BNA

Pension & Benefits Daily

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Executive Pay: Skydiving With a New Parachute

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Introduction*

The financial crisis of 2008 and the ongoing downturn in the economy has had a significant effect on executive compensation and on executives' leverage in negotiating the terms and conditions of their employment and equity agreements. The overwhelming outcry about excessive pay from shareholders and the public has resulted in federal regulations that limit executive pay for top executives at public companies and impose compensation restrictions and disclosure requirements on large companies generally. In addition, there has been a return to performance-based compensation, as well as a movement toward eradicating guaranteed bonuses on Wall Street and among other bonus-based businesses.

However, because of a need for top talent in tough times, companies are adjusting to the newly imposed restrictions and, where possible, are finding creative ways to structure compensation packages for employees. Unfortunately, public opinion is not as easily assuaged. The current challenge for companies and their counsel negotiating executive agreements is to balance the need for attracting and compensating top talent against potential negative public opinion. How hard and where to push becomes a concern in order to ensure that these agreements pass muster with the companies' shareholders.

With these considerations in mind, attorneys representing executives should be aware of the most recent trends, developments, and regulations that will affect negotiations in the current economy.

1. Recent Regulations Affecting Executive Compensation

Any attorney negotiating an executive employment agreement must be familiar with the current regulations that affect executive compensation and should know when to seek the assistance of a tax adviser or a compensation expert.

Since the financial crisis of 2008, a number of laws aimed at governing and limiting the payout of executive

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* This article is based on *Changing Economy Impacts Executive Pay* (172 PBD, 9/9/09; 172 PBD, 9/9/09). Excerpts of this paper appeared in *Executive Employment Agreements*, Benefits Practice Resource Center (BNA), June 6, 2011.

compensation have been proposed and enacted. Therefore, it is important for executive's counsel to be aware of these latest developments.

Initially, significant limitations on executive compensation were enacted by the American Recovery and Reinvestment Act of 2009 (ARRA),[1] which was signed into law on Feb. 17, 2009, by President Obama. Among other things, ARRA amended § 111 of the Emergency Economic Stabilization Act of 2008 (EESA)[2] that related to executive compensation limitations for financial institutions receiving funding under the Troubled Asset Relief Program (TARP). Under the original terms of EESA, only the top five most highly paid executives of a public company receiving assistance under TARP were subject to compensation limitations and restrictions. ARRA significantly expanded these limitations and restrictions to as many as the next 20 most highly compensated employees, or to such higher number as the U.S. Department of the Treasury may determine is in the ''public interest.'' Further, ARRA went so far as to revisit compensation determinations made prior to its enactment to confirm that such prior compensation determinations were consistent with TARP and not contrary to the ''public interest.''[3]

Many companies have since paid off their TARP debt, and thus the executive compensation limits set out by ARRA have become less applicable or relevant. U.S. regulators then turned to new legislation that could regulate and limit executive pay. The result was the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[4] signed into law on July 21, 2010. Dodd-Frank is broad reaching legislation that includes new rules for mortgage lending, risk management, product development, investment management, customer service/communications, and executive compensation. Specifically, § 956 of the Act addresses incentive compensation with a focus on prohibited and excessive compensation. Although the Dodd-Frank Act was originally meant to focus on Wall Street, the executive compensation provisions aim to significantly modify corporate governance and disclosure practices for almost all U.S. public companies. The new law ushers in fundamental changes in executive compensation disclosure, compensation committee independence, shareholder voting rights, and clawbacks, which will be implemented by various federal regulations over the course of the next two years.

a. ''Say-on-Pay'' and Compensation Disclosures. In this regard, on Jan. 25, 2011, the Securities and Exchange Commission (SEC) adopted final rules[5] implementing certain provisions of the Dodd-Frank Act. Specifically, § 951 amended the Securities Exchange Act of 1934[6] by adding a new § 14A(a)(1),[7] the ''say-on-pay'' provision, which requires all public companies to present to their shareholders an advisory resolution to approve compensation of its named executive officers, as disclosed pursuant to the executive compensation disclosure rules,[8] at least once every three years. The frequency of these advisory votes must be determined by a separate shareholder resolution no less than every six years and shareholders may elect to have the ''say-on-pay'' vote every one, two, or three years, with initial votes to be held on or after Jan. 21, 2011.[9] Further, § 951 also modified the Exchange Act by adding a new § 14A(b)(1)[10] regarding ''golden parachute'' disclosures, requiring any person making a proxy solicitation relating to sale, acquisition, or merger to include disclosure of any compensation arrangements between the soliciting person and the company's named executive officers.

