Compensation Committee Leadership Network

April 2018

VIEWPOINTS

Tax reform and workforce changes

In the first months of 2018, compensation committee chairs are confronting a wide array of challenges and opportunities. Like other company leaders, they are digesting the implications of the first comprehensive tax reform in over 30 years. At many companies, they are also dealing with the fact that tomorrow's workforce will be very different from today's due to emerging technologies. In addition, they are grappling with how to ensure a safe workplace for their employees following a wave of accusations about the inappropriate behavior of senior executives.

On March 19 and 20, 2018, Compensation Committee Leadership Network (CCLN) members met in Washington, DC, to discuss these and other topics of interest to their committees.

Directors react to tax reform

The Tax Cuts and Jobs Act (TCJA), signed into law by President Trump on December 22, 2017, is the first major tax reform legislation passed in the United States in more than 30 years. CCLN members were joined by Bradd Williamson and Dave Della Rocca, both partners at Latham & Watkins, to discuss resulting changes to the executive compensation landscape and how their boards are responding to some of the broader implications of reform.

New deductibility rules are not likely to cause major changes to pay plans

The most material change related to executive compensation is the amendment of Internal Revenue Code Section 162(m): Limit on Compensation. This change eliminates the deduction for performance-based bonuses to named executive officers.[i] As a result, compensation more than $1 million paid to covered executives—now including the chief executive officer (CEO), chief financial officer, and the three other most highly compensated individuals—is not deductible, whether "performance based" or not. In addition, once people are covered executives, their compensation will always be subject to the statute even for amounts paid—including severance and retirement payments—even if they no longer hold a covered position.[ii]

Members said that the removal of the 162(m) deduction is not likely to result in significant changes to how most compensation committees set pay. This prediction is consistent with how health insurers reacted to provisions in the Affordable Care Act that removed the performance-based exception and lowered the cap on deductibility of compensation to $500,000.[iii] Meridian's Annette Leckie told members, *"That industry has been living with a significantly lower deduction for five years, and we haven't seen any material changes result from it."*[iv]

Members emphasized that major changes to pay plans are unlikely because the tax code was just one of many reasons why their compensation committees rely on performance-based metrics. One member said, *"Even though certain requirements were removed, they are still considered to be good governance practices. Large shareholders and advisory firms will still be expecting us to perform in the ways we functioned before."* Indeed, Institutional Shareholder Services has indicated that it will continue to recommend voting against executive pay awards that are not reasonably linked to performance metrics.[v]

The new law also includes a grandfathering clause for qualified performance-based compensation arrangements that were maintained under "written binding contracts" as of November 2, 2017, and are not materially modified thereafter.[vi] Members noted that it is not entirely clear what it takes to keep a contract within the scope of this provision. Mr. Williamson noted, *"IRS clarification would be helpful, but issuing guidance on this is not an immediate priority for them."*

The benefits of tax reform provide new options for boards

In an effort to make the US tax code more competitive in the global marketplace, TCJA includes the establishment of a flat corporate rate of 21%. The law also provides for the deemed repatriation of untaxed foreign earnings at more accommodating tax rates due over an eight-year period.[vii] Members said that because of the materially lower expected tax burden, newfound access to liquid offshore earnings, or both, their companies are experiencing a balance sheet boon and are evaluating what to do in this new environment.

Compensation committees are making immediate adjustments to reflect the lower tax rate

In many cases, a lower corporate tax rate makes it easier for management to hit its targets. CCLN members agreed that it is important to make immediate adjustments to their targets or results so that management does not receive a boost directly attributable to the lower tax rate. In a recent article in the *Wall Street Journal,* Deloitte's Michael Kesner commented, "Many companies already have increased their 2018 annual incentive plan targets and 2018 to 2020 performance cycle goals to reflect lower taxes … Often plans provide for adjustments to performance metrics or reported earnings used in incentive plan calculations in the event of certain unplanned or unforeseen events, and such adjustments often include a change in tax law."[viii] Meridian's Marc Ullman agreed and told members, *"This isn't a new thing for compensation committees. By and large, people realized there was windfall and dealt with it right away."* One member added, *"We are treating this the same as any other unusual incident that happens in the year that you would adjust for."*

