Outlook for 2014: Key Governance, Legal and Regulatory Considerations for Executive Rewards

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For the past several years, executive compensation policies and practices have been under intense scrutiny by lawmakers, the media and governance experts. As a result, practices are continually evolving in an effort to appropriately balance companies' needs to reward and motivate talent while aligning pay with shareholder interests – all within an increasingly complex regulatory and governance environment.

This Viewpoint is intended to help clients remain abreast of important issues across several fronts – *legal, regulatory and governance* – by providing a brief overview of recent developments.

Key Takeaways

- *Recent policy updates issued by proxy advisors are limited in scope, but will impact evaluations of pay-for-performance alignment and governance practices.*
- *Plaintiffs' attorneys continue to pursue derivative suits targeting shareholder-approved plans.*
- *Some post-employment benefits could be considered discriminatory under the Affordable Care Act, resulting in employer and/or individual penalties*
- *The US Treasury has recently issued guidance pertaining to:*
  - *Conditions necessary to establish a substantial risk of forfeiture under IRC §83*
  - *Proper timing of tax-deductible incentive compensation*
- *Compliance of shareholder approved incentive plans with requirements of IRC §162(m)*

Proxy Advisor 2014 Policy Updates

Both ISS and Glass Lewis have issued updates to their 2014 proxy voting guidelines. While updates cover a broad range of corporate governance issues, we have focused particularly on those affecting executive compensation matters. On this front, the headline might be: "Few Changes on the Horizon."

The most substantive change to ISS' 2014 executive compensation policies relates to its pay-for-performance evaluation methodology. Beginning in 2014, ISS will assess alignment under its Relative Degree of Alignment (RDA) test based on relative total shareholder return (TSR) performance and average annual CEO pay over the latest three years. This compares with their prior methodology that placed greater emphasis on the most recent year's performance.

This change will complicate matters for companies that have recently experienced a turnaround in their performance (but provide relief to organizations whose performance weakened in the most recent fiscal year). The change will also limit the impact of end-of-period pay actions taken by some companies to fare better under ISS' test, which should take pressure off of committees to manage short-term pay outcomes.

Glass Lewis appears to have made no changes to their executive pay-for-performance evaluation criteria for 2014. Rather, 2014 policy updates suggest companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership. Pledging, however, is perceived as a more nuanced matter, leading Glass Lewis to conclude that blanket policies prohibiting stock pledging may discourage executives from buying and/or retaining earned stock, thereby lessening their "skin-in-the-game." Glass Lewis will evaluate pledging considering a number of factors, including:

- Prevalence of pledging among company executives and employees;
- Magnitude of pledged shares as a percentage of total executive ownership and outstanding shares;
- Characteristics of company stock (e.g., volatility, cyclicality); and
- Overall governance policy of the company, including disclosure of pledging policies and any waivers to those policies granted by the committee.

Equity Plan Litigation

In a recent Delaware Chancery Court case, the court refused to dismiss a shareholders derivative action alleging that grants of stock options to a company executive was improper because the equity plan under which the options were awarded was drafted in a manner that could lead to conflicting interpretations. This case serves as a reminder that plans should be drafted with sufficient detail and clarity to limit the potential for conflicting interpretations, and should regularly be reviewed and revised to address areas under particular scrutiny from plaintiffs' attorneys.

In this specific case, one provision of the company's equity incentive plan provides that no participant in the plan may receive more than 150,000 options or SARs in any calendar year, while another provision specified "the aggregate number of shares of Stock of which all Performance Awards and Stock Options may be granted…under the Plan in each year of the Performance Period is 450,000." In reliance on the second provision, the compensation committee awarded an individual executive 449,436 options in 2011 and 285,000 options in 2012, describing the grants as "discretionary performance awards." The derivative action claims the grants violated the 150,000 limit on option/SAR awards otherwise contained in the plan. The court has allowed the claim to proceed to trial, concluding that the plaintiffs had made a reasonable argument that the compensation committee knowingly violated the 150,000 option/SAR limitation set forth in the plan.

Executive Health Benefits

The Affordable Care Act imposes severe penalties on employers that sponsor insured health plans that are preferential toward highly compensated employees (e.g., providing additional or enhanced plan benefits) and IRC §105(h) imposes adverse tax consequences on executives participating in discriminatory self-insured plans.

