Recent Trends in Executive Compensation in the United States

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Wayne N. Outten and Cody Yorke, Outten & Golden LLP

I. Introduction

Executive compensation trends in the US are affected by a network of inter-related factors including legal and regulatory requirements, market and cultural trends, and shareholder pressures. In this paper, we review recent developments in securities and tax regulations affecting executive compensation, as well as recent lawsuits around executive compensation. We conclude with an update of recent drafting trends in executive agreements.

II. Recent developments in the regulatory framework in the United States affecting Executive Compensation

(a) Securities Regulations affecting executive compensation

In 2002, the Sarbanes-Oxley Act ("SOX")[1] was passed, in response to a slew of corporate business scandals, primarily the Enron scandal, in which the Company's officers and employees had, among other things, misrepresented earnings in reports to shareholders in order to line their own pockets. SOX is primarily aimed as preventing this type of corporate misconduct by, among other things, imposing certain internal financial controls for publicly-traded companies.

In particular, Section 304 of SOX requires that CEOs and CFOs of publicly-traded companies disgorge their bonuses, incentive pay, other equity-based compensation, and any profits from sales of company stock that they received within 12 months following a financial restatement as a result of their own misconduct.

[1] Pub. L. 107-204, 116 Stat. 745 (2002). The full title is "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."

In 2010, the Dodd-Frank Act was enacted in response to the 2008 financial crisis.[2] The Act is primarily aimed at regulating financial markets to ensure market stability and to avoid another financial crisis. Section 954 of the Dodd-Frank Act, "Recovery of Erroneously Awarded Compensation," amended the Securities Exchange Act of 1934 to empower the SEC to implement rules requiring publicly-traded companies to adopt clawback policies with a 3-year lookback period, aimed at a broader set of executives than just the CEO and CFO, and without the requirement of executive misconduct. The SEC proposed rules under Section 954 in 2015, but the rules remain merely proposed rules; observers disagree on whether they are likely to be implemented.[3]

American investors, publicly-traded companies, executives – and the attorneys who represent and advise them – continue to await Dodd-Frank clawback regulations. In the meantime, in the absence of Dodd-Frank regulations, many publicly-traded companies have designed their own limits on executive compensation, often in response to shareholder pressure.

(b) Recent Tax Amendments affecting executive compensation

Tax laws and regulations are also primary sources of limitations on executive compensation. Over the past 15 years, the US has passed new laws limiting executive compensation. Like SOX and Dodd-Frank, these rules are aimed at controlling compensation levels for senior executives. For example, Section 409A of the Internal Revenue Code ("IRC"),[4] passed as part of the American Jobs Creation Act of 2004, imposes complex requirements on deferred compensation schemes (which are broadly defined and can include severance plans and even separation agreements), and imposes an 20% excise tax on employees who violate 409A's requirements. Sections 280G and 4999 of the IRC regulate so-called golden parachutes by denying a corporate tax deduction for (280G) and imposing a 30% excise tax on (4999) payments that exceed a statutory threshold, made to senior executives in connection with a change-in-control.

[2] Pub. L. 111-203, 124 Stat. 1376 (2010).
[3] *Compare* Jesse Hamilton, *Wall Street Pay Proposal Being Negotiated by SEC, Bank Regulator*, BLOOMBERG (May 16, 2019), https://www.bloomberg.com/news/articles/2019-05-16/wall-street-pay-proposal-being-negotiated-by-sec-bank-regulator (reporting that regulators are close to a final draft) *with* John Heltman, *Don't hold your breath for an executive compensation rule*, AMERICAN BANKER (Mar. 13, 2019), https://www.americanbanker.com/opinion/dont-hold-your-breath-for-an-executive-compensation-rule ("Even now, regulators seem pretty lukewarm, at best, about whether there has been any progress.").
[4] 26 U.S.C. § 409A (2018).

