As we approach the mid-point of 2014, executive compensation matters continue to be a major focus of not only companies and their management teams, but also stockholders and institutional investors, government regulators, and the media. The past several years have seen significant changes in the laws regulating executive compensation, including proxy disclosure reform, shareholder advisory “say-on-pay” votes, and independence requirements for compensation committees and their advisors. Further, final rules implementing the requirements under Section 953 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, requiring disclosure of “pay versus performance” information and of comparisons of the annual compensation of CEOs and the median total annual compensation of all other employees, are expected to be issued by the SEC by year-end 2014. This News Alert provides a brief update concerning executive compensation developments that are expected to be in the spotlight throughout the remainder of this year and beyond.

1. Code Section 409A Audits

The Internal Revenue Service (“IRS”) recently announced an audit program that will review fifty companies for compliance with nonqualified deferred compensation plan requirements of Section 409A of the Internal Revenue Code of 1986, as amended (“Section 409A”). Unless exempt under the applicable regulations, the requirements of Section 409A apply to all “nonqualified deferred compensation plans” that provide a legally binding right during a year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) an employee in a subsequent year. Many elements of executive compensation that are not traditionally considered “deferred compensation” may fall within the scope of Section 409A, including nonqualified (i.e., “excess” or “supplement”) retirement plans, employment and severance arrangements, bonus and equity incentive arrangements, reimbursements and in-kind benefits.

Section 409A imposes penalties (including immediate income inclusion, interest and an additional 20% penalty tax) on participants in “nonqualified deferred compensation plans” that do not comply with requirements of or otherwise fall within an exception to the rules. The regulations issued under Section 409A provide rigid rules as to the time and form of payment of deferred compensation, including requiring that the material terms of a plan subject to Section

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be set forth in writing. The planned audits will focus on the deferred compensation of the selected companies’ ten most highly paid employees. In reviewing the plans and agreements that it receives in response to its information requests, the IRS will focus on (1) initial elections to defer compensation; (2) subsequent deferral elections to further defer compensation; and (3) plan distributions (including whether distributions to “specified employees” of public companies on account of their separation from service are delayed six months).

As a result of the broad reach and technical complexity of Section 409A, there are many potential pitfalls for both companies and employees. For instance, they may run afoul of Section 409A in situations where (1) payments are conditioned upon a release of claims during a period overlapping two calendar years; (2) payments are accelerated in connection with a corporate transaction that does not constitute a “change in control event” under Section 409A; (3) severance is payable upon a termination of employment that does not constitute a “separation from service” under Section 409A (such as where a former executive continues to provide significant services as a consultant after termination of employment); (4) health coverage, reimbursements and tax gross-ups and other in-kind benefits continue to be paid or provided following a termination of employment; (5) new or amended arrangements result in changes in the time and form of payment of, substitutions for, and/or offsets from nonqualified deferred compensation; and (6) grants of discounted stock options or restricted stock units with retirement vesting provisions are made to employees.

In light of the IRS’ Section 409A audit program, companies should consider conducting a privileged pre-audit of their existing compensation arrangements, particularly those applicable to its management team, to ensure compliance with (or an exemption from) Section 409A. Although IRS programs to correct documentary or operational failures to comply with Section 409A generally no longer are available, there may be ways to correct or limit Section 409A liability flowing from technical violations of the rules, depending on the particular facts and circumstances. In any case, it is clear that companies should not wait for the IRS to commence an audit to act.

2. Health Care Reform

Health care reform under the Patient Protection and Affordable Care Act (“PPACA”) significantly impacts the way employers provide health care coverage to their employees. By requiring specific levels of coverage for certain employees and imposing excise taxes and other penalties for noncompliance, PPACA has forced companies to review and revise the structure of their health and welfare plans and to address new compliance and reporting requirements.

In the executive compensation space, PPACA has a measurable impact on the structure, cost and scope of providing post-termination health care continuation. Many employment and severance arrangements for former executives provide for the continuation of health and welfare benefits for a specified period following termination of employment. Prior to PPACA, companies had many options available to them to provide former executives with coverage, including continuing the executives on their existing employer health plans (to the extent permitted under the applicable plan or policy), purchasing a separate health insurance policy for the benefit of the executives, reimbursing or subsidizing the cost of COBRA coverage or paying additional cash severance sufficient to cover the costs of individual policies on the open market.
The continuation of coverage, however, is not always practicable. On the one hand, continuation of self-insured health plan coverage for former executives could be found to discriminate in favor of highly compensated employees under Internal Revenue Code Section 105(h) if the access to and level of coverage are not available to employees generally (and thus the coverage and benefits subject to income tax on the former executive). On the other hand, even in the case of fully-insured group plans to which the nondiscrimination rules did not apply prior to PPACA, often the cost of keeping former employees on the “active” employee group health plan was prohibitively expensive. Nonetheless, prior to PPACA, both companies with self-insured plans and companies with fully insured plans were free to go out on the market and purchase an individual or group health insurance policy for one or more former executives, since the nondiscrimination rules were inapplicable to fully insured health plans.

