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Analysis

4 Trends Executive Compensation Attorneys Are Watching

By Kellie Mejdrich · Listen to article

Law360 (February 23, 2024, 5:27 PM EST) -- A Delaware Chancery judge's rejection of Elon Musk's $55 billion Tesla pay package shows how a court historically viewed as corporate-friendly may be shifting, one of several trends executive compensation experts told Law360 they're seeing.

Here are four issues executive pay lawyers should have on their radar.

Delaware Getting Less Executive-Friendly

Attorneys highlighted Delaware Chancellor Kathaleen St. J. McCormick's blistering 200-page post-trial opinion from Jan. 30, which found Musk was provided unfair compensation, as a high-profile example of recent rulings in Delaware that backed shareholder accusations over executive pay. The decision also comes as shareholder derivative suits are on the rise overall.

Among the criticisms from Chancellor McCormick in her opinion were that the terms of Musk's pay package were too lenient and that the board didn't tie enough of his pay to performance. Chancellor McCormick also specifically criticized what she said was a "bare minimum" clawback policy that could have been used to incentivize Musk's attention given his "significant time commitments at his other companies."

Another core holding from Chancellor McCormick was that when ruling on shareholders' fiduciary breach claim over Musk's pay award, the most onerous of transactional standards of review under Delaware law applied, called "entire fairness." Judge McCormick found that a more deferential business judgment standard didn't apply because the directors who approved Musk's pay weren't independent from him.

Longtime benefits and executive compensation attorney Andrew Oringer, a partner at the Wagner Law Group, said the Delaware ruling on Musk's pay package was a "high-profile rejection" and part of "a recent trend in Delaware towards greater activism on the part of courts regarding compensation programs."

Shortly after the decision, Musk announced Tesla would move its incorporation to Texas. Oringer said the trend in Delaware courts "towards making things more challenging" for corporations overall could drive other companies to look at incorporating beyond the state.

"Maybe it won't hold on appeal. But if it does, I think you're going to start to see advisers wondering whether or not there aren't other state alternatives," Oringer said.

"And I think you are going to start to wonder whether or not other states are possibly going to aggressively try to entice corporations to incorporate in their jurisdictions," he added.

Ryan Wilkins, chair of Stradling Yocca Carlson & Rauth LLP's corporate and securities practice, who works on executive compensation matters, said he's also picked up on a shifting perception about Delaware:
"There is a general impression in the boardroom that Delaware has gotten less corporation- and executive-friendly in the past year or so."

But he added that he's continuing to speak with public companies incorporated in other jurisdictions that seek out Delaware.

"I think people have noticed, and it is causing people to express concern. It has not gotten so far as to the point where directors are starting to ask, 'Should we be incorporating somewhere else?' I've not had those conversations," Wilkins said.

Shift Toward Performance-Based Pay

Attorneys that work on executive compensation involving both public and private companies told Law360 another major trend they're seeing is an increasing focus by companies on performance-based compensation.

Benjamin Ferrucci, a member at Mintz Levin Cohn Ferris Glovsky and Popeo PC who focuses his executive compensation practice on private equity transactions and startup companies, said he's witnessed a shift toward performance in acquisition-related pay packages.

"There's an attempt to align better management's performance with ultimate value on a liquidity event," Ferrucci said.

"There's more equity being granted, and that equity grant is being split, in my opinion, more heavily toward performance-related multiples in terms of vesting conditions," Ferrucci said. He said those conditions have included tying compensation to rates of return or multiples of invested capital.

Ferrucci said he thinks the shift is driven by "a more focused interest on particular contributions of the management team to actually grow the company's value long term."

Cody Yorke, a partner at Outten & Golden LLP who advises public and private company executives on compensation issues, also highlighted "an increasing focus on pay being linked to performance."

Yorke said she's been watching the issue for many years, "but I think there's an acceleration of that I'm seeing."

Clawback Policy Reviews

On the public company side, Yorke said rules the U.S. Securities and Exchange Commission finalized at the end of 2022 explaining how mandatory clawbacks of performance-based pay should work for current and former executives have prompted company reviews of those policies.

The rules put formal policy in place that Congress called for more than a decade ago under the 2010 Dodd-Frank financial overhaul. In response to those rules, major stock exchanges, including Nasdaq and the New York Stock Exchange, had their clawback listing standards approved by the SEC in June.

"The final regulations are not that different from the proposed regulations that we were living under for 15 years, but everybody had to go through the exercise" of reviewing their clawback policies, Yorke said.

She said those reviews have spurred some public companies to revise their benefit plans and their clawback policies. As a result, the policies have changed in ways some public company executives might not be aware of, she said.

"Executives who've been at the same company for many years are seeing new clawback policies being put in place. The award agreements that they are used to seeing are different this year," Yorke said.

Yorke also pointed to a Delaware Chancery decision from January 2023 denying a motion to dismiss claims in a shareholder suit against David Fairhurst, McDonald Corp.'s former executive vice president and global chief people officer, as one example of litigation that's driving company changes.

In that case, Fairhurst was accused of breaching his fiduciary duty by allowing a corporate culture to develop that condoned sexual harassment and misconduct.

Yorke said the suit alleged "a new theory for executive officers, that this could be the basis of a clawback."

Perquisite Disclosure In Focus

A renewed focus by the SEC and litigation targeting disclosure of public company executives' perquisites — perks and other personal benefits such as traveling on company aircraft for personal reasons — has pushed companies to review their policies, attorneys said.

Erica Schohn, head of the executive compensation and benefits practice at Skadden Arps Slate Meagher & Flom LLP, said she's been frequently helping public company clients with "review of their perquisite disclosure and processes." Schohn, who didn't discuss specific companies in her interview, said recent litigation related to perquisite disclosure is one reason companies are reexamining their practices.

"In particular, as is often the case, there's a lot of focus on aircraft usage," Schohn said of the litigation. When flights personally benefit an executive, they can be subject to disclosure rules.

Schohn added that while there haven't been recent changes in law on perquisite disclosure, "the facts have changed — and the main fact that's changed is, since the pandemic, there's a lot more remote working," she said.

"The increase in remote working has put pressure on the perquisite analysis," Schohn said, including with regard to flights for remote executives to company headquarters.

Schohn said companies can lessen the likelihood of any civil penalties by focusing on having good processes in place, self-reporting any failure to disclose perquisites and cooperating with any SEC investigation.

Schohn said the focus for public companies should be "to have a policy that works through the fact patterns that are relevant to them, to stick to that policy" and to train workers on the policy and disclosure rules.

"And then to adequately report back to the compensation committee a summary of how that policy was applied on an annual basis," Schohn said.

--Editing by Aaron Pelc and Nick Petruncio.

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