

Executive Compensation and Equity Compensation Plan Issues for Consideration as 2010 Approaches

December 9, 2009

The following checklist describes important issues for consideration as 2009 comes to a close and we enter into 2010. Though not exhaustive, this list is intended to provide a reminder of some of the issues that will need to be considered as we enter a new year.

- **Section 409A Special 2009 Correction Opportunity:** Although the deadline for complying with the documentary requirements of Section 409A of the Internal Revenue Code (the Code) was December 31, 2008, there are some tools available for addressing Section 409A compliance failures that can limit, and in some cases eliminate, the adverse tax consequences associated with an inadvertent failure to comply with Section 409A of the Code. Failure to comply with the requirements of Section 409A will result in the imposition of a 20% penalty tax, plus interest charges, on the individual (i.e., executive or director) benefiting from the nonconforming arrangement.

Pursuant to Notice 2008-113, a special opportunity for correction during 2009 without incurring additional taxes under Section 409A of the Code is provided for specified operational failures occurring prior to 2009 with respect to a non-insider. This special opportunity allows identification and correction in 2009 of such failures dating back to January 1, 2005. It is important to note that Notice 2008-113 generally does *not* offer relief with respect to a failure to satisfy the documentary requirements of Section 409A and no correction program for documentary failures has been implemented by the IRS. In addition, under the IRS corrections program for operational failures, there are opportunities to correct certain kinds of current year (i.e., 2009) operational failures so long as such correction is done promptly. (For further details on Section 409A correction opportunities, see our LawFlash issued on February 11, 2009 at http://www.morganlewis.com/pubs/EB_409ACorrectionOpportunities_11feb09.pdf.) There are rumors of imminent issuance of an IRS corrections program for documentary failures, and we will issue a LawFlash promptly when that occurs.

- **Section 162(m) Qualified Performance-Based Compensation:** Many public companies rely on the performance-based compensation exception to the \$1 million annual deduction limit under Section 162(m) of the Code for compensation payable to their top executives. Pursuant to Revenue Ruling 2008-13, compensation payable for performance periods beginning after

January 1, 2009 will not qualify for the Section 162(m) performance-based compensation exception if it may be paid without regard to whether the performance goals are met (for example, when the executive retires, is involuntarily terminated without cause, or terminates employment for good reason).

There is a limited exception for compensation payable pursuant to the terms of an employment contract in effect on February 21, 2008 (without respect to future renewals or extensions, including renewals or extensions that occur automatically absent further action of one or more of the parties to the contract). In order to ensure that compensation intended to qualify for the performance-based compensation exception under Section 162(m) continues to comply with the exception, public companies should review their bonus plans and equity plans, as well as all arrangements providing severance benefits, to make any necessary amendments to address this new ruling for 2010 performance periods. (For further details on Section 162(m) pitfalls, see our LawFlash issued on February 23, 2009 at http://morganlewis.com/pubs/EB_HotTopics_Section162m_23feb09.pdf.)

- **Section 162(m) Shareholder Reapproval:** Under Section 162(m) of the Code, shareholders of a public company must approve the material terms of the performance goals in the plan under which performance-based compensation is to be paid. If the compensation committee has the authority to change the targets under a performance goal, (and this is the case if the specific targets under the plan are not publicly disclosed) in order for compensation payable under the plan to continue to qualify for the performance-based compensation exception under Section 162(m), the material terms of the performance goal must be disclosed to, and reapproved by, the company's shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which the shareholders previously approved the performance goals. Therefore, if shareholders last approved the business criteria in a plan in 2005, the material terms of the performance goals must be submitted to shareholders for reapproval in the 2010 shareholder meeting.
- **ISO and ESPP Information Returns:** Section 6039(a) of the Code requires corporations to file an information return with the IRS, in addition to providing employees with an information statement, following a stock transfer pursuant to the exercise of incentive stock options (ISOs) or pursuant to an employee stock purchase plan (ESPP) that occurs on or after January 1, 2007. Until recently, the IRS had not issued final regulations detailing the exact information required, the format in which the required information is to be provided, or the due date of the information returns. On November 16, 2009, final regulations were issued that explain this reporting requirement. These regulations are applicable for stock transfers that occur in 2010 pursuant to ISO exercises and stock transfers under ESPPs. While no IRS reporting is required in 2010, exercises in 2010 will generate filing requirements in 2011, thus suggesting that companies should now review their reporting processes in this area. (For further details on the final ISO and ESPP filing requirements, look for our LawFlash to be issued shortly)
- **Employment Tax Audits:** In connection with its National Research Program study on employment taxes, the IRS has indicated that it plans to take actions to address misclassification of employees as independent contractors, which affects millions of workers and contributes to the tax gap. The IRS's interest in conducting audits is to ensure that employers are making the proper determination and that workers are being treated properly, and the IRS has indicated a

potentially broad scope for these audits (i.e., 6000 companies over 3 years). Employers should review their practices and policies for classifying workers. (For further details on the IRS audits, see our LawFlash issued on October 26, 2009 at

http://www.morganlewis.com/pubs/EB_PayrollTaxAuditInitiative_LF_26oct09.pdf.)