New laws have imposed a stringent cap on corporate tax deductibility for executive compensation. IRC Section 162(m) imposes a $1M limit on corporate tax deductibility for certain senior executives. That section was amended recently to include the CEO, the CFO, and the three other highest-paid executives; prior to the amendment, the CFO was not included automatically. More importantly, the provision has been amended to include all aspects of compensation within the $1M limit, including performance-based bonuses, equity-based compensation, and deferred compensation. The Netflix Case, discussed below, revolved around the Company's alleged use of the performance-based compensation "loophole" by falsely inflating incentive compensation.

While it is still unclear exactly how this change will affect executive compensation trends, one important implication from the perspective of an attorney representing executives is apparent: under the modified rule, severance payments, accelerated vesting, and/or distributions of deferred compensation upon separation would be included in the $1M limit, meaning that companies will be disincentivised to make these payments in one year and will be more interested in maintaining the original vesting schedule or agreeing on a schedule of instalments that keeps the total annual payment to the executive under $1M.

III. Recent Case Law Developments

Very few disputes over executive compensation or bonuses end up in the courts in the US. The primary reason for this is that most such disputes that end up in litigation are resolved through private arbitration. Many executive employment agreements in the US contain arbitration provisions governing disputes under the agreements (including compensation disputes). Registered representatives in the heavily-regulated financial services industry are required to arbitrate any disputes through the Financial Industry Regulatory Authority ("FINRA"). Outside of the financial services industry, many employers require employees to sign arbitration agreements at the outset of or during their employment as a condition of employment in which the employees agree to waive their rights to file a claim in court and to submit any disputes to arbitration. Typically, such arbitration procedures, deliberations, and decisions are private and confidential. Even those occasional disputes that are not subject to an arbitration agreement are usually settled without a trial, or often, without formal litigation being commenced.

As a result, most cases in US courts around executive compensation arise not out of executives making claims for unpaid bonuses or other compensation, but out of shareholder derivative actions, as shareholders are not bound by arbitration agreements. Below, we review some recent lawsuits in this area.

(a) CBS – Shareholder Corporate Waste Claim for Compensation Paid to an Incapacitated Executive

Feuer v. Redstone[5] was a corporate waste claim brought against CBS for paying $13M in compensation (both salary and bonuses) to its Executive Chairman Sumner Redstone while he was incapacitated and therefore incapable of performing any services for CBS. CBS is a public company that was indirectly controlled by Mr. Redstone through a dual-class capital structure. Mr. Redstone served as CBS's Executive Chairman from 2006-2016. During the same period, Mr. Redstone alleged in an elder abuse lawsuit against a live-in girlfriend that he had been incapacitated for a significant period of that time. Shareholders relied on that allegation in bringing the corporate waste claim. CBS unsuccessfully brought a motion to dismiss the action. In denying CBS's motion in part, the Court noted the difficulty in pleading a corporate waste claim under Delaware law (where many companies in the US are incorporated because of its favorable laws toward corporations), stating that the standard is whether the board's decision "was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests." The lawsuit settled in March 2019 for $1.25 million, which was paid out by CBS's insurance company and will go back into the company's coffers, not to individual shareholders.

(b) Netflix – Shareholder Corporate Waste Claim for Easy Performance Targets

Netflix recently defeated a corporate waste claim brought by shareholder City of Birmingham Relief and Retirement System alleging that it intentionally set performance objectives too low, thus allowing executives to easily out-perform their goals and earn high levels of compensation. The suit alleged that the practice was part of a tax-avoidance scheme

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[5] No. 12575–CB, 2018 WL 1870074 (Del. Ch. Apr. 19, 2018).

under the now-amended tax law - IRC Section 162(m) - discussed in section II(b) above, before the $1M cap was changed to include performance-based compensation. The suit alleged that the company's top officers had met their performance targets seven out of eight quarters and missed the last quarter by only 1%.