However, PPACA changes the landscape for providing post-termination continuation coverage. Under PPACA, nondiscrimination rules “similar” to those applicable to self-insured health coverage will apply to fully insured plans. At this point, however, it is unclear how those rules will apply until further guidance is provided. There is a risk that continuing health coverage for former executives under a group insurance plan or an individual insurance policy could be deemed to discriminate in favor of executives. If found to be discriminatory, the plan or plan sponsor could be subject to an excise tax or civil money penalty of $100 per day per individual discriminated against (i.e., all non-highly compensated individuals), and the plan could be forced to provide non-discriminatory benefits. In light of PPACA, companies should audit their executive employment and severance agreements to identify potential violations of the nondiscrimination rules under PPACA (as well as the rules under Section 409A applicable to post-termination health care continuation, as mentioned above).

Despite the need for additional regulatory guidance, companies have several options for providing post-termination health coverage to former executives. Perhaps the most common approach is to agree to pay or reimburse any COBRA continuation coverage elected by the former executive. However, to comply with applicable nondiscrimination rules, the reimbursement of coverage should generally be treated as taxable income to the former executive. Moreover, the duration of coverage will be limited to the period that COBRA coverage is available (generally 18 months post-termination). An alternative approach is to pay additional cash severance with the expectation that the executive can use the net cash (after taxes) to purchase insurance coverage. Not only is the cash approach “clean and simple,” it allows companies to cover or subsidize the cost of health coverage for periods beyond the applicable COBRA period.

It should be noted that as a consequence of the substitution rules under Section 409A, employers generally cannot provide executives with the right to choose between cash or continued coverage or the right to “liquidate” continued coverage for cash. As a result, companies generally must decide at the time of execution of an employment or severance agreement that provides for continued health care coverage (or cash in lieu of coverage) how to structure such benefits in a manner that does not violate PPACA or Section 409A.

3. Compensation Clawbacks

In general, a clawback provision is a contractual agreement that authorizes an employer to recover compensation paid to an executive upon the occurrence of a certain event or action by
the employee. The circumstances triggering the recoupment of compensation vary among companies and industries, but typically include financial restatements or errors in the calculation of incentive compensation. Recoupment may also be a remedy in “bad boy (or girl)” situations where an executive engages in misconduct that constitutes “cause”, violates a restrictive covenant (e.g., non-competition and non-solicitation provisions), or engages in ethical violations or other misconduct.

There has been a notable increase in companies adopting incentive compensation clawback policies over the past few years, particularly at the senior management level and in connection with financial restatements. While companies implement clawback policies for various business reasons, certain U.S. laws require the adoption and/or implementation of clawback provisions. Section 304 of the Sarbanes-Oxley Act, for instance, requires the CEO and CFO to return bonuses, equity and other incentive-based compensation received, and profits realized, during the twelve-month period following issuance of a financial statement which must be restated due to material noncompliance with a financial reporting requirement, whether or not misconduct is attributable to the CEO and/or the CFO. Section 111 of the American Recovery and Reinvestment Act requires companies that received government relief under the Troubled Assets Relief Program to recoup any bonus, retention award or incentive compensation paid to its top 25-highest paid employees based on statements of earnings, revenues, gains or other criteria which were later found to be materially inaccurate.

In addition to specific rules and regulations, public companies and their respective clawback policies are subject to the requirements of proxy advisory firms and the institutional investors they advise. Proxy advisory firms generally advocate for robust clawback policies. For example, Institutional Shareholder Services (“ISS”) will make recommendations to shareholders voting on clawback policies based on whether the company has adopted a formal clawback policy, the rigor of the clawback policy (including how and under what circumstances compensation is recovered), whether the company has chronic restatement history or material financial problems, whether the clawback policy substantially addresses the concerns raised by the proponent; whether the recoupment of incentive or stock compensation from senior executives is disclosed; and any other relevant factors. Additionally, ISS notes that clawback provisions can potentially mitigate the impact of risky incentives that may motivate excessive risk-taking.