- **FICA Taxes:** FICA taxes, which are composed of the Social Security tax (6.2%) and the Medicare tax (1.45%), are imposed on wage payments to employees and are paid by both the employer and the employee. Generally, vested benefits under supplemental executive retirement plans (SERPs) are not taxed for FICA tax purposes until the participant terminates employment. However, the Code provisions applicable to nonqualified defined benefit plans contain an “early inclusion” rule under which an employer may elect to tax a participant’s vested benefit under a SERP before the participant terminates employment. Under ordinary circumstances, there would be no reason to elect early taxation of SERP benefits. However, some practitioners and business leaders anticipate that Congress may increase FICA tax rates in the future. If a FICA tax increase becomes enacted, there may be a benefit to taxing SERP benefits for FICA tax purposes in 2009, based on current FICA tax rates, instead of having the SERP benefit taxed at termination of employment at increased FICA tax rates. (For further details on the early inclusion rule, see our LawFlash issued on November 20, 2008 at http://www.morganlewis.com/pubs/EB_HotTopics_ThroughTheDonutHole_20nov08.pdf.)
- **SEC Proposals on Disclosure Requirements and Proxy Solicitation Rules:** On July 10, 2009, the Securities and Exchange Commission (SEC) issued a release proposing various amendments to the executive compensation and corporate governance disclosure requirements in proxy statements. If the SEC adopts the proposed amendments soon, they may be effective for the 2010 proxy season; otherwise, it is unclear when the amendments will become effective. The proposed amendments include:
 - A requirement that the company include a discussion in its Compensation Discussion and Analysis if the company’s compensation policies and practices create risks that could have a material adverse effect on the company.
 - A requirement that the aggregate fair value of stock and equity–based awards granted during the fiscal year be disclosed in the Summary Compensation Table and the Director Compensation Table, rather than disclosure of the amount of expense accrued in the financial statements in the fiscal year for outstanding stock or equity–based awards.
 - Expansion of disclosure requirements about directors and director nominees, setting forth a description of their particular experience, qualifications, attributes, or skills that qualify them to serve as directors of the company and as members of the committees on which they serve.
 - Additional disclosure requirements about a company’s leadership structure, including why the company has chosen to combine or separate the chief executive officer and board chair positions and whether the company has a lead independent director.

- Expansion of disclosures required about compensation consultants if they play a role in the determination or recommendation of executive or director compensation and also provide other services.
- Requirement that companies disclose shareholder voting results within four business days after the meeting on Form 8-K under proposed Item 5.07, rather than on Form 10-Q or Form 10-K.

(For further details, see our LawFlash issued on July 21, 2009 at http://www.morganlewis.com/pubs/Securities+EC_ExecCompCorpGovDisclosure_LF_21jul09.pdf.)

- **RMG U.S. Corporate Governance Policy:** On November 19, RiskMetrics Group (RMG) released its 2010 U.S. Corporate Governance Policy (RMG Policy), which is effective for shareholder meetings held on or after February 1, 2010. The RMG Policy includes the following updates:
 - Consistent with the increased focus by Congress, companies, shareholders, legal practitioners, and consultants on the way in which executives are compensated, the RMG Policy identifies practices that RMG believes encourage inappropriate risk-taking. According to the RMG Policy, such “problematic pay practices” include guaranteed bonuses, single performance metrics used for short-term and long-term plans, high severance packages, high pay opportunities relative to industry peers, mega annual equity grants, and disproportionate level of supplemental pensions. Mitigating factors, such as clawback provisions and stock ownership and holding guidelines, will be considered in RMG’s assessment.
 - The RMG Policy provides that when evaluating executive pay, consideration will be given to the alignment of the chief executive officer’s total direct compensation and the total shareholder return over a period of five years (in addition to the one-year and three-year analysis under the current RMG policy). The focus will be on companies with sustained underperformance relative to peers.
 - RMG has updated its policy regarding director independence to reflect a more pragmatic approach and to clarify the application of its policy.

(For further details on the final RMG Policy, look for our LawFlash to be issued shortly.)

- **Say on Pay:** “Say on pay” legislation is pending in Congress, which would require compensation packages for executives at publicly traded companies to be submitted to shareholders for a non-binding vote. (For further details on “say on pay” legislation, see our LawFlashes issued on June 18, 2009 at http://www.morganlewis.com/pubs/BF_SayOnPayVotes_LF_18jun09.pdf and on July 10, 2009 at http://www.morganlewis.com/pubs/SecuritiesLF_TARPSayOnPayVotes_10jul09.pdf.)
- **Compensation Committee and Consultant Independence:** There has been a push by Congress for regulatory reform relating to the independence of compensation committees and consultants.

Legislation has been proposed that would require compensation committees to meet more exacting standards for independence and independence of compensation consultants. While it is not clear whether such legislation will be passed, companies should nonetheless assess the independence of their compensation committees as well as compensation consultants and other advisers. The current CD&A disclosure rules require discussion of a company's relationship with an outside consultant and the extent to which the consultant is involved in compensation committee activities.

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