Members also discussed the impact of reform on equity-based pay and the associated challenge of a substantial uptick in share prices. *"So much of the compensation plans are paid out in equity. When the stock value goes up somewhat materially, there is naturally a windfall at some companies."* said one member. *"You just need to acknowledge [that windfall.]"*

Companies are sharing the benefits of tax reform with workers

In some high-profile cases, companies have increased pay at lower levels of their organization. Companies including Bank of America and American Airlines received media attention at the beginning of the year for one-time bonuses ranging from $250 to $1,000.[ix] Companies have also increased wages, including Target and Walmart, which both raised their lowest-paid employees' wages to $11 per hour.[x] Lowe's also announced it would be expanding employee benefits to include paid parental leave for full-time employees.[xi] Some expect more changes; a Pearl Meyer survey found that 20% of 300 companies surveyed have already provided some enhanced benefits to employees, and 35% are considering making further changes to employee benefits.[xii]

Several CCLN members' companies gave bonuses to a broad group of employees; members said that the resulting goodwill was significant. One member said, *"We are giving bonuses farther down in the company than ever before. We hope this will incentivize people to perform at a higher level."* Another member said, *"We did one-time bonuses and added to our 401(k) matches. It's resonating well in the halls of the organization, and there has been a remarkable uptick in morale."* Other companies are increasing wages. *"We took a big portion of savings and increased entry-level pay. We are very worried about talent and retention and look at this as a long-term investment,"* said one member.

Members also discussed other uses for the proceeds of tax reform. Several mentioned investing in technology or other forms of research and development. *"We are putting more money into data mining,"* said one member. Some said that tax reform has also fueled talks about potential acquisitions, and others are also returning capital to shareholders via buybacks or dividend increases.

Discretionary director pay and self-interest

The Delaware Supreme Court ruled on December 13, 2017 (In re Investors Bancorp, Inc. Stockholder Litigation), that equity awards granted to directors were "self-interested decisions" and except in limited circumstances must be reviewed under the entire fairness rule (which requires the board to prove that its decision is in the best interest of the shareholders) rather than the business judgement rule (wherein there is a presumption that decisions are made in the best interests of shareholders).[xiii] The court ruled this to be the case even when shareholders previously approved the applicable plan with a director-specific share limit: "when stockholders have approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters, and a stockholder properly alleges that directors inequitably exercised that discretion … the directors will be required to prove the fairness of the awards to the corporation."[xiv]

Discretionary director pay and self-interest

CCLN members and guests discussed the implications of this ruling and approaches to ensuring clear and narrow limits on director pay plans. Mr. Williamson said, *"The implication is that including annual director limits in an equity plan may not necessarily make you immune to a lawsuit. One alternative is to adopt a director-specific shareholder approved plan providing for formula-based equity grants, although at this point most are hoping that this will not be necessary, and that the Investors Bancorp. case will come to be viewed as an instance of 'bad facts make bad law'."* Ms. Leckie told members, *"It's also a good idea to beef up your disclosures. You want to be able to show shareholders that you have a reasonable approach that is benchmarked against peers."*

Technology is reshaping the workforce

Advances in technology continue to change the nature of work. Dimitris Papageorgiou from EY's People Advisory Services joined members for a discussion on how companies can best prepare for and utilize these advances, both now and in the future.