The most notable recent legal development relating to compensation clawbacks, however, has yet to be completed. Under Section 954 of the Dodd Frank Act (“Recovery of Erroneously Awarded Compensation”), the SEC must adopt rules directing the national securities exchanges and associations to prohibit the listing of any security of an issuer that has not developed and implemented policies providing that,

in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.
The SEC rules must also require the disclosure of any such clawback policy. Failure to comply with these clawback requirements generally will result in the prohibition of the listing of the issuer’s stock on any national securities exchange or association.

Almost four years since the passage of the Dodd Frank Act in July 2010, rulemaking with respect to the clawback of incentive compensation has yet to be enacted – or even proposed – by the SEC. Without any proposed rulemaking or official guidance on compensation clawbacks, public companies and compensation practitioners continue to face many uncertainties when adopting, reviewing and updating their compensation clawback provisions and policies, including:

- Who are a company’s “executive officers” and to what extent will clawbacks apply to former executives or to directors or consultants?
- When is a financial statement “required” and not merely advisable?
- Will personal misconduct or fault be a condition of clawback?
- What types of “incentive-based” compensation will be subject to clawback (i.e., only compensation based on financial metrics / performance-based conditions, or also cash bonuses and equity compensation conditioned only upon services)?
- When is incentive compensation considered to be “received”?
- Will there be exceptions and/or transitional rules for newly public companies, foreign private issuers, smaller reporting companies, emerging growth companies or other categories of companies?
- How will clawback provisions be enforced, including by whom, whether enforcement will be automatic or discretionary and how they might apply following a change of control transaction such as a merger or sale?
- What disclosure obligations will apply to the clawback policies and actions to recover compensation?
- Can a company or executive officer limit or back-stop recovery through indemnification or insurance?
- What requirements and disclosure rules will apply to the review and amendment of clawback policies?

In light of the many ambiguities and open questions under the Dodd-Frank clawback rules, many companies (particularly those outside of the Fortune 100) appear to be waiting for SEC guidance prior to adopting an incentive compensation clawback policy. While we continue to advise clients to wait for additional guidance from the SEC and exchanges on these issues before establishing new clawback policies, practical considerations (including good corporate governance or pressure from investors) may nonetheless require the review and/or adoption of clawback provisions prior to the adoption of the Dodd Frank Act clawback rules. To ensure flexibility to smoothly comply with the rules once effective, companies entering into new or amended compensation arrangements with executive officers should consider including an express warranty from the executive. Under the warranty, the executive would acknowledge the clawback requirements under the Dodd Frank Act (and other applicable laws and/or company
policies), and agree to repay any compensation required by any clawback obligations imposed by law or policy.

Conclusion

Although Section 409A audits, health care reform and compensation clawbacks will be at the forefront of executive compensation developments in the near future, it is interesting how each came about and the impact each could have on future design of executive compensation programs.

- Section 409A was introduced in 2004 (although final regulations were not finalized and effective until much later), in large part, in part, in response to the acceleration of payment of deferred compensation by executives at Enron before it went into bankruptcy. Ten years later, the IRS has only now begun auditing compliance with those rules.

- Health care reform under PPACA was signed into law in March 2010 to make health insurance available and affordable; however, pending further guidance on the applicability of nondiscrimination rules to fully insured plans, PPACA has made providing health care continuation to former executives more complicated, and in some cases (whether due to the costs of coverage or the taxation of benefits), more expensive.

- Compensation clawbacks have been required by law under Sarbanes-Oxley, TARP and the federal insider trading regulations and have been adopted as a means to mitigate excessive risk taking and other “poor pay practices.” However, the most recently required clawback rules remain outstanding many years following the enactment of the Dodd Frank Act, at a time when stocks are trading at their all-time highs and the economy seemingly recovered from the “Great Recession” that spawned many of the provisions of the Act.

In each case, not only has the applicable regulatory guidance, rulemaking and/or enforcement been subject to significantly delay and uncertainty, but also each will significantly influence the way companies structure their executive compensation programs going forward.

As executive compensation continues to be a hot-button issue for companies, stockholders, executives, regulators and the media, there is little doubt that there will continue to be legislation and reform proposing to regulate executive compensation in the future, and with them, additional uncertainty and complexity as to how to comply with the rules while at the same time, designing an appropriate mix of compensation and incentive opportunities to best attract, incentivize and retain key executives.

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