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GT Insights for Public Companies

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SEC

States and Municipalities Propose Increased Tax Based on Higher CEO Pay Ratios

Legislation has been proposed in California, Connecticut, and Rhode Island that would effectively provide for increased taxation for publicly-traded companies that disclose higher CEO pay ratios. CEO pay ratio refers to a comparison of the compensation of a company's CEO and that of the company's median employee (calculated in accordance with SEC rules).

Connecticut and Rhode Island have introduced legislation, which is still pending, that seek to impose differing tax treatment for companies based on their CEO pay ratio. Connecticut's proposed bill would replace the current corporate income tax on publicly-traded companies with a corporate income tax rate based on CEO pay ratio with the highest rate of 25 percent being imposed on companies with a pay ratio greater than 250:1 (as disclosed in its SEC filing). By comparison, the bill in Rhode Island establishes a surtax on corporations reporting that their pay ratio is equal to or greater than 100:1 with the highest rate of 25 percent being imposed on companies with a pay ratio equal to or greater than 250:1. The Rhode Island surtax would be added to the amount of the tax computed under the state's net income tax.

The California bill would impose an increased tax rate for publicly-held corporations starting Jan. 1, 2019 based on its own calculation method. Under the bill, the chief operating officer or the highest paid employee is to be compared to the median compensation of "all employees…including all contracted

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employees under contract." Significantly, the applicable net income tax rate would increase by an additional 50 percent if a company reduces its U.S. full-time employees by 10 percent or more during the previous tax year. While the bill applies to all public companies that are subject to California tax, it excludes banks and financial institutions.

Currently, only the City of Portland, Oregon has enacted CEO pay ratio taxation. The legislation, which took effect in January 2017, imposes an executive pay surcharge which is levied as a percentage of what a publicly-traded company owes through the City of Portland Business License Tax. A surcharge of 10 percent of base liability is applied if a covered company reports a pay ratio of at least 100:1, but less than 250:1, as disclosed in its SEC filings. The surcharge increases to 25 percent of base tax liability if the ratio is 250:1 or greater.

EY Study Highlights Staff's Amenable Approach to Reg. S-X Relief Requests

According to an April 4, 2018, Ernst & Young (EY) publication, the Staff of the Division of Corporation Finance has become increasingly amenable to companies' requests for relief from certain financial statement disclosures required by Reg. S-X. In recent speeches, both SEC Chairman Jay Clayton and Director of the Division of Corporation Finance Bill Hinman indicated the SEC's willingness to consider requests for relief and encouraged companies to do so where the required disclosures are burdensome and not material to investors. Hinman also encouraged companies to reach out to the Staff prior to undergoing the cost and effort of preparing an extensive request for relief.

Under Rule 3-13 of Reg. S-X, the SEC has the authority to modify or waive the financial reporting requirements under Reg. S-X if the waiver or modification is consistent with investor protection. The Staff, which has been delegated this authority, considers the materiality of the information sought to be omitted in determining whether to grant a request.

According to EY, the Staff has been prompt in responding to requests, often within a week, and has shown a willingness to change past views on certain matters.

Some situations are addressed by the Staff's existing guidance, such as those described in its Financial Reporting Manual (FRM). For example, Reg. S-X requires companies to provide separate financial statements of certain acquired businesses, with the number of years depending on the significance of the acquisition. However, according to the FRM, some relief may be available depending on the circumstances. A company may request relief to provide abbreviated "carve-out" financials for an acquired business that represent less than substantially all of the assets of the selling entity where the financial statements of the selling entity would not be informative. The Staff considers the impracticality of preparing full financial statements as a key consideration.

For situations not addressed in the FRM, according to EY, companies should consider Chair Clayton's principle: whether the Reg. S-X requirement is burdensome and results in disclosure not material to investors. Discussing complex situations with the Staff prior to endeavoring to prepare a request can save time and cost, help focus the analysis on the issues the Staff considers most important in evaluating a request, and eliminate unnecessary background information and analysis.

Corporate Governance

ISS and Glass Lewis Recommended that GE and its Auditor Part Ways after More than a Century

ISS and Glass Lewis recommended that shareholders vote against ratifying its auditor, after over a century in that role. In January 2018, GE announced that it was taking a $6.2 billion charge to its fourth-quarter earnings related to an insurance portfolio and also setting aside approximately $15 billion over the next seven years for statutory cash contributions to its insurance subsidiary. Shortly after this announcement, GE disclosed that the SEC was investigating the process that led to the insurance reserve increase and the fourth-quarter charge, as well as GE's revenue recognition policies and controls over long-term service agreements.

In its 2018 proxy, GE made a case for the benefits of a long-tenured auditor, including a higher audit quality, efficient fee structure and no onboarding or educating a new auditor. However, according to a *Wall Street Journal* article, in its report, ISS recommended a vote against keeping the auditor because of, "the apparent extent of GE's previously-undisclosed liabilities and accounting issues." ISS further noted that the decision to keep an audit firm should be balanced "against the risk that a long-tenured auditor can become too close to a client, and the potential for a new auditor to uncover problems previously unidentified." Glass Lewis asserted that it generally supports the auditor selection "except when we believe the auditor's independence or audit integrity has been compromised."

On April 26, preliminary figures revealed that only 64.9 percent of GE's shareholders ratified its auditor selection at GE's annual meeting as opposed to 94 percent last year, demonstrating one of the highest levels of shareholder opposition to a company's auditor in recent years, according to Audit Analytics. While, according to a report published by Audit Analytics, votes against auditor ratification are rare, this serves as a reminder that proxy advisers are prepared to go against long-standing auditors, and that some shareholders may vote against the auditor when there are serious concerns regarding accounting issues.

