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Executive Compensation and Equity Compensation Plan Issues for Consideration as 2011 Approaches

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The following checklist describes important executive compensation and equity compensation issues for consideration as 2010 comes to a close and we enter into 2011. Though not exhaustive, this list is intended to provide a reminder of some of the issues that will need to be addressed before 2010 ends or considered as 2011 begins.

- **Section 409A Special 2010 Document Correction Opportunity and Updated Section 409A Correction Procedures.** In 2008 the Internal Revenue Service (IRS) established a correction program providing a means to address operational failures occurring in arrangements subject to Section 409A (Section 409A) of the Internal Revenue Code (Code) (IRS Notice 2008-113 – Operational Correction Program). In 2010 the IRS established a similar correction program to address Section 409A document failures (IRS Notice 2010-6 – Document Correction Program) that allows for the correction of document failures in a way that can limit, and in some cases eliminate, the adverse tax consequences associated with an inadvertent failure to comply with the document requirements of Section 409A. Most recently the IRS issued guidance (IRS Notice 2010-80 (published November 30, 2010)) modifying the requirements under each of the Operational Correction Program and the Document Correction Program.

  Failure to comply with the requirements of Section 409A generally results in automatic taxation of all amounts deferred under the plan (whether or not such amounts are actually paid or available) and the imposition of a 20% federal penalty tax (and potentially a similar state tax), plus interest charges, on the individual (i.e., executive or director) benefiting from the nonconforming arrangement. Therefore, the opportunity to correct inadvertent failures under each of the Operational Correction Program and the Document Correction Program can be a valuable tool in avoiding the heavy tax penalties imposed by Section 409A on violations.

  While the transition period for corrections to be made under the Operational Correction Program has ended, transition rules provided under the Document Correction Program and Notice 2010-80 allow for more favorable correction treatment of document failures if correction is completed in 2010, or, for certain failures, in 2011 and 2012.

  The Document Correction Program, as modified by Notice 2010-80, permits correction of many document failures without current tax consequences or the imposition of additional taxes under Section 409A. However, it also includes a number of instances in which, even after correction has been completed, an employee may face a negative tax result upon the occurrence of subsequent events. These negative tax consequences do **not**, however, apply to corrections completed in 2010. Under the "transition period" provided in the Document Correction Program, the ability to correct Section 409A document failures without subjecting the deferred amount to potential subsequent imposition of tax under Section 409A generally ends on December 31, 2010. If a plan document failure is corrected under Document Correction Program on or before December 31, 2010, the plan is treated as having been corrected on January 1, 2009 (the transition relief expiration date), and no income inclusion under Section 409A will be required as a condition of the relief. As part of the correction, any operational failures arising out of the retroactive amendment to the plan (e.g., payments made in 2009 or 2010 that should not have been made under the corrected plan) must be corrected on or before December 31, 2010 under the Operational Correction Program.

Importantly, Notice 2010-80 has generally modified the service provider (employee) disclosure requirements originally included in both the Operational Correction Program and the Document Correction Program. Taxpayers generally considered the most onerous requirement under the IRS correction guidance to be the requirement that in most cases, an affected service provider (employee) generally must file with the IRS an information statement detailing the correction procedure. However, Notice 2010-80 provides that an employee is no longer required to file an information statement for a document correction under the Document Correction Program that is completed by December 31, 2010 or for certain corrections under the Document Correction Program that are completed by December 31, 2011. Furthermore, under the Operational Correction Program, an employer does not have to provide an employee with an information statement regarding the correction of an operational error that is corrected in the same year in which it occurred. In each instance of correction identified above, however, the employer must still complete and file an information statement with its applicable income tax return.

Notice 2010-80 also modified the Document Correction Program to allow correction of document failures affecting a linked plan, subject to applicable conditions, so long as the time and form of payment under the linked plan is not affected by the amount deferred under, or the payment provisions of, the plan to which it is linked. The original transition period under the Document Correction Program for correction of certain errors involving linked nonqualified plans (ending December 31, 2011) was not changed by Notice 2010-80.

Additionally, Notice 2010-80 expanded the Document Correction Program to permit correction of document errors involving stock rights that are subject to Section 409A and generally were designed to be compliant with Section 409A (e.g., stock options rights intentionally granted with an exercise price below fair market value that have restricted settlement provisions intended to comply with Section 409A) so long as the stock right includes permissible exercise events, including a fixed date or period beginning and ending within one taxable year, or a permissible payment event permitted under Section 409A. For these purposes, a permissible payment event includes certain payment events that are eligible for correction under the Document Correction Program.