New technologies are leading to a wave of automation

Certain technologies have been identified as game changers for the workforce, each with major implications for advancing an organization's capabilities. CCLN members' companies are integrating the new technologies in a variety of ways, with the majority focusing on automating repetitive business processes using robotic process automation (RPA). *"RPA is making its way to the board in a big way,"* said one member. Distinct from a physical robot, RPA technology is computer software that replicates the work of a human. It "captures and interprets existing applications, manipulates data, triggers responses and communicates with other systems."[xv] One of RPA's most notable benefits is that it utilizes existing systems rather than replacing them. Mr. Papageorgiou told members, *"Companies are using software robots to automate tasks like human resources [HR] benefits administration and new-employee onboarding. It has been very successful in terms of cost efficiencies."*

More companies are also exploring ways to utilize artificial intelligence (AI). AI describes technologies that are "capable of ingesting information and instructions, learning from interactions with human beings and responding to new situations and questions in a human-like way."[xvi] While RPA is utilized for more routine tasks, AI is making inroads in areas where more advanced skills are required. Mr. Papageorgiou explained, *"RPA is about creating tasks for a bot to complete. AI is further up the food chain, and you can utilize it to train the bot to recognize things on its own. It's intended to augment workers' abilities to make them more effective."* The Wall Street Journal recently reported that "the possibilities unleashed by artificial intelligence could eventually lead to human workers being replaced by robots in occupations that have yet to be affected by automation."[xvii]

Innovative technologies will continue to come to the market in waves. Mr. Papageorgiou explained that while large companies are already using RPA in the finance and HR functions, many are still in the early stages of determining how AI and other technologies will change their business. Members acknowledged that investing in technology now will put companies in a better position as technology continues to evolve in the future.

Workforce transformation requires a strategic approach

Experts largely agree that the future will include more humans working side by side with machines. The secret to success, they say, lies in the ability "to deconstruct work into discrete elements—that is, seeing the tasks of a job as independent and fungible components. Deconstructing and then reconfiguring the components within jobs reveals human-automation combinations that are more efficient, effective, and impactful."[xviii] In many cases, that means reshaping the workforce and equipping employees with new and different skills.

To prepare for that future, CCLN members are encouraging their management teams to align current and future workforce changes with their long-term business strategy. Members emphasized that this process must be CEO led. One member said, *"We are moving away from the traditional HR strategy and asking our CEO to develop a comprehensive people strategy."* Another member said, *"We are planning based on the fact that the skill set we need today won't be the skill set of tomorrow. We don't know what the future will bring, so we are asking management to build scenarios."*

CCLN members' companies are pursuing a mix of retraining existing workers and attracting new talent. *"The debate is whether you work with the people you have or start over. We are coming out somewhere in between,"* said one member. Another said, *"We are pursuing both options. We had some employees raise their hand and go down a new road with us. We've also had to be aggressive about finding new talent as well."* Members mentioned a variety of approaches to securing talent:

- **Partnering with universities and other education providers.** Several members agreed that enhanced cooperation between corporations and academia is critical in overcoming the expected gaps: *"We are talking about partnering with universities and thinking about public policy issues because the government is way behind on this,"* said one member. Mr. Papageorgiou agreed: *"The pace of change exceeds the pace of learning, and it's highly problematic."*
- **Identifying employees eager to learn new skills.** One member said it was important to offer a range of choices to existing employees for professional development: *"Some of our employees are pursuing nanodegrees in specific technologies through online programs like Udacity; others are pursuing advanced degrees at a major university. The employee base is really excited about these options."*
- **Becoming a workplace of choice.** Other members are focused on being an attractive choice for new talent. One member emphasized the need to open innovation hubs in new

cities: *"It's crucial that you are building locations in the right areas. You've got to be where the talent is."* Another member added, *"The work environment is critical to recruiting. We've found that it made a big difference to offer a virtual workplace and a lot of flexibility."*

Members agreed that the organization of the future will look very different. Mr. Papageorgiou said that the apprenticeship model of the past is fading away as temporary and flexible work arrangements become more commonplace: *"People are not coming in at a low level and working their way up. You may bring in giggers to do a task while incorporating technology simultaneously."* In response, companies are creating different arrangements within their workforces. *"Generalists and management will continue to follow a horizontal path. There will also be an expanding vertical path that consists of highly specialized gig workers and robots. Successful organizations will find a way for all of them to work together seamlessly,"* said Mr. Papageorgiou.