Employment contracts and severance arrangements that provide post-employment health benefits are but one area that should be closely scrutinized for potentially discriminatory benefits. For example, "2 years of continued health and welfare benefit coverage at no cost" following a change-in-control could be viewed as discriminatory if other employees are limited to COBRA and/or are required to pay the full amount of COBRA benefits. We recommend companies engage with their benefits counsel to review plan benefits and terms to ensure they (i) do not entitle executives to discriminatory benefits or (ii) are drafted in a manner such that intended benefits may be provided without violating the antidiscrimination rules**.**

Section 83 Transfer Restrictions

IRC §83 governs the taxation of property received in exchange for services, such as restricted stock awarded to employees. Generally, taxation of property will occur on the transfer date unless the property is subject to "a substantial risk of forfeiture." If a substantial risk of forfeiture does exist, taxation will occur when the conditions or restrictions creating the risk of forfeiture no longer apply. It is important to clarify that §83 regulations are related to, but distinct from, §409A tax rules that govern taxation of property to be delivered in the future (e.g., restricted stock units). Companies should review the terms of awards governed by §83 to ensure both applicable service and performance conditions conform to the updated guidance.

Recent US Treasury guidance largely confirms its past positions on conditions under which a substantial forfeiture risk is presumed to exist, including situations in which:

- The recipient was required to provide substantial future services for the employer or enter into a substantial covenant not to compete with the employer; or
- Vesting was conditioned upon attaining certain business-related goals.

Under the prior rules, the IRS could overcome the presumption of a substantial risk of forfeiture if it could demonstrate forfeiture was unlikely to be enforced if the award's conditions were not satisfied. The new guidance appears to provide the IRS another route to challenge the presumption based on the likelihood that the forfeiture event would occur. Such a situation might arise if the property were subject to a non-substantive performance conditions (e.g., annual revenue must exceed $1). The new rules also confirm the IRS' position that acceleration of vesting upon an involuntary separation from service without cause (or separation from service as a result of death or disability) will not, on its own, overcome a presumption that a substantial risk of forfeiture exists.

Timing of Tax Deductions for Incentive Compensation

The IRS recently issued a memorandum clarifying the requirements regarding deductions for bonuses paid in the year after the year for which they were earned. Companies should review both plan terms and internal administrative procedures to ensure awards are being deducted in the proper time period.

Under the accrual method of tax accounting, bonuses paid within 2½ months after the end of the taxable year may be deductible in the year earned (vs. deductible in the year paid) if, by the last day of the year in which the bonus is earned:

- Economic performance has occurred;
- The bonus can be determined with reasonable accuracy; and
- All other events have occurred that establish the fact of the bonus liability (the so-called "all events test").

The memorandum published by the Chief Counsel of the IRS addressed three scenarios that, in their view, would prevent a bonus from being deductible in the year earned:

- The company retains the right to modify or eliminate the bonuses for one or more executives at any time prior to payment;
- The bonuses were subject to compensation committee approval that was not granted prior to the end of performance year; and
- The bonuses were determined, in part, by taking into account subjective employee performance appraisals that were not completed and factored into bonus determinations prior to the end of the performance year.

IRS 162(m) Audit Program

The Internal Revenue Service has an ongoing audit program related to enforcement of IRC Section 162(m). This program has uncovered several relatively common plan provisions that can limit deductibility of compensation under 162(m). Companies should review their plan provisions and administrative procedures to avoid these areas of concern:

A. Employment and/or severance agreements that provide for payment of bonuses in the event of retirement or other termination of employment, even if the performance goals are not met.

B. Equity plans lacking required provisions specifying (i) maximum individual awards and (ii) stock option and SAR exercise prices to be no less than the fair market on the date of grant.

C. Failure of committees to document (i) the establishment of performance goals within the first 90 days of the performance period (but no later than the end of the first 25% of the performance period) and (ii) certification that performance goals and targets have been met before the compensation is paid.

D. Lapsed shareholder approval of specific performance goals. For plans under which outside directors have the authority to determine the actual performance targets, shareholders must reapprove performance goals every five years.

E. Deductions for "sign-on" or other similar awards provided at the time of hire that were not awarded under a shareholder-approved plan.

F. Except in certain specific cases set forth in Treasury Regulations, failure to obtain approval from public shareholders for payment of awards issued prior to an IPO. This rule applies even if the plan was approved by the private shareholders prior to the IPO.

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