Notice 2010-80 also clarifies issues affecting payments to be made "within" a set number of days following a separation from service that was contingent upon the employee's execution of a release. Guidance issued under the Document Correction Program suggests that such language makes it possible for an employee to manipulate the year in which a payment is made simply by accelerating or delaying the execution of the release and, therefore, such a provision violates the prohibition on an employee directly or indirectly designating the calendar year of payment and is not compliant with the requirements of Section 409A. While this assertion by the IRS regarding Section 409A compliance of release provisions continues to be a viewed as a debatable proposition by many practitioners, Notice 2010-80 expands the Document Correction Program to provide that language the IRS considers noncompliant may be corrected by amending the arrangement to provide either (a) for payment only on the last day of a designated period following a permissible payment event, or (b) for payment in the second taxable year if in any event the designated period begins in a first taxable year and ends in a second taxable year. Notice 2010-80 provides additional transition relief for correction of these types of failures through December 31, 2012, and relieves an affected employee from having to file an information statement with the IRS detailing the correction of such failure so long as correction is completed before December 31, 2012. The employer must still file an information statement with its applicable income tax return.

In order to take advantage of the most beneficial elements of the Section 409A correction regimes (i.e., the ability to correct document failures without facing negative tax consequences), most correction steps must be completed by December 31, 2010. However, new guidance issued under Notice 2010-80 does extend the transition deadline for corrections involving a payment to be made contingent upon a release to December 31, 2012. Notice 2010-80 also alleviates the requirements that the employee must comply with the notice and reporting requirements so long as correction is completed by the applicable transition deadline (generally December 31, 2010). However, the employer must still comply with all notice and reporting guidance.

(For further details on Section 409A correction opportunities, see our January 11, 2010 LawFlash, "IRS Issues Document Corrections Program for Deferred Compensation Plans Under Code Section 409A," available at http://www.morganlewis.com/pubs/EB_409ADocCorrections_LF_11jan10.pdf and our February 11, 2009 LawFlash, "2009 Offers Section 409A Correction Opportunities," available at http://www.morganlewis.com/pubs/EB_409ACorrectionOpportunities_11feb09.pdf.)

- **Say-on-Pay Requirements.** On October 18, 2010, the Securities and Exchange Commission (SEC) issued the first set of proposed rules (Proposed Rules) to implement the executive compensation and related corporate governance requirements imposed on most public companies by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Proposed Rules provide additional guidance with regard to the three separate nonbinding shareholder votes required by the Dodd-Frank Act: (i) a vote on executive compensation (Say-on-Pay); (ii) a vote on the frequency of presenting Say-on-Pay votes to shareholders (Say-on-Frequency); and (iii) new disclosure requirements and a vote on compensation associated with acquisitions effected by means of mergers, acquisitions, consolidations, sales, or other similar transactions and dispositions (Say-on-Golden-Parachutes).

  The Say-on-Pay and Say-on-Frequency requirements will apply with respect to annual shareholder meetings **held on or after January 21, 2011**, whether or not the Proposed Rules are finalized by then. However, the Say-on-Golden-Parachutes rules will become effective only once the Proposed Rules have been finalized (but in no event will the Say-on-Golden Parachutes rules be effective for shareholder votes before January 21, 2011).

  For the 2011 proxy season, companies should consider the following requirements of the Proposed Rules in preparation for the Say-on-Pay and Say-on-Frequency vote solicitation:

- The Say-on-Pay vote is required to approve the compensation of the named executive officers as such compensation is disclosed pursuant to Item 402 of Regulation S-K (including the compensation discussion and analysis (CD&A), the compensation tables, and other narrative executive compensation disclosures, if applicable, required by Item 402).

- The CD&A for the upcoming proxy statement must focus on the pay-for-performance aspects of executive compensation, so that the shareholders understand those programs when casting their votes. The CD&A should also discuss how compensation policies and decisions have taken into account shareholder advisory votes. (Note: For the 2011 proxy season, it is unlikely that a company will have conducted a prior shareholder advisory vote on compensation and, therefore, this requirement seems not to be applicable for the 2011 proxy season. Future proxy statements must, however, include this information.)