While § 951 applies to all public U.S. companies, the provisions do not impose say-on-pay or say-on-frequency advisory votes on ''smaller reporting companies'' with assets of less than $75 million until after Jan. 21, 2013. Disclosure requirements regarding ''golden parachute'' payments in connection with change in control transactions took effect April 25, 2011. Finally, TARP companies are not subject to the new rules while they are still under TARP reporting rules.[11]

Other provisions of the Dodd-Frank Act will force public companies to make specific disclosures that will likely impact executive compensation structures. For example, under § 953 of the Act companies will have to make pay for performance disclosures demonstrating the relationship between executive compensation actually paid and the company's financial performance, as well as pay disparity disclosures providing the ratio of median total employee compensation (other than the CEO) to CEO compensation. Section 955 also requires disclosure of whether directors or employees are permitted to hedge company securities. The SEC's proposed rules for implementing these provisions are expected at the end of 2011, with the final rules set to take effect sometime in the first half of 2012.

b. Financial Institutions and Incentive Pay. Most recently, on the heels of the SEC's adoption of the Dodd-Frank Act provisions, the Federal Deposit Insurance Corporation (FDIC) and other agencies proposed new rules[12] regarding incentive compensation paid to financial institution employees. Proposed by the FDIC on Feb. 7, 2011, these rules will specifically apply to all banks and financial institutions with assets greater than $1 billion that provide incentive compensation to their employees. All ''covered financial institutions'' will be required to annually report incentive compensation arrangements to their primary regulators within 90 days of the fiscal year end. The definition of ''covered'' persons includes any executive officer, employee, director, or principal shareholder of a covered financial institution. There is no specific category of employee that is outside of the scope of the rules since they are tailored to apply to all employees whose duties expose the organization to a possibility of a material financial loss.

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[1] Pub. L. No. 111-5.
[2] Pub. L. No. 110-343.
[3] EESA § 111(f)(1), as amended.
[4] Pub. L. No. 111-203.
[5] Securities Act Release No. 33-9178, 76 Fed. Reg. 6010 (Feb. 2, 2011).
[6] 15 U.S.C. § 78a et seq.
[7] 15 U.S.C. § 78n-1(a)(1).
[8] See Item 402 of Regulation S-K
[9] 15 U.S.C. § 78n-1(a)(2) & (3)
[10] 15 U.S.C. § 78n-1(b)(1) & (2).
[11] Securities Act Release No. 33-9178, *supra* note 5.
[12] Exchange Act Release No. 34-64140 (March 29, 2011), jointly proposed by the federal banking agencies—FDIC, SEC, Office of the Comptroller of the Currency, Federal Reserve System, Office of Thrift Supervision, and National Credit Union Administration—published in 76 Fed. Reg. 21,170 (April 14, 2011).

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The proposed FDIC rules also impose heightened standards for ''larger covered financial institutions,'' or institutions with $50 billion or more in consolidated assets.[13] For these larger institutions,[14] the rules require that at least 50 percent of incentive-based payments be deferred for a minimum of three years for designated executives. Moreover, boards of directors of these larger institutions must identify employees who individually have the ability to expose the institution to substantial risk (in addition to executive officers), and must determine that the incentive compensation for these employees appropriately balances associated risk and rewards according to enumerated standards. The comment period for the proposed rules closed May 31. Final rules are expected to be published in 2011 and will most likely be effective for fiscal years beginning in 2012.

According to the FDIC, the proposed rules would move the U.S. closer to aspects of international compensation standards. The FDIC believes that the proposed regulations would help eliminate incentive-based compensation arrangements that encourage inappropriate risk or may result in material financial losses. According to the proposed rules, each ''covered'' company must institute policies and procedures for incentive-based compensation arrangements that are commensurate with the size and complexity of the institution and provide annual reports on incentive compensation structures to appropriate federal regulators.