Washington State Court Rules in Favor of HomeStreet in Proxy Suit

On March 30, the Superior Court of King County, Washington ruled in favor of HomeStreet, Inc. with regard to a lawsuit brought by an affiliate of Roaring Blue Lion Capital against HomeStreet. In the underlying lawsuit, Blue Lion sought a preliminary injunction to prohibit HomeStreet from rejecting Blue Lion's director nominations and shareholder proposals. This came after Blue Lion submitted a proposal to separate the position of chairman and CEO and nominated two board candidates.

The Court affirmed HomeStreet's position that Blue Lion failed to comply with HomeStreet's advance notice bylaw, which required, among other things, that Blue Lion disclose certain information relating to share ownership and contracts or understandings with respect to HomeStreet. According to HomeStreet, Blue Lion fell short of the bylaw requirements on at least 32 instances.

As a result of the Court's decision, Blue Lion's director nominations and proposals for HomeStreet's 2018 annual meeting will be disregarded, no proxies in favor of Blue Lion's nominees and proposals will be recognized, and no votes cast in favor of Blue Lion's nominees or proposals will be tabulated at the annual meeting.

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SEC Enforcement

SEC Enforcement Concerning CEO Fraud and Auditor Involvement

On April 13th, the SEC charged the CEO of a company with making false and misleading statements in the company's SEC filings and press releases, and with manipulating the company's stock.

Specifically, the SEC alleged that the CEO took $450,000 in unauthorized withdrawals from the company and then caused the company to mischaracterize his withdrawals as salary, prepayments, or loans in Forms 10-K and 10-Q. The complaint further alleges that the CEO caused the company to issue false and misleading press releases disclosing non-existent sales of medical devices by a company subsidiary and manipulated the market for company stock by coordinating secret trading with a friend whom he had hired as an unregistered broker to solicit investments in the company through private placement agreements. The SEC is seeking a permanent injunction, disgorgement with prejudgment interest, a civil penalty, and an officer-and-director bar, among other things.

In separate administrative proceedings, the SEC settled with the company, its auditor, the audit engagement partner, and the broker regarding their respective involvement in the above schemes. Importantly, with respect to the auditor and audit engagement partner, the SEC found the parties knew or should have known of the CEO's misrepresentations and thus caused the material misrepresentations and omissions. They also found that the auditor and auditor engagement partner failed to satisfy the applicable review and audit standards. Without admitting or denying the SEC's findings, they agreed to a cease-and-desist order, to each pay disgorgement with interest and civil penalties, and to be permanently suspended from appearing before the SEC as accountants.

Litigation

Delaware Chancery Court Explains That "Director Consent Statute" Is Not Limited to Claims for Breach of Fiduciary Duty, Declines to Dismiss Fraud Complaint Against Majority Stakeholder of Merged Corporation

In the context of cross-claims of fraudulent inducement by parties to a merger, the Court of Chancery addressed several principles of Delaware law, providing confirmation that:

- application of the "director consent statute" is not limited to claims for breach of fiduciary duty;
- civil conspiracies can exist among a company and its subsidiaries; and
- claims for negligent misrepresentation require a "special relationship."

In the complicated fact pattern presented by this case, the Plaintiff alleged that the Defendant misrepresented its financial position to induce Plaintiff into a merger, and the Defendant counterclaimed that the Plaintiff both misrepresented its own financial position before the merger and, as the surviving entity's majority member, caused it to engage in fraudulent accounting practices after the merger. Plaintiff also sued several corporate affiliates of a private equity firm that held the majority interest in Defendant prior to the merger, along with three individual non-Delaware residents who managed that firm's investments in the Defendant. Plaintiff's claims asserted fraud, conspiracy, and negligent misrepresentation.

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Three important takeaways for directors and officers of Delaware corporations can be found in the ruling on the individual defendants' motion to dismiss.

First, the Court held that the nonresident individuals were proper parties to claims alleging their participation in a fraud, and thus properly subjected to Delaware jurisdiction under the director consent statute (10 Del. C. § 3114), despite the absence of fiduciary duty claims against them. Discussing precedent from the Delaware Supreme Court's decision in Marc Hazout v. Tsang Mun Ting, the Vice Chancellor explained that: (a) personal jurisdiction over a non-resident director or officer may be had where the corporation is a named party and the corporate fiduciary is "a necessary or proper party" to the action and there is "a close nexus between the claims involving the corporation which made it a party to the suit, and the conduct of the nonresident fiduciary; (b) a director or officer is a "proper party" where she "has a tangible legal interest in the matter that is separate from" the corporation's; and (c) a director or officer is a "necessary party" if her rights "must be ascertained and settled before the rights of the parties to the suit can be determined."

Second, the Court rejected the argument that the Plaintiff had impermissibly alleged a conspiracy between a company, its subsidiary, and agents of the entities. The Vice Chancellor noted that the preclusion argument advanced by the individual defendants only operates to bar alleged conspiracies between a company and its wholly-owned subsidiaries. The Court also noted that nothing bars a private equity firm and its principal from conspiring with a company it controls but does not wholly own.

Third, the Court dismissed the negligent misrepresentation claim against the individual defendants because they did not have a fiduciary relationship with Plaintiffs and, instead, were simply counterparties who negotiated with Plaintiff at arms' length. The key factor in this outcome was that, although they were principals of the private equity firm that controlled the Defendant, the individual defendants were not themselves party to the merger agreement at issue and therefore did not have the "special relationship" with Plaintiff that would be required to maintain such a claim.

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