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Executive Compensation: Are You In Compliance?

How the SEC and Congress are Confronting the Disguised and the Deferred

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It's no secret that for sometime now the Securities and Exchange Commission (SEC), institutional investors and shareholder services, have all been dissatisfied with the opaqueness of required executive compensation disclosure in Proxy Statements under Item 402 of Regulation S-K. In fact, the SEC may soon consider revising the executive compensation disclosure rules, at least with respect to certain types of compensation disclosure that are viewed by critics of current disclosure compliance as particularly lacking in transparency and detail.

It's also no surprise that Congress enacted Section 409A of the Internal Revenue Code to address the long-standing frustration of the Internal Revenue Service's (IRS) efforts to i) contain the proliferation of deferred compensation; ii) regulate how compensation may and may not be deferred; and iii) dictate what was "good" deferred compensation and what was, in the view of the IRS, a "bad" deferral or, put more technically, received, either constructively, under the so-called "economic benefit" doctrine or pursuant to some other theory of "receipt" or "benefit." "The IRS also weighed in recently with Notice 2005-1, providing some limited guidance to taxpayers.

Given these developments and the likelihood of further SEC and IRS action, what does the in-house lawyer need to be doing today to be prepared for the upcoming Proxy Statement season and to ensure that his client's deferred compensation plans and agreements are in compliance with (or exempt, *ie*, grandfathered, from) IRC §409A?

Executive Compensation Disclosure

The same old executive compensation disclosure attitudes and approaches may no longer pass muster. After the Enron and World Com debacles, and post-Sarbanes-Oxley, the focus of regulators and investors alike is fixed on more and better corporate governance. An important aspect of this "corporate governance bandwagon" is the attention that executive compensation disclosure has recently received and is likely to receive in the relatively near future. In his recent speech in San Francisco on Oct. 20, 2004, Allan Beller, Director, Division of Corporation Finance at the SEC, stated that: "Too many issuers and their advisers have followed a pattern of opaque or unhelpful disclosure [of executive compensation] that confirms the worst suspicions of concerned investors …." The clear message that rang forth from Beller's presentation is that non-transparent, obfuscated, poorly detailed and "buried" disclosure should not be tolerated and may well be getting more and more attention from the SEC and the investor community, both specifically and generally. For example, the current perspective of Proxy Statement readers (and the SEC) is that the Compensation Committee report has never moved much from being a relatively non-informative collection of "boilerplate" passages. Little or no attention is typically paid by in-house lawyers to what the Compensation Committee actually did during the year in preparing the Compensation Committee report.

In fact, the SEC is now considering possible action with respect to improving and clarifying the required disclosure of, among other executive

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compensation areas, perquisites, retirement benefits and deferred compensation, total compensation, director compensation and Compensation Committee reports. In the past, the SEC has challenged such companies as General Electric and W.R. Grace for failing to disclose adequately perquisites and retirement benefits paid to their respective former CEOs, Jack Welch and J. Peter Grace, Jr.

In-house counsel and their outside legal advisers should take steps now to review their current practices and attitudes toward executive compensation disclosure to ensure that the registrant they represent will not become the subject of embarrassing media attention and a similar SEC enforcement action.

Most companies rely heavily on outside legal counsel to prepare or at least review the executive compensation disclosure required for Proxy Statements. The outside lawyer is frequently positioned and used as a buffer between in-house counsel and both executive management and the Board of Directors, and the inevitable tension created by deciding what to disclose and how to disclose it. In-house counsel needs to remember, however, that the client is the registrant and not the board members or the individual executives. Moreover, outside counsel are perceived as too frequently trying to be "creative" with disclosure and placing disclosure in sections of the Proxy Statement where it is less likely to be located or understood in context. These practices are coming under more and closer scrutiny and in-house counsel is well advised to consider upgrading their client's practices and disclosure attitude.

For this upcoming Proxy Statement season, in-house counsel should focus on at least four areas: the required Compensation Committee report, perquisites, retirement benefits and deferred compensation. These are likely to be the first areas to receive renewed and focused attention from the SEC.

As noted above, the Compensation Committee report on executive compensation should not be a mark-up, year after year, of the previous Proxy Statement's report. Rather, it should detail the decision process of the Compensation Committee and tell the story of what the Compensation Committee did and why it did so. An articulation of the overall compensation philosophy and program structure should also be included. In this regard, the ratio of cash compensation to equity compensation should be set forth and explained. In addition, there ought to be discussion of the specific company policies in place addressing compensation matters. For example, does the company have written employment agreements? Change-in-Control agreements? Severance agreements or programs? Does the registrant use performance-based compensation? If it does, to what degree and why?

Ideally, the Compensation Committee will have engaged in an annual analysis and discussion of all elements of the registrant's executive compensation program or package. This would include year-by-year comparisons, input on comparables from independent compensation consultants and an understanding of how each element of the total compensation package impacts and relates to other elements of pay and benefits. For example, in-house counsel should make sure that the Compensation Committee comprehends the effect of annual bonuses on the accrued benefit under a Supplemental Executive Retirement Program or the impact bonuses might have on "change-in-control" parachute or other severance payments. If more than one independent compensation-consulting firm is being engaged by the Compensation Committee — not an unusual occurrence — it may be a good idea to bring them together and obtain observations from each as to the total compensation package. These analyses should be set forth in the Compensation Committee report. Get credit for it.