All of the regulations discussed above make clear that the days of paying excessive executive compensation unchallenged by regulators and shareholders is over. It is also clear that with ''say-on pay'' and other provisions in the Dodd-Frank Act, public companies will become much more shareholder driven in regard to their executive compensation policies. For example, policy guidelines used by Institutional Shareholder Services Inc.[15] to formulate voting recommendations on executive pay and corporate governance issues recommend annual shareholder votes on executive compensation,[16] and include on the list of egregious pay practices single trigger change in control pay provisions, tax gross ups, and single trigger vesting of unvested equity in the event of involuntary termination.

An attorney negotiating an employment agreement for an executive joining the ranks of a public company or a financial institution must be aware of all of these statutory and regulatory limitations, as well as proxy adviser policies and guidelines and how they will affect his or her client.

c. Tax Issues: Section 409A. In regard to the tax issues, the most important tax regulation that has recently affected employment agreements is Section 409A of the Internal Revenue Code (I.R.C.). Section 409A was added to the I.R.C. by Section 885 of the American Jobs Creation Act of 2004, and became effective on Jan. 1, 2005.[17] Section 409A regulates the tax treatment of ''nonqualified deferred compensation.'' The Internal Revenue Service issued initial guidance on Dec. 20, 2004, and final regulations were published on April 17, 2007. The final regulations became effective and the transition period expired on Jan. 1, 2009. During the transition period, various companies modified their plans in order to comply with Section 409A standards for deferred compensation and to preserve favorable tax treatment for plan participants or ''service providers'' (e.g., employees).[18]

Section 409A provides that unless a ''nonqualified deferred compensation plan'' complies with various rules regarding the timing of deferrals and distributions, all vested amounts deferred under the plan for the current year and all previous years become immediately taxable (including a 20 percent penalty tax) to the employee.[19] The result of these restrictions is that most of the details under a deferred compensation arrangement must be in writing and defined from the beginning of the deferred compensation arrangement (unless one of the exceptions from the regulations applies). For purposes of Section 409A, a deferred compensation plan is one that ''provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year.''[20] Under Section 409A, a ''plan'' includes an employment agreement.[21]

With regard to short- and long-term compensation, under Section 409A, if an annual bonus is earned in one taxable year and paid in another, it may constitute a nonqualified deferred compensation plan. If an em-

[13] The Dodd-Frank Act defines ''covered financial institution'' to include any of the following types of institutions that have $1 billion or more in assets: (i) a depository institution or depository institution holding company, as defined in § 3 of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. 1813); (ii) a broker-dealer registered under § 15 of the Exchange Act (15 U.S.C. 78o); (iii) a credit union, as described in § 19(b)(1)(A)(iv) of the Federal Reserve Act; (iv) an investment adviser, as defined in § 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); (v) the Federal National Mortgage Association; (vi) the Federal Home Loan Mortgage Corporation; and (vii) any other financial institution that the appropriate federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

[14] The proposed rules define larger covered financial institutions relative to the applicable agency. For the federal banking agencies and the SEC, the definition covers those financial institutions with total consolidated assets of $50 billion or more. For credit unions the definition applies to those financial institutions with total consolidated assets of $1 billion or more. For the FHFA, all Federal Home Loan Banks with total consolidated assets of $1 billion or more are larger covered financial institutions.

[15] 2011 US Policy Summary Guidelines, available at http://www.issgovernance.com/files/ISS2011USPolicySummaryGuidelines20110127.pdf.

[16] *See supra* note 7. Dodd-Frank requires only that companies ''[n]ot less frequently than once every 3 years'' hold a shareholder say-on-pay vote on executive compensation.

[17] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 85, 118 Stat. 1418, 1634 (2004) (codified at I.R.C. § 409A (Supp. V 2005)).

[18] For definition of ''Service Provider,'' see Treas. Reg. § 1.409A-1(f). In addition to employees, ''service providers'' can include independent contractors.

[19] I.R.C. § 409A(a)(1)(A) & (B).

[20] Treas. Reg. § 1.409A-1(b)(1).

