Outlook 2014


On the corporate governance side of executive compensation practice, the proposed pay ratio disclosure rules will continue to occupy center stage in 2014—even though some practitioners say the important issue is pay-for-performance. On the tax side, little is expected to change in the world of tax code Section 409A and deferred compensation in the upcoming year.

The Securities and Exchange Commission voted Sept. 18 to propose the pay ratio disclosure rules (182 PBD, 9/19/13; 40 BPR 2239, 9/24/13). If finalized in 2014, the rules will take effect in 2015, and will require reporting by companies in their 2016 proxy statements. Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to adopt a rule under which companies are required to disclose the median of annual total compensation of all employees except the chief executive officer, the annual total compensation of the CEO and the ratio of compensation of the other employees to that of the CEO.

Proponents often cite the disclosure as providing an additional metric for evaluating and voting on say-on-pay proxy proposals and as providing valuable information for the investing public (230 PBD, 12/2/13; 40 BPR 2774, 12/3/13; see, e.g., comment letter from the California Public Employees’ Retirement System, http://www.sec.gov/comments/s7-07-13/s70713-579.pdf; comment letter from Calvert Investments Ltd., http://www.sec.gov/comments/s7-07-13/s70713-605.pdf).

Opponents of pay ratio disclosure generally cite to the complexity and cost of compliance (236 PBD, 12/10/13; 40 BPR 2807, 12/10/13; see, e.g., comment letter from the American Benefits Council, http://www.sec.gov/comments/s7-07-13/s70713-871.pdf).

Pay Ratio Proposed Rule. According to John J. Gorman, a partner with Luse Gorman Pomerenk & Schick P.C. in Washington, “most rational people agree that the statutory requirement serves no purpose from an investors’ standpoint.” He said in an interview Jan. 15 that the rule “reflects a purely political goal, which will be of dubious effect, of embarrassing public companies into paying executives less. With that backdrop, and although the SEC made some effort to allow flexibility, the rule is still way too complex and will be costly to implement and will expose companies to unnecessary potential liability,” Gorman said.

James D.C. Barrall, a partner with Latham & Watkins LLP in Los Angeles, said in an interview Jan. 10 that he doesn’t expect there to be major differences between the proposed and final pay ratio rules. “I’m inclined to think [the final rules] will be very close to the proposed rules,” he said.

The SEC “did a very good job in allowing companies to find the median employee by using statistical sampling” or other reasonable methods, Barrall said. The “rules are very practical,” and the SEC has found support among those on both sides of the issue as reflected in the comments, he said.

Even though the SEC has received high marks for providing flexibility in the proposed rules, the commission “could have done many things differently to mitigate the costs and burdens of this rulemaking,” Gorman said in e-mail comments.

For example, Gorman said, “it could have excluded part-time employees, or in the alternative it could have allowed annualization of compensation for such part-time employees. That would produce a more meaningful result.”

“If nothing else,” Gorman said, “the SEC should have provided for a safe harbor from liability for the disclosure provided, if, for example, an issuer makes a good faith effort to determine the median employee in terms of compensation, within the SEC framework for making such determination, and retained its records for a fixed period of time.”

The next hurdle is how to draft the pay ratio disclosure, Barrall said. “My view is that the statute wasn’t needed. Investors weren’t asking for that information; the information was covered well in other parts of the proxy,” he said. The pay ratio disclosure “just adds a ‘sticker shock’ number,” he said.

Looking ahead, it’s hard to see how the disclosure will play out in the long term, Barrall said. Companies may “do the bare minimum required by the rules or they may feel a need to present things in supplemental analyses or textual analyses” to explain disparities such as “why $10,000 in India is a lot more than $10,000 in the United States,” he said.

“Consistent with my view that ‘less is more’ these days, I wouldn’t encourage companies to rush out there and try to make sense” of a “poorly drafted” law, he said. Instead, they should “just wait to see what the SEC does in the final rules,” see “what thinking emerges in the industry” and “go that way,” so as not to stand out, he said.

“There is no percentage in being in the leading edge” of pay ratio disclosure, Barrall said. “It is better to be in the mainstream of your peer group” to head off proxy litigation challenges, he said.
Importance of Pay-for-Performance. Barrall’s personal view is that “the pay ratio rule is not an important issue like pay for performance.”