Finally new items for the Compensation Committee to consider for discussion going forward include compensation "claw-backs" or disgorgement of compensation, especially in respect of performance-based compensation if financial statements are restated downward, the propriety of tax gross-ups generally (and watch out for gross-up requests in the case of imposition of the 20% additional tax under Internal Revenue Code §409A), Rule 10b5-1 trading programs, and equity-based compensation's dilutive impact.

In respect of perquisites, the SEC may more closely scrutinize expenses that purport to be business-related, but are actually personal and compensatory in nature. Pay particular attention to disclosure regarding airplane usage (or, worse, yacht usage). Find out if there is a personal element to the trip. Did the spouse accompany the executive? What was the trip's purpose and destination? Personal use of aircraft or boats has been valued for IRS purposes using the charter value and SIFL (Standard Industry Fare Level) rates methods. Consider also using an incremental cost analysis. If the aircraft is owned, the charter value, SIFL rate determination or incremental cost (that is, the various flight expenses, such as, pilot and co-pilot salary, fuel, landing fees, gate fees and flight attendants), are compensation and need to be disclosed and reported to the IRS. In the case of a time-share arrangement, consider allocating the cost on an hourly usage basis. Do not assume

that unused airtime is a freebie because it would otherwise have been wasted.

Helpful examples of perquisites disclosure can be found in the Pfizer and Honeywell proxy statements. Also, if the registrant's executives reimburse the registrant for all personal expenses or if the registrant is so egalitarian that no perquisites are provided to executives that are not also provided to the rank and file employees, disclose that in the Proxy Statement. Again, get credit for "positive" disclosure. There's no SEC rule prohibiting this.

For retirement plans and deferred compensation disclosure, best practices include making sure that deferred compensation arrangements and defined contributions, respectively, disclosed in the Salary and All Other Compensation columns of the Summary Compensation Table are coordinated with the disclosure for the defined benefit-type plans described in the Pension Plan Table later on in the Proxy Statement and disclosing the investment returns to date on all non-qualified deferred compensation. Although technically not required by S-K Item 402, these are hidden costs and Alan Beller effectively made the case in his speech that "all compensation should be disclosed."

Deferred Compensation

Generally, Section 409A requires non-qualified deferred compensation plans to restrict distributions, accelerations of benefits and elections. The only permissible distribution events are:

- Separation from service;
- Disability;
- Death;
- A specified time;
- A change in control; or
- An unforeseeable emergency.

A plan may not permit the acceleration of any scheduled payment due under the plan and all deferral elections must be made in the year prior to the year in which the services are performed for such compensation. Finally, any election to further defer payments must not: 1) be effective until 12 months after the election; 2) be made less than 12 months prior to the first scheduled payment date, and 3) defer payment for less than 5 years from date such payment would otherwise be made.

Section 409A will not apply to any amounts deferred prior to Dec. 31, 2004, unless the deferral is materially modified after Oct. 3, 2004. Freezing an existing plan should not be considered a material modification. Moreover, the rights of participants in respect of grandfathered deferrals remain governed by the terms and conditions of the plan in effect on Dec. 31, 2004.

In-house counsel, if they have not begun to do so already, should do two things to address the new Section 409A deferred compensation rules. First, an audit or inventory should be conducted of all the registrant's deferred compensation obligations. Second, care must be taken so that existing plans are not modified in a way that would cause the grandfathered status of a plan or agreement to be inadvertently forfeited. The planning process should begin now so that all plans and agreements which need changes going forward can be properly amended or restated to bring them into compliance before the Dec. 31, 2005 deadline (but without forfeiting grandfathered status).

Some common trouble spots are:

- **Plan terminations.** Under the new rules, a plan termination is not a permissible distribution event. Many deferred compensation plans have this "feature" hidden away at the end of the plan.
- **Hardship distributions.** If the current hardship distribution provision does not provide for payment to cover the tax liability generated by the hardship withdrawal itself, think twice about adding it when the plan is restated as Notice 2005-1 appears to suggest that doing so could upset grandfathered status.
- **Changes in payment form.** Pay attention to plans that allow participants to switch from installment payments to lump sums as these will likely be impermissible accelerations.
- **Change-in-control distributions.** Notice 2005-1 defines a "change-in-control" only in the context of corporations. How this will be applied to partnerships, limited liability companies and business trusts is unclear. This is particularly troubling in the hedge and mutual fund industries where director and portfolio manager fees are routinely deferred, but few groups operate in corporate form.

Conclusion

Regulation of executive compensation disclosure and deferrals is, like it or not, on the increase and getting more complicated. In-house counsel ought to review their disclosure and deferral practices to determine what needs revision. The failure to do so could result in embarrassing adverse publicity, and executive discontent, and could be expensive, in time and money expended dealing with government investigators, shareholder constituency groups and the IRS.

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