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EXECUTIVE COMPENSATION

Executive compensation challenges, both new and old

The past year brought with it new challenges as corporations increasingly sought to incorporate environmental, social and governance (ESG) issues into compensation decision making. Old issues surrounding "say on pay" and clawbacks of incentive compensation were reinvigorated. The year also brought with it some good news in the form of a reprieve for employers. The Ontario Court of Appeal sensibly overturned a lower court decision refusing to enforce a clause requiring the forfeiture of equity grants on termination of employment without cause.

Here we summarize some of the most impactful executive compensation developments of the year.

Tying compensation to ESG

An increased interest in the environmental and social impacts of corporate activity has led to growing calls to expressly tie executive compensation to the achievement of ESG goals. The objective is to provide an express incentive to management to drive improvements in such areas.

It has always been common for companies in certain industries such as mining, utilities and energy to include some key performance measures relating to environmental and health and safety performance in the personal performance scorecard when making short-term incentive compensation payment assessments. These may also be included in the corporate performance scorecard.

However, corporations are now making greater efforts to expressly identify such performance measures in the public disclosure of their short-term incentive compensation practices. Performance measures are also being expanded to include metrics related to social responsibility more generally. However, it is rare for payouts of long-term incentive compensation to be tied to ESG metrics, in part because of the difficulty in setting and measuring longer-term ESG goals.

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Say on pay

Decisions made regarding executive compensation in response to the impacts of the COVID-19 pandemic on business operations and stock prices were under close scrutiny during the 2021 proxy season. And shareholders were not hesitant to make their views known through "say on pay" votes, where held.

The average level of support among the 223 TSX companies we identified that conducted say on pay votes during 2021 was 91.5%. However, at a record six companies, investors voted against the issuers' say on pay resolution – Chemtrade Logistics Income Fund (40.1% approval), CI Financial Corp. (38.1%), Gildan Activewear Inc. (40.9%), Precision Drilling Corporation (42.4%), RioCan Real Estate Investment Trust (24.1%) and Vermilion Energy Inc. (41.8%). Issues flagged by the proxy advisors included a pay-for-performance disconnect, outsized retention and one-time awards, large discretionary CEO bonuses and poor disclosure of a former executive's severance arrangements. Shareholder dissatisfaction with compensation decisions was especially high this year. In addition to the record number of failed votes, 10 issuers received say on pay support of between 50% and 75%.

Say on pay remains a voluntary practice in Canada. However, that could change in the future. Although not yet in force, amendments made to the *Canada Business Corporations Act* (CBCA) require prescribed corporations to disclose their approach to the remuneration of the directors and members of senior management of the corporation. These changes would also require issuers to conduct an annual non-binding shareholder vote on the disclosed approach. The January 2021 final report of the Capital Markets Modernization Taskforce, which was established to review and advise on potential improvements to Ontario's capital markets, included a recommendation for mandatory annual advisory votes on executive compensation practices for all publicly listed issuers.

Compensation clawbacks

Requirements for the clawback of incentive compensation were first adopted in the U.S. under the Sarbanes-Oxley Act of 2002. Under that statute, if an issuer is required to prepare an accounting restatement as a result of misconduct, the United States Securities and Exchange Commission (SEC) has the authority to require the CEO and CFO to repay to the listed company certain incentive compensation and profits from stock sales received in the 12 months after the release of the financials that must be restated. In 2015, the SEC proposed rules that would require U.S. stock exchanges to adopt listing requirements providing for the clawback of excess incentive compensation received during the three years prior to a financial restatement. The rule also proposed to require each listed company to disclose its clawback policy and provide disclosure about its recovery of excess incentive-based compensation. Progress on the proposed rule stalled until this October, when the SEC voted to reissue its prior proposal for a new 30-day comment period.

Canadian executive compensation disclosure rules require summary disclosure of any clawback arrangements affecting named executive officers. These rules do not, however, mandate adoption of clawback policies.

Despite the absence of clawback requirements, many corporations have chosen to adopt their own incentive compensation clawback arrangements. These arrangements have continued to evolve. Larger corporations have adopted policies which reserve the right to claw back incentive compensation not only in the event of a financial restatement, but also for reasons of misconduct alone. These arrangements are being increasingly reflected in long-term incentive compensation plans and employment agreements for larger issuers.

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Amendments to the CBCA that are not yet in force will require the directors of a prescribed corporation to place before shareholders, at the annual meeting, prescribed information respecting the recovery of incentive benefits or other benefits paid to directors and members of senior management. Regulations related to the amendments have not been finalized, but the requirements will likely apply only to publicly traded corporations.

It remains to be seen whether the CBCA amendments and the renewed focus of the SEC on its proposed clawback rule will lead to mandatory requirements in Canada or changes to the range of practices in effect today.

A win for employers

Last year, we reported that in *Battiston v. Microsoft Canada Inc.*, the Ontario Superior Court of Justice concluded that a termination clause requiring forfeiture of unvested long-term incentive awards on termination of employment without cause was not enforceable. This conclusion was based on the Court's view that the clause was "harsh and oppressive" and on the fact that the employee, according to the Court, did not receive notice of the clause.

On appeal, however, the Ontario Court of Appeal concluded that the judge's finding of lack of notice was an error. The Court noted that the employee had made a conscious decision not to read the stock award agreement, despite expressly confirming that he had done so for 16 years. By misrepresenting his assent to the agreement to his employer, the employee put himself in a better position than an employee who did not make a misrepresentation, thereby taking advantage of his own wrongdoing. Osler acted on the appeal for Microsoft Canada Inc.

Increasing complexity

Investors and regulators continue to scrutinize compensation determinations and outcomes closely. Both have shown that they will take action when there is a perceived disconnect between compensation outcomes and perceived value creation for investors. This disconnect will continue to add complexity to decision making by directors and has the potential to significantly affect remuneration disclosure going forward.

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