For a company, “it is not worth spending a huge amount of time writing” its story on the pay ratio numbers,” he said. “It doesn’t matter; it’s not an issue for investors if the company is doing well and CEO pay is not out of whack with the rest of the world,” he said.

Instead the major theme in corporate governance for public companies will continue to be pay-for-performance, he said. We should expect to see more companies “moving towards supplemental definitions of pay” in their proxy disclosure, Barrall said.

Supplemental definitions, such as realized pay and realizable pay, are used by some companies in their proxy disclosures to give what they consider to be a more accurate picture of executive pay (160 PBD, 8/19/13; 40 BPR 1997, 8/20/13). These alternative definitions are used in addition to the required SEC definition of total annual pay, found in Item 402 of Regulation S-K. The Conference Board and the National Association of Corporate Directors have produced white papers that propose standard definitions of realized pay and realizable pay (242 PBD, 12/18/13; 40 BPR 2918, 12/31/13).

With respect to supplementing proxy disclosure, Barrall said that “companies need to be very careful” in how they select compensation measures and how they describe in their proxy statements the measures they use.”

Proxy disclosure litigation and investigations continue to be pursued by law firms, Barrall said. Companies must take care in their disclosures, particularly “when they ask shareholders to approve more shares” for their equity plans, he said.

New York-based Faruqi & Faruqi LLP has filed many shareholder lawsuits that allege inadequate disclosure related to equity plan proposals and say-on-pay proposals (110 PBD, 6/7/13; 40 BPR 1398, 6/11/13).

Section 409A. Once a front-burner issue, Section 409A has been left to simmer while regulators turn their attention to health care and other issues. However, practitioners say that lack of clarification on some Section 409A issues is frustrating, particularly when promised guidance has not materialized.

With the prospects of a tax system overhaul this year being slight (7 PBD, 1/10/14; 41 BPR 72, 1/14/14), practitioners are not expecting any huge surprises from the Treasury Department or the Internal Revenue Service.

Apart from issuing final income inclusion regulations, no other Section 409A items are on the Treasury/IRS priority guidance plan (224 PBD, 11/20/13; 40 BPR 2722, 11/26/13).

Section 409A continues to be a major factor in the design of a wide variety of deferred compensation arrangements. Its broad scope and complexity are apparent in final rules issued in 2007 (68 PBD, 4/11/07; 34 BPR 897, 4/17/07) and in effect since 2009. Section 409A generally governs nonqualified deferred compensation plans’ timing of deferral elections and permissible payment events. In December 2008, the IRS proposed regulations on how to calculate amounts includable in income due to plan failures to comply with Section 409A (234 PBD, 12/8/08; 35 BPR 2717, 12/9/08). Final regulations may be out by the end of 2014, according to Robert J. Neis, deputy benefits tax counsel with Treasury’s Office of Tax Policy. Section 409A(b) rules relating to offshore trusts and assets restricted under rules added by the Pension Protection Act have been dropped from the Treasury/IRS priority guidance plan (224 PBD, 11/20/13; 40 BPR 2722, 11/26/13).

Laurence Seymour, a partner with Latham & Watkins in Los Angeles, said Jan. 13 that he would like to see more guidance on some 409A issues that affect his day-to-day practice. The three issues are the short-term deferral exception, stock option/stock appreciation right cash-outs, and liquidity event payouts associated with an initial public offering or a change in control (CIC). In an e-mail, Seymour explained the need for guidance on these issues as follows:

Short-Term Deferral Exception. Section 409A, Seymour said, “provides that an amount constitutes a deferred payment and is thus ineligible for the short-term deferral exception if the amount ‘will or may’ be paid later than the end of the ‘applicable 2-1/2-month period’ (most typically, the applicable 2-1/2-month period expires on March 15th of the year following vesting). It is not clear under the regulations whether this assessment (i.e., the assessment of whether a payment will occur within the applicable 2-1/2-month period) can be made at the time of vesting, or instead must be made at the earlier time that the legally binding right to the payment first arises (e.g., the applicable contract or grant date).”