[21] For the definition of ''Plan,'' see Treas. Reg. § 1.409A-1(c). The concept of ''plan'' as covered by § 409A includes many different types of compensation and benefit plans in which executives participate.

ployer pays part of the annual bonus shortly after the close of the year in which the services were performed and pays the rest in a later year, the timing and nature of the payments would be subject to Section 409A and must comply with the distribution requirements under Section 409A.[22] The annual bonus must be paid in the year the services are provided or within 2½ months following the end of the employee's tax year or the employer's tax year, whichever is later (the ''short-term deferral'' rule under Section 409A) in order to avoid the application of Section 409A.[23]

Under Section 409A, stock options and stock appreciation rights are excluded from the treatment as deferred compensation if they meet certain requirements. In this regard, a stock option must have an exercise price no less than the fair market value of the stock on the date of grant to the employee, i.e., it cannot be discounted. Shares of restricted stock are not deferred compensation for purposes of Section 409A, but restricted stock units are deferred compensation that must comply with Section 409A. Other forms of equity compensation grants must be examined carefully to determine whether they fall within the statute's definition of deferred compensation. The application of the rules to equity plans and grants can be complicated, and careful attention must be given as to how the rules apply to a particular form of equity compensation.

2. Changes in Executive Compensation Structure

These new rules and regulations have significantly changed the form and nature of executive pay. Companies are designing compensation programs that, depending on the company's cash flow, are heavily weighted toward long-term rewards and are partially or wholly performance-based. The form and nature of incentive compensation differs across industries. However, any compensation arrangement for an executive must have an equitable mix of short-term and long-term incentive compensation.

a. Short-term Incentive Compensation. Short-term incentive compensation is usually paid to executives in the form of an annual incentive bonus. Larger companies typically have standard incentive compensation plans describing how annual bonuses are accrued, which should be reviewed by the executive and his or her attorney. Smaller companies or start-ups may present the employee with targets and milestones based purely on performance, while other companies (particularly financial institutions) state in their offer letters that their short-term incentive compensation is totally discretionary.

Because of current developments in the economy and the scrutiny over executive compensation, many companies (whether public or private) will have to justify their allocation of annual bonuses to their shareholders. The metrics and rationale for paying out these bonuses should be based on realistic individual achievements and performance targets. These metrics may include both the employee's performance, the division or department performance, and the company's overall performance throughout the fiscal year. The executive or the attorney negotiating the compensation package should insist on a clear definition of what metrics will be used in calculating the annual incentive bonus.

These metrics or the formula used to calculate them may include achievement of specific EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) targets, a certain level of sales, or other goals appurtenant to the executive's performance of his or her responsibilities under the agreement. However, the ''cause'' definition in executive's employment agreement should never include a performance trigger that could result in an employee being fired for ''cause'' because he, his department, or the company did not reach the performance goals defined in the bonus formula.

While bonus guarantees have become less popular, they are not obsolete, especially in industries and areas of the economy that are currently in development and have a high probability of being lucrative in the next few years. However, it is expected that guaranteed bonuses for more than one fiscal year will not be offered (even to top executives) without clawbacks and safeguards to protect the company.

Finally, any employment agreement should state what will happen to the accrual of the bonus in the event the executive is terminated before it is paid, if the agreement expires before the end of the employer's fiscal year, or if the bonus is in a deferred scheme and it has not vested at termination. In the event the agreement provides for any guaranteed bonus, any portion of the guarantee that remains unpaid when the employee is terminated should be paid out to the employee (sometimes in lieu of other standard severance) because of the employee's missed opportunity cost. If no guaranteed bonus is contemplated by the agreement, the employee should at least receive a prorated portion of the annual bonus to the extent the employee fulfilled the detailed performance objectives described in the agreement.

b. Long-Term Incentive Compensation. In order to retain talent, especially in a down economy, in addition to paying annual bonuses, companies are granting more long-term incentive compensation. Long-term incentive compensation is often structured as a grant of equity or another long-term plan that will vest over a specific period of time. By granting long-term incentive compensation to employees, companies ensure that the employee is motivated to stay with the company and perform well, as the employee is now an investor in the company's losses or profits.

Long-term compensation may take the form of statutory or nonqualified stock options, restricted stock grants, phantom stock, performance shares, stock appreciation rights, and other kinds of compensation. Aside from making sure that each grant of equity or employee entitlement to future grants is referenced and detailed in the employment agreement (as well as what happens to the grant in the event of termination), it is essential that such a grant of equity compensation complies with applicable tax rules.