Board must oversee these workforce changes

Boards are responsible for assessing their companies' progress in both adopting new technologies and creating the workforce of the future. Members said that they are focused on whether the company has the right workforce, the tools to remain competitive, and is capitalizing on the benefits of technological changes in an ethical way.

Mr. Papageorgiou advised members to be aware of red flags in discussions with management: *"The board should be concerned if management is casting certain technologies off as fads and continuing to focus on the present as opposed to what is around the bend."* Several members expressed frustration that management teams often paint an overly optimistic picture of their progress: *"We are constantly hearing that we are the best at this and that. I find it hard to judge how we are really doing on a relative basis,"* said one member. Another member said, *"When we press management on whether they are getting the right people and skill sets, we are told everything is fine. I have a feeling that this won't serve us well in the long term."* One member shared an effective practice when assessing management's performance in this area: *"We do deep dives on where things stand with outside vendors. We review their assessment and then hear from management. Usually we find we are not as far along as management says we are."*

CCLN members said that board education is critical to effective oversight. *"Board members need to understand the technology and the resulting changes to the workforce so that we can lead the charge on these issues,"* said one member. Another member shared an example: *"The company has been very intentional in educating the board. We have found it to be helpful since the technology is moving so rapidly."* Several members said that training is most helpful when it occurs in different settings. *"It helps to get out [of the boardroom] and see the technology in action. I find getting on the shop floor accelerates our education in a big way,"* said one member.

Board oversight of workplace conduct

Corporate sexual harassment awareness is at an all-time high, fueled by a series of high-profile misconduct charges against business leaders. Ousters of executives at 21st Century Fox, Wynn Resorts, and other companies in the wake of accusations of harassment and worse have damaged corporate reputations and diminished shareholder value. [xix]

The Council of Institutional Investors recently released a list of recommendations for board oversight of sexual harassment issues that included the following statement:

> Companies of all sizes and industries stand to benefit when the board of directors plays a central role in setting a strong tone at the top and providing leadership on corporate culture, including combatting sexual harassment, empowering employees to bring forward concerns, and treating all employees fairly. Directors should pay attention to these issues, not only because they are responsible for risks that affect their companies' bottom lines, but also because they have an obligation to shareholders to exercise oversight in the company and promote sound governance practices. [xx]

Jennifer Fay, a partner at Goodwin, joined members for a discussion on effective board practices. Ms. Fay counseled members to be proactive and look for ways to improve existing policies and practices, such as by making pre-employment hiring processes for key executives more robust and by bolstering harassment training programs. Ms. Fay warned members that *"most clawback policies are not broad enough"* to cover workplace misconduct and encouraged members to review both clawback policies and employment agreements to empower the board should misconduct arise.

Network members said that once misconduct has been alleged and substantiated, the board should take a firm stand, even if it means losing a top performer. One member said, *"You need to be responsible to shareholders, but also to employees and culture. If you don't take the bad actor out, you are saying their actions are acceptable."* Another member added, *"You hire executives for their judgement. If he or she exercises egregious judgement, then you need to act."*

Conclusion

In addition to discharging their core responsibilities, directors are often asked to think about what changes in the business environment create opportunities and increase risks for their companies. Changes to 162(m) will increase compensation-related tax liabilities, but other elements of tax reform give companies new opportunities to reward their people and shareholders, in the short and long term. Technological disruption will create winners and losers. The #metoo movement has caused significant reputational damage to some companies, but at those companies and many others the movement could spur changes that strengthen a company's culture and workforce. For network members, the question is not whether the glass is half full or half empty, but what directors can do to fill the cup.

About this document

The Compensation Committee Leadership Network (CCLN) brings together compensation committee leaders from North America's most prominent companies for private discussions about improving the performance of their corporations and earning the trust of their shareholders. *ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions.

The views expressed in this document represent those of the Compensation Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, or Tapestry Networks. Please consult your counselors for specific advice.