“If the assessment must be made at the time the legally binding right arises, then payments with event-based vesting (e.g., severance) must by their terms be made within 2-1/2 months after vesting to qualify for the short-term deferral exception. This strict 2-1/2-month limitation would thus apply even if the qualifying termination occurs early in the year (a time at which the applicable 2-1/2-month period may actually continue for up to 14-1/2 months, that is, through March 15th of the next-subsequent year). The incongruous result is that installment payments (e.g., salary continuation) made during or shortly after the actual year in which the vesting event (involuntary termination) occurs cannot qualify for the short-term deferral exception.”

Referring to the American Bar Association Joint Committee on Employee Benefits report of informal oral comments made by IRS and Treasury officials at the Section of Taxation Employee Benefits Committee meeting on May 10, Seymour said that “the IRS seemed to bless vesting-date assessments of short-term deferral payment timing in its 2013 JCEB responses on 409A. In light of divergent observations on this point in the past, it would be helpful if Treasury would provide certainty through official guidance confirming this approach.”

Option Cash-Outs. “Section 409A treats the conversion or exchange of a stock right (e.g., stock option or stock appreciation right) for a legally binding right to compensation in a future taxable year as an ‘extension’ of the stock right, subject to potential Section 409A penalties,” he said.

In the context of merger and acquisition transactions, “acquirers may wish to cancel an employee’s unvested stock rights upon the consummation of the transaction in exchange for which the employee receives a right to payment of the stock rights’ value (i.e., the ‘spread’) on the applicable post-close vesting date(s), subject to the employee’s continued employment through the applicable vesting date(s). This format continues the existing
retention incentive and avoids potential windfalls to employees,” Seymour said. The Section 409A definition of extension, he continued, “may be read literally to apply to this vesting-date payout scenario, which application would generally result in Section 409A penalties for the employees.”

“For several reasons, including that the payout of applicable ‘spread’ on post-close vesting dates represents payment on the first possible payment date under the award (i.e., the first date on which the award is exercisable), it is implausible to construe post-close vesting date stock right payouts as extensions of these awards,” he said.

“Treasury has indicated a willingness to clarify that the extension definition does not pick up this type of option treatment—it would be great to see published clarification on this point in 2014,” Seymour said.

**Liquidity Event Payouts.** The third item on Seymour lists, liquidity event payouts, often impact emerging growth companies and startups.

Section 409A identifies IPOs as potential “substantial risks of forfeiture,” that is, vesting conditions, that are eligible for use with short-term deferral exempt payments, Seymour said. “The absence of both (i) IPOs as enumerated payment events for deferred compensation and (ii) CICs as enumerated vesting conditions eligible for use with the short-term deferral exception creates substantial uncertainty when planning objective, nonabusive liquidity event payouts,” he said.

“Section 409A also enumerates CICs as permissible payment events for deferred compensation,” he said. “IPOs and CICs are conceptually similar events that often constitute alternative business objectives for private companies,” he said.

“Treasury should clarify in published guidance that CICs can constitute vesting conditions and, ideally, offer a safe harbor or at least factors to be considered in determining when IPOs and CICs do in fact qualify as such. In addition, it would be very helpful if Treasury would formally provide that an IPO constitutes a permissible fixed-date payment event with respect to non-qualified deferred compensation (without regard to whether such IPO also qualifies as a vesting condition for purposes of the short-term deferral exception),” he said.

**Section 162(m)(6).** One item on the guidance plan—the Section 162(m)(6) proposed regulations—may be finalized in early 2014. Section 162(m)(6) limits the deduction for compensation to employees of certain health insurance providers to $500,000.

Treasury’s Neis has repeatedly said that Treasury and the IRS hope to issue final regulations for Section 162(m)(6) in advance of when companies begin filing tax returns using the deduction (233 PBD, 12/5/13; 40 BPR 2803, 12/10/13). Although employers are able to rely on the proposed regulations, they may be taking a wait-and-see approach in the hope that the final regulations will provide additional relief, practitioners say. If employers file extensions for calendar year 2013 tax returns, they won’t have to file returns until September, and may be able to take advantage of some broader provisions in the final regulations.

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