The new limitations on executive compensation for some public companies as well as the increased scrutiny over executive compensation will mean that equity grants must be justifiable to shareholders. These recent developments have resulted in deferred compensation being subject to not only time vesting, but performance vesting. In this regard, the executive and the attorney

[22] I.R.C. § 409A(a)(2)(A).

[23] If the agreement provides that the bonus ''might'' be paid within 2½ months period, it will not meet the ''short-term deferral'' exception.

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should review all equity plans and ensure that the grants subject to performance vesting are based on realistic performance triggers and expectations.

Additionally, it is expected that many companies will go back to granting stock options to executives—a deferred compensation practice that has become less popular over the last few years, especially in public companies. The renewed interest in this type of deferred compensation is fueled by reports of executives having been paid large amounts while their companies' performance deteriorated. Stock option grants will incentivize employees to participate in the company's success and will also result in their sharing in the company's failures, as the options are worthless if the share price is below the grant price of the options.

In negotiating grants of long-term compensation, it makes sense to match the term of employment to the vesting of equity grants to ensure that the equity has a chance to vest during the employment term. Every equity plan should also contain specific information about the termination and forfeiture of the equity and a waiver and acknowledgment section in which the employee confirms his or her knowledge and understanding of the terms.

3. Clawback Provisions. With recent developments in the regulation of financial institutions and executive compensation, employers are frequently inserting clawback provisions into employment agreements and other executive compensation plans. Clawbacks are contractual provisions that require an employee to repay compensation following a specific event or other trigger. These provisions are usually triggered upon an employee's termination of employment, in the event of an employee's misconduct, or upon an employee's departure and subsequent work for a competitor.

In addition to using clawbacks on a contractual basis, certain federal regulations mandate or specifically allow clawbacks of executive compensation under certain circumstances. The Sarbanes-Oxley Act of 2002 requires recoupment of certain bonuses and other incentive compensation previously paid to a chief executive officer (CEO) and a chief financial officer (CFO) of a public company if it is determined that their activities significantly contributed to a financial statement restatement, which resulted in a determination that the executives had received unearned incentive compensation as a direct result of their own misconduct. The enforcement of the clawback provision of Sarbanes-Oxley lies with the SEC and does not provide private plaintiffs standing to bring a claim against the CEO or the CFO.

ARRA also has a clawback requirement that calls for recovery of any bonus, retention award or incentive compensation paid to a senior executive officer and any of the next 20 most highly compensated employees of a financial institution receiving TARP funds if the compensation was based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.

Under the Dodd-Frank Act, each U.S. public company will have to implement a clawback policy.[24] The Act requires a company to recover from any current or former executive officer (following an accounting restatement due to material noncompliance with any financial reporting requirements), any incentive compensation (including equity grants) paid during the three-year period preceding the date that the company was required to prepare the accounting restatement that was based on the erroneous data. The clawback would be calculated as the excess amount paid on the basis of the restated results. Under the Act, there is no need to show any executive wrongdoing in order to recoup the compensation. Further guidance from the SEC is not expected until late 2011 with final rules likely to be effective for the 2012 proxy season, and as such, most companies have delayed implementing this clawback policy and are only enforcing the clawback policy currently required under Sarbanes-Oxley.

Aside from the regulatory clawbacks that protect shareholders and U.S. taxpayers, most clawback provisions create a contractual obligation to pay back incentive compensation or a sign-on bonus upon an employee's termination or departure and should be carefully negotiated and drafted. In an employment agreement, the circumstances that would allow for any clawback on an annual bonus or a sign-on bonus should be limited to termination with cause or voluntary resignation without good reason. Further, any clawback trigger should be limited in time and scope.

In regard to executive agreements or another compensation plans that contain a contractual obligation to pay back incentive compensation, the manner and timing of the payment should be carefully planned considering Section 409A consequences, standard income tax consequences, and any possible violations of wage laws that may be triggered by the clawback.

Conclusion

The economic downturn will continue to create new rules and trends that will affect what executives are offered and what their counsel can negotiate. Changed perceptions of what is an acceptable or appropriate compensation package will sway companies to alter and modify their equity, deferral, and bonus plans.

It will be interesting to see in the near future how public and other companies balance the parallel need for executive talent with the strict requirements of Dodd-Frank and pressure from their shareholders. Ultimately, this balance will be evident in a new generation of executive employment agreements.

[24] *See* Exchange Act § 10D, 15 U.S.C. § 78j-4.