jury should not be ''out'' with respect to the value of hard-wiring into plans a variety of provisions that enable companies to resolve award disputes in an efficient manner that maximizes deference to company decisions and minimizes the risk of costly litigation. There is significant and recent court authority in favor of enforcing dispute resolution mechanisms such as the following:

- Exhaustion of Plan Remedies before litigation may be required (arbitration could be required if a company favors that mechanism for dispute resolution);
- Forum Designation, with consent to personal jurisdiction – so that all litigation is centered in one convenient jurisdiction;
- Internal Claims Limitation Periods - to require that award holders assert claims with in a designated period (such as 90 or 180 days after complained-of conduct occurs);
- External Stature of Limitations – to lock in a limited period such as one to two years within which court actions must occur (thereby avoiding much longer periods – usually six years or more for contract actions based on an alleged breach of an award agreement);
- Standard of judicial review, in order to limit court review to an arbitrary and capricious or other standard, that calls for the highest reasonable level of deference to the employer's decision regarding claims by award holders; and
- 1. Attorneys' Fees – to entitle the party that substantially prevails in litigation to recover its attorneys' fees and expenses (thereby discouraging claims that lack a solid foundation).

A more complete discussion of these and other possible stock plan improvements appears in Mark Poerio's 2016 Bloomberg Law article found here.

CONCLUSION Public and private companies should place a premium on having suitable state-of-the-art stock award plans at their disposal. These plans are best designed to have an ''omnibus'' design that establishes a solid foundation for making customized awards – in a wide range of forms (from stock options and SARs, to restricted stock and RSUs, to deferred share units, phantom equity, and cash-settled bonuses or other payouts). Going to shareholders for approval of a new plan in 2018 should be a smart move. That is because, thanks to the stock market's dramatic upswing, shareholders should be expected – in 2018 -- to approve new and improved stock plans. Those inclined to delay action until a future year should ask themselves: are shareholders more likely to react favorably now, or later?

Mark Poerio is a partner at Wagner Law Group. For 30 years, Mark has been in private practice with a focus on executive compensation, employee benefits, and fiduciary matters, especially from a business, governance, tax, securities, and litigation perspective. He currently serves as President of the prestigious American College of Employee Benefits Counsel, and on the executive board of the American Benefits Council.