Client Alert

September 2018

Section 162(m) Guidance Clarifies Executive Compensation Limitations, with Caution to Corporations

On August 21, 2018, the Internal Revenue Service issued Notice 2018-68 (IRB 18-36) (the "Notice"), which provided new guidance for the changes made to Section 162(m) of the Internal Revenue Code, as it was amended by the Tax Cuts and Jobs Act passed last year (the "Act"). Effective for all tax years beginning on or after January 1, 2018, Section 162(m) generally limits the allowable deduction that public companies may take for compensation paid to the principal executive officer or principal financial officer, the three other most highly compensated officers and certain executive employees called "Covered Employees."[1] The previous exception for qualified performance-based compensation and commissions was generally eliminated, so that all contractually obliged compensation paid to a covered employee in excess of $1 million is now nondeductible. However, the Act included a transition rule, under which these changes would not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and is not materially modified after that date.

The Notice clarifies the definition of a "covered employee" and that the IRS and the Treasury Department have determined from the legislative history that there is no end-of-year requirement. The newly issued guidance also sets forth a fairly strict interpretation of when a contract is considered to be materially modified and no longer covered by the "grandfather rule." As a threshold matter, the guidance makes clear that the agreement must be a written, binding contract in effect on November 2, 2017, which obligates the company to pay under any applicable law.

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[1] The term "Covered Employee" also includes any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934, as amended, by reason of the employee being among the three highest compensated officers in the applicable tax year plus the principal executive officer and principal financial officer, or an individual working in such capacity.

Significantly, the IRS anticipates that future Treasury regulations will address many of the concepts identified in the Notice and that it will apply to all tax years beginning on or after 2018.

Impact on Performance-Based Compensation Packages

While the notice provides some helpful clarity, it still leaves open the question of what constitutes contractually obliged compensation. Specifically, it is unclear whether compensation arrangements that allow company boards to decrease performance-based pay (negative discretion compensation) are still subject to the $1 million cap. In response, some boards may look to decrease performance-based compensation as part of their overall executive pay package. In particular, companies may seek to decrease bonuses and increase salaries, since deductibility no longer differentiates between the two.

However, corporations are cautioned against such restructuring as a matter of course, as institutional investors expect that executive pay programs emphasize performance-based incentives. The purpose of these awards is both to retain and incentivize management to drive performance that aligns with long-term corporate strategy which, in turn, creates value for shareholders. While the tax deduction for performance pay afforded under Section 162(m) provided an added benefit, it was certainly not investors' primary motive for encouraging performance-based programs. Moreover, Institutional Shareholder Services (ISS), a leading proxy advisory firm, advocates strongly for pay for performance structures, which is a key factor in its analysis of executive compensation programs.

Shareholder Litigation

As a cautionary example against quick reactions to the December 2017 tax law overhaul, Netflix Inc. became one of the first companies to restructure its compensation for its top executives, cutting cash bonuses in favor of a higher salary. As may have been expected, in April of this year, the City of Birmingham Relief and Retirement System filed a shareholder derivative complaint against the Netflix board, alleging that the performance-based bonuses paid to executives were essentially a sham.[2] Essentially, they argued that the bonuses were solely designed to allow Netflix to receive tax deductions under the new tax law, and the achievement of performance goals was a "*fait accompli*."

Although the case is still ongoing and its outcome unknown, the growing number of shareholder actions challenging compensation plans further illustrates institutional investors' — and courts', for that matter —

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[2] *City of Birmingham Relief and Retirement System v. Hastings et al*, Case No. 5:18-cv-02107 (N.D. Cal. April 6, 2018).

heightened interest in board-directed compensation. In December 2017, the Delaware Supreme Court in *In re Investors Bancorp Inc. Stockholder Litigation*[3] ruled that, barring certain limited exceptions, a Delaware court may not apply the deferential "business judgment" standard in reviewing challenges to director compensation awards granted by a board under stockholder-approved equity incentive plans. Rather, courts should apply the "entire fairness" standard to scrutinize shareholder litigations alleging breach of fiduciary duties of directors granting discretionary awards to themselves through a stockholder-approved compensation plan. Under the new standard, defendant directors must prove that the awards were fair to the company.

This heightened level of scrutiny emphasizes shareholder engagement in reviewing decisions made regarding the rigor of incentive targets and "sham" compensation. The ongoing Netflix litigation is just the latest high-profile instance of a corporation's exposure to compensation challenges. Between legislative changes tightening tax deductions and courts' increased scrutiny, corporations ought to carefully evaluate their compensation plans and awards to minimize the likelihood of shareholder challenges. Although it is still too soon to observe any trend shifts in compensation plan design, boards are generally not expected to, and perhaps should not, make significant changes to their compensation packages as a reaction to the changes made to Section 162(m).

Please contact the Olshan attorney with whom you regularly work or one of the attorneys below if you would like to discuss further or have questions.

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[3] C.A. No. 169, 2017 (Del. Dec. 13, 2017).