Fox Rothschild LLP
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DECEMBER 2009

EMPLOYEE BENEFITS PRACTICE
ALERT

# Key Developments in Executive Compensation: What Should a Public Company Do Now and in 2010?

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Both the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC) have issued extensive guidance over the past two years on executive compensation matters. Everything from "say on pay" to Compensation Disclosure & Analysis (CD&A) disclosure to clawbacks to proxy access to deductions of compensation paid to key executives under Section 162(m) of the Internal Revenue Code (Code) have been addressed. Although much of this guidance is proposed, there are certain steps that public companies should be taking before the end of this year or early in 2010 to address executive compensation issues.

## What To Do by December 31, 2009

- Amend Employment Agreements To Ensure Section 162(m) Deduction for Performance-Based Compensation
  Section 162(m) of the Code generally prohibits a public company from deducting compensation paid to a "covered employee" (generally the CEO and the three next highest paid officers) that exceeds $1 million. One of the major exceptions to this rule is if the compensation qualifies as "performance-based compensation." The IRS ruled in 2008 that compensation does not qualify as "performance-based compensation" if, in addition to being payable upon the attainment of the performance target(s), such compensation also is payable upon an involuntary termination without cause, a good reason termination or a voluntary resignation by the employee. However, informal conversations with the IRS have indicated that a double trigger change in control provision still may qualify (depending upon the facts) as "performance-based compensation." Under the IRS guidance, employment agreements that contain these provisions (single trigger payment upon involuntary termination without cause, termination for good reason or voluntary resignation by employee) generally must be amended to eliminate such provisions on or before December 31, 2009.[1]
- Commence Review Compensation Committee Charters
  In July 2009, the Treasury Department proposed legislation to Congress on compensation committee independence and "say on pay," generally requiring:
  - Except to the extent the SEC grants an exemption, each member of the compensation committee must be independent (that is, must not accept consulting, advisory or other compensatory fees from the issuer of the securities or qualify as an "affiliated person" with respect to the issuer or any of its subsidiaries);
  - Any compensation consultant, legal counsel or other advisor (presumably, meant to cover accountants and consulting firms other than compensation consulting firms) must meet standards of independence to be established to the SEC;
  - Each compensation committee must be allotted sufficient resources to retain a compensation consultant; and

- Beginning one year after applicable legislation is enacted, each company must disclose whether its compensation committee has obtained the advice of an independent compensation consultant, and if not, explain the reason for not doing so. (This requirement appears to be designed to make the retention of a compensation consultant the "default" option.)

Legislation is now pending in Congress, specifically, the Corporate and Financial Institutions Compensation Fairness Act of 2009 (which has been passed by the House), that would implement some or all of these requirements, along with others. What's the effect of noncompliance? Delisting of the securities on the applicable exchange, a truly ugly outcome. Even if the legislation is not passed this year, the handwriting appears to be on the wall regarding the direction in which public company compensation committee independence is moving. Further, a public company that moves in the direction of enhanced compensation committee independence certainly would be engaging in "best practices."

## What To Do in Early 2010

- Get Ready for "Say on Pay"
  In the same proposal, Treasury proposed requiring public companies to afford shareholders with an annual opportunity to make nonbinding votes on executive compensation matters:
  - Any proxy or consent solicitation material for a meeting of the shareholders (or a special meeting in lieu of the annual meeting) that concerns an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of the issuer must disclose, in a clear and simple tabular format, any change in control-related agreements or arrangements providing for present, deferred or contingent compensation to executive officers; and
  - Shareholders must be provided with an opportunity to vote separately on such agreements or arrangements; however, the vote is not required to be binding.

The Treasury's concern is with the approval of so-called "golden parachutes." Reflecting a similar concern, "say on pay" provisions also appear in the legislation that has made its way through the House on compensation committee independence. The disclosure and voting requirements appear to apply only to the company's named executive officers.

- Get Ready for the New CD&A Disclosure and Proxy Solicitation Rules
  In July 2009, the SEC issued proposed CD&A and proxy solicitation rules relating to executive compensation. The material changes include the following:
  - The CD&A must include a discussion of any company compensation practices that may materially adversely affect the financials of the company;
  - The aggregate fair value of the stock and equity-based awards **granted** during the fiscal year must be disclosed in the Summary Compensation Table and the Director Compensation Table; and
  - The role of compensation consultants must be disclosed, if such role materially affects the compensation of executives or directors.

## Conclusion

Attention to changes in IRS and SEC guidance on executive compensation practices matters more to public companies now than perhaps at any time in recent memory. Action is required by the end of this year to avoid potential losses on tax deductions and to set the stage for compensation committee practices that reflect not only "best practices" but also the direction in which the IRS, SEC and Congress clearly are proceeding. Action is required early next year to address "say on pay" concerns, which have become much more important to shareholders seeking to align executive pay with company results, and the direction in which the SEC is moving on enhanced disclosure in proxy statements.

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[1] The IRS ruling applies only to performance periods beginning on or after January 1, 2009. In addition to pre-2009 performance periods, the ruling does not apply to payments made pursuant to employment contracts in effect (without regard to renewals) on February 21, 2008.