Appendix A: Participants

The following directors participated in the meeting:

- Carl Berquist, Beacon Roofing and Supply
- Les Brun, Hewlett Packard Enterprise
- Erroll Davis, Union Pacific
- Roxanne Decyk, Orbital ATK
- Marianne Harris, Sun Life Financial
- Jim Kennedy, United Continental
- Bill Kerr, IPG
- Annette Leckie, Meridian Compensation Partners
- Karen Maidment, TD Bank Group
- Joyce Roché, AT&T
- Virginia Ruesterholz, The Hartford and Frontier
- Marc Ullman, Meridian Compensation Partners

The following directors took part in discussions before or after the meetings:

- Ramani Ayer, XL Group
- Beth Cobert, CBRE
- Kathy Hill, Moody's
- Mel Lagomasino, The Coca-Cola Company
- Steven Reinemund, Marriott International and Walmart, Inc.
- Ron Rittenmeyer, IQVIA
- Samme Thompson, American Tower

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Endnotes

[i] Alicia Ritcey and Jenn Zhao, "Netflix's Cash Bonuses Become Salary Thanks to Tax Plan," *BloombergTechnology,* December 28, 2017.

[ii] "The Tax Law's Game-Changing Impact on Executive Compensation," *Agenda,* January 8, 2018.

[iii] Sarah Anderson, "How Obamacare Can End Bloated CEO Pay," *Fortune,* August 27, 2014.

[iv] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics. Annette Leckie and Marc Ullman from Meridian Compensation Partners have permitted their remarks to be attributed.

[v] Amy I. Pandit and Patrick Rehfield, "'Say on Pay' Hasn't Gone A-Way under Tax Reform, Reminds ISS," *National Law Review,* February 12, 2018.

[vi] Baker Botts, "Tax Reform Act: Impact on Executive Compensation," *Ideas,* December 20, 2017.

[vii] Andrè Benayoun, "IRS Issues Preliminary Guidance on One-Time Repatriation Tax under Tax Reform Law," Berkowitz Pollack Brant Advisors and Accountants, January 10, 2018.

[viii] Deloitte, "How Tax Reform May Affect Executive Compensation," *CFO Journal* (sponsored content), *Wall Street Journal,* February 5, 2018.

[ix] Paul Bedard, "Over 100 Companies Giving 'Trump Bonuses' after Tax Victory 'Tsunami Building,'" *Washington Examiner,* January 4, 2018.

[x] Lauren Gensler, "Walmart Is Raising Its Minimum Wage to $11 an Hour after Sweeping Tax Reform," *Forbes,* January 11, 2018.

[xi] Lauren Thomas, "Lowe's to Give Some Employees Bonuses of up to $1,000 and Expand Benefits Due to Tax Reform," CNBC, January 31, 2018.

[xii] "Employers Mixed on How to Share Tax Reform Savings with Employees," Pearl Meyer, February 15, 2018.

[xiii] For the opinion, see *In re* Investor Bancorp, Inc. Stockholder Litigation, C.A. No. 12327-VCS, 2017.

[xiv] Ibid., 3–4.

[xv] EY, *Robotic Process Automation in the Finance Function of the Future* (New York, Ernst & Young Accountants LLP, 2016), 2.

[xvi] EY, *Is the Future of Finance New Technology or New People?* (London: EYGM Limited, 2016), 11.

[xvii] Jason Bellini and Matt McDonald, "The New Robot Revolution in Manufacturing: Moving Upstream," *Wall Street Journal,* February 1, 2018.

[xviii] Ravin Jesuthasan and John Boudreau, "Thinking Through How Automation Will Affect Your Workforce," *Harvard Business Review*, April 20, 2017.

[xix] Tony Chapelle, "Listed: Worst Reputational Crises of 2017," *Agenda,* February 5, 2018.

[xx] Rosemary Lally and Brandon Whitehill, *How Corporate Boards Can Combat Sexual Harassment: Recommendations and Resources for Directors and Investors* (Washington, DC: Council of Institutional Investors, 2018), 3.