- The Say-on-Frequency vote must provide shareholders four choices with respect to the frequency on which the Say-on-Pay vote is to occur: every year, every two years, every three years, or abstain. Companies should consider whether to include a recommendation on Say-on-Frequency votes. (Note: For the 2011 proxy season, a company can offer a choice among only every one, two, or three years if the company's proxy service provider's system cannot handle abstentions.)

- The Proposed Rules currently provide that an issuer need not include a separate advisory Say-on-Golden-Parachutes shareholder vote in the merger proxy statement to the extent that the compensation has previously been included in the issuer's executive compensation disclosures that were subject to a prior Say-on-Pay vote. However, the Say-on-Golden-Parachutes disclosure will require one or more detailed tables and additional text disclosing **all** compensation and benefits resulting from the proposed transaction (this disclosure will be substantially beyond the current proxy requirements). Companies should consider whether to include the Say-on-Golden-Parachute disclosures in the 2011 proxy statement provisions relating to the Say-on-Pay vote.

(For further details on the Say-on-Pay, Say-on-Frequency, and Say-on-Golden-Parachutes requirements, see our November 15, 2010 LawFlash, "SEC Issues Proposed Rules Regarding Say-On-Pay and Golden Parachute Requirements Under the Dodd-Frank Financial Reform Bill," available at http://www.morganlewis.com/pubs/EB_SECProposed%20Rules_SayOnPayAndGoldenParachute_LF_15nov10.pdf.)

- **Section 162(m) Shareholder Reapproval.** Under Code Section 162(m), 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 Code 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 of a plan in 2006, the material terms of the performance goals must be submitted to shareholders for reapproval in the 2011 shareholder meeting. (For further details on shareholder approval under Code Section 162(m), see our March 9, 2010 Hot Topics Alert, "Section 162(m) Pitfalls," available at http://www.morganlewis.com/pubs/EBHotTopics_Section162mPitfalls_09mar10.pdf.)

- **ISO and ESPP Information Returns.** Code Section 6039 sets forth two reporting requirements for employers sponsoring plans that provide for incentive stock options (ISOs) and/or employee stock purchase plans (ESPP): (1) employers must provide employees with a written summary of important details regarding the transfer of stock acquired upon exercise of either an ISO or an option under an ESPP and (2) employers must furnish an information return to the IRS with the same details. Although the reporting requirements were suspended for 2008 and 2009, on November 16, 2009, the IRS issued final regulations that provide guidance with respect to the reporting requirements and require compliance with such requirements for triggering stock transfers that occur in **2010**. Both the information returns and statements must be made on Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), or Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c), as applicable. Information statements must be provided to employees by January 31 of the year immediately following an applicable transaction (January 31, 2011 for transactions occurring in 2010), and the information returns must be filed with the IRS by February 28 (paper filings) or March 31 (electronic filings). Companies should determine if there were any stock transfers occurring in 2010 as a result of an ISO exercise or a stock transfer under an ESPP that would subject the company to the Code Section 6039 information and filing requirements in 2010.

  For purposes of identifying a transaction that triggers the need to provide an employee with an information statement and to provide the IRS with an information return, an "applicable transaction" for an ISO is identified as the exercise of the ISO. For purposes of the ESPP reporting requirements, however, an employer is only required to file a return relating to the first transfer of legal title. If an employer maintains a system to deposit shares acquired by employees under an ESPP directly into a brokerage account, the first transfer of legal title occurs when the shares are deposited into the brokerage account. If, however, an employer either issues a stock certificate directly to an employee or registers the shares in the employee's name on the employer's record books and the employer or its transfer agent holds the shares for the employee in book-entry form, the first transfer of legal tile does not occur on the issuance of the stock certificate or the registration of the stock ownership on the record books. Instead, the first transfer of legal title would occur, for example, when the employee sells the stock or transfers the stock to a brokerage account established on behalf of the employee.

  Upon either (i) the exercise of an ISO or (ii) the first transfer of legal title of stock purchased under an ESPP, the company must provide an employee with an information statement and the IRS with an information return. Returns and statements will need to be provided for any such stock activity occurring in 2010.

  (For further details on ISO and ESPP reporting requirements, see our December 21, 2009 LawFlash, "IRS Issues Final Regulations on Reporting Requirements for Incentive Stock Options and Employee Stock Purchase Plans," available at http://www.morganlewis.com/pubs/EBLF_IRSFinalRegsOnReportingReqsForIncentiveStockOptions_21dec09.pdf.)

