

# Pay Ratio Not Applicable to Certain Externally-Managed Issuers

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Many public issuers that are master limited partnerships (“MLPs”) or real estate investment trusts (“REITs”) have no employees, and instead, are externally managed by a related entity pursuant to a service agreement. This fact pattern, which is common to MLPs and REITs, raises a question of whether the issuer has to comply with the pay ratio disclosure rules of Item 402(u) of Regulation S-K (the “Pay Ratio Rule”) if neither it, nor any of its consolidated subsidiaries, have employees.

- **Basic Requirements of the Pay Ratio Rule.** The Pay Ratio Rule generally requires an issuer to disclose the ratio of the total compensation of the median employee of the issuer and its consolidated subsidiaries, to the total compensation of the issuer’s Chief Executive Officer.
- **Worker Classification (Independent Contractor v. Employee).** Under the Pay Ratio Rule, whether an issuer or any of its consolidated subsidiaries have “employees” can be determined in accordance with any widely recognized legal test (*i.e.*, a law other than the SEC rules) that the issuer relied upon to determine the initial classification of its workers. One of the most widely recognized of such tests is the worker classification test set forth under U.S. federal income tax laws, which generally applies common law agency theories to the determination of whether a worker is an employee or an independent contractor (*i.e.*, such test that focuses on the control of the worker). *See Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992). *See also Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003).
- **Common Characteristics of an Externally-Managed Issuer.** Common characteristics of an externally-managed issuer include: (i) neither the issuer nor any of its consolidated subsidiaries have employees; (ii) the issuer’s audited financials reflect that it has no employees, and such is also reflected in the issuer’s Form 10-K; (iii) the issuer is externally-managed by an upper-tier entity (*e.g.*, a general partner) pursuant to a service agreement; and (iv) such upper-tier entity employs the workers, issues Form W-2s, and second the

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employees to the general partner.

Based upon the above, we think some externally-managed issuers will have no pay ratio disclosure if neither the issuer nor its consolidated subsidiaries have employees. However, before arriving to this conclusion, we recommend that issuers have legal counsel review the service agreement and secondment agreements between the sponsor, general partner and/or the issuer to verify that neither of the agreements unintentionally creates common-law employee classification at the issuer level.

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