In this type of shareholder derivative action, shareholders are required to first bring their concerns to the company's board of directors and make a demand that the board take action - or they must demonstrate to the court that such a demand would have been futile. In this case, the shareholder did not make a demand to the board, and the Court held that it had not demonstrated that such a demand would have been futile.

(c) Twenty-First Century Fox - Derivative Suits & #MeToo

Over the last several years in the US, the #MeToo movement has contributed to the exposure of many high-level and high-profile executives for their sexual harassment and sexual assault of employees. Many of these allegations have exposed in the press, and activists have looked for ways to hold employers accountable when they fail to take steps to stop such sexual misconduct. One tactic has been to use shareholder derivative suits.

The largest one to date was filed by Twenty-First Century Fox shareholder City of Monroe Employees' Retirement System ("CMERS") against Twenty-First Century Fox's directors.[6] The dispute arose initially out of former Fox News reporter Gretchen Carlson's lawsuit against the Company for sexual harassment and wrongful termination, which alleged that Fox News CEO Roger Ailes had sexually harassed and retaliated against her. Her suit led to an internal investigation, which resulted in Mr. Ailes' departure from the Company. CMERS filed a books-and-records request. Over the next several months, numerous other employees came forward alleging sexual harassment by Mr. Ailes, as well as Fox News commentator Bill O'Rielly. CMERS drafted a derivative claim against the board for breach of fiduciary duty and against Ailes for unjust enrichment, and the parties entered into mediation. The case settled in 2017 for a $90M monetary payment, as well as corporate governance reforms.

[6] *City of Birmingham Relief & Ret. Sys. v. Hastings*, No. 18-cv-02107-BLF, 2019 WL 3815722 (N.D. Cal. Feb. 13, 2019).

The case has inspired numerous similar actions against other employers that have allowed sexual harassment and retaliation to continue. This will be a very interesting litigation trend to follow in the coming years - to see whether other such actions will see the same kind of success as the Twenty-First Century Fox case.

IV. Recent Drafting Trends

In part through the threat of derivative actions, as well as through their power to vote against compensation increases or discretionary bonus payouts, shareholders have stepped in where regulators have left a gap. As a result, many publicly-traded companies have included in broad "cause" definitions that dis-entitle executives to bonuses and that impose aggressive forfeiture and clawback provisions for conduct that takes place during employment or is discovered after employment. In our practice, we have seen an increase in these clauses in employment and compensation agreements that provide the employer greater rights to refuse to pay out - and to clawback - performance-based compensation. In particular, more employers are including clauses that will enable them to terminate executives accused of sexual harassment without paying severance, and an increase in "cause" and forfeiture/clawback clauses triggered by conduct that harms the employer's reputation, often under a "detrimental activity" rubric. These clauses are sometimes broadly drafted in a way that attempts to reserve to the employer the right to cause forfeiture or clawback for anything it determines is detrimental.

In line with our observations, a recent survey of major Silicon Valley employers shows that most of these employers have clawback policies that go further than what is mandated by SOX, with many including clawbacks for breaches of restrictive covenants, as well for detrimental activity.[7] As this article points out, major institutional investors also are including clawback considerations when making investment decisions. For example, BlackRock, one of the largest institutional investors in the US, favors policies that allow for recoupment from any senior executive whose conduct caused harm to shareholders or reputational risk to the company, or resulted in a criminal investigation.

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[7] Jonathan M. Ocker, Justin Krawitz, Benjamin T. Gibbs, *The State of Play on Clawbacks and Forgeitures Based on Misconduct*, PILLSBURY (June 7, 2019) ,https://www.pillsburylaw.com/en/news-and-insights/state-of-play-on-clawbacks-and-forfeitures-based-on-misconduct.html.

V. Conclusion

While executive compensation trends in the US are affected by a range of factors, the most significant factor in recent years has come from activist shareholders putting pressure on corporate boards. It remains to be seen how this caselaw will develop, as well as whether the SEC will ever enact clawback requirements under Dodd-Frank.