- **Acceleration of Bonus Payments.** It is anticipated that taxes on income, dividends, and capital gains may increase in 2011 if certain tax cuts adopted in 2001 expire. As a result, companies may be considering accelerating the payment of executives' bonuses in order to pay the bonuses into 2010 before the tax rates increase. Companies should keep in mind that the acceleration of bonus payments could raise issues under Section 409A. In addition, allowing executives to choose the year in which their bonuses are paid could accelerate the inclusion of income for all individuals eligible for bonuses regardless of whether an executive elects to receive the bonus in 2010 or 2011.

As a company reviews opportunities to accelerate the payment of executive bonuses into 2010, the company should consider the impact such an action would have on executives who do not receive accelerated payments, including potential constructive receipt issues. Public companies must also consider whether the accelerated payments will be made to any covered employee under Code Section 162(m) and whether the accelerated payment could cause the bonus to fail to qualify as performance-based compensation. In particular, the timing of the payment may shorten the performance period or may not provide the compensation committee sufficient time to certify that the targets were met. Additionally, any acceleration of bonus payments for named executive officers will likely need to be disclosed in the proxy statement.

- **Discrimination Issues Under Insured Health Plans.** For plan years beginning on or after September 23, 2010, fully insured health plans that are not grandfathered will be subject to nondiscrimination testing under the Patient Protection and Affordable Care Act (the Healthcare Reform Law). Providing continued health coverage to a departing executive that extends beyond the COBRA period or directly subsidizing continued coverage for former executives could result in a nongrandfathered fully insured plan failing its nondiscrimination test and the imposition of a penalty on the employer. The penalty is $100 per day per affected individual. The maximum penalty for an unintentional failure is $500,000 per year. The Department of Health and Human Services, the IRS, and the Department of Treasury have requested comments concerning the application of the nondiscrimination testing rules.

  Sponsors of fully insured health plans should review existing employment and severance agreements and consider the impact of the nondiscrimination requirements (if grandfathered status does not apply) to the extent former executives receive (or current executives will be entitled to receive) continued health coverage beyond the COBRA period or direct subsidy of continued coverage on discriminatory terms. In negotiating new agreements, companies may want to consider limiting continued health coverage to the COBRA period and providing cash reimbursements of COBRA premiums instead of direct subsidies for former executives. It may also be possible to establish a fully insured retiree only plan for executives, which is not subject to nondiscrimination testing.

- **Financial Reform Changes.** While the 2011 proxy season will require companies to comply with the Say-on-Pay and Say-on-Frequency vote solicitation requirements of the Dodd-Frank Act, compliance with certain other provisions of the Dodd-Frank Act has been postponed as per the following:

  - *Compensation Committee Independence* – The SEC anticipates issuing proposed rules in December 2010 and final rules between April and July 2011. It is unclear as to whether such rules will apply in 2011 (for companies with a fiscal year-end of June 30 or later) or will be delayed until 2012.
  - *Disclosure by Institutional Investment Managers of Votes on Executive Compensation* – The SEC anticipates issuing final rules in the first quarter of 2011.

- *Recovery of Erroneously Awarded Compensation (Clawbacks)* – The SEC anticipates issuing proposed rules between April and July 2011, which should be applicable for the 2012 proxy season.
- *Executive Compensation Disclosures (Internal Pay Equity)* – The SEC anticipates issuing proposed rules between April and July 2011, which should be applicable for the 2012 proxy season.
- *Disclosure Regarding Employee and Director Hedging* – The SEC anticipates issuing proposed rules between April and July 2011, which should be applicable for the 2012 proxy season.
- *Voting by Brokers* – Effective July 21, 2010, brokers were restricted from (without instruction) voting shares held in customer accounts on matters involving executive compensation, director elections, or "other significant matters" identified by the SEC. The SEC anticipates issuing proposed rules between April and July 2011, which should address other "significant matters" for which brokers will not be permitted to vote uninstructed shares.

(For further details on how the Dodd-Frank Act effects executive compensation and corporate governance requirements, see our November 15, 2010 LawFlash, "SEC Issues Proposed Rules Regarding Say-On-Pay and Golden Parachute Requirements Under the Dodd-Frank Financial Reform Bill," available at http://www.morganlewis.com/pubs/EB_SECProposed%20Rules_SayOnPayAndGoldenParachute_LF_15nov10.pdf.)

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