

Client Alert

Latham & Watkins
Tax Department

2008 Proxy Season: New Developments and Reminders Regarding Executive Compensation Disclosures and Equity Plans

The 2008 proxy season is upon us and with it we want to remind public companies of new developments over the past 12 to 18 months, which include guidance issued by the Securities and Exchange Commission (SEC) regarding its new executive compensation and related person disclosure rules and a new private letter ruling issued by the Internal Revenue Service (IRS) changing its views on Internal Revenue Code Section 162(m) (162(m)) qualified performance-based compensation paid upon "involuntary terminations." Public companies should also consider and review the issues raised by 162(m) regarding the establishment and administration of their performance-based incentive compensation plans and consider the approaching deadline for documentary compliance with Internal Revenue Code Section 409A (409A).

Executive Compensation

A. Tabular Disclosure of Executive Compensation

Issuers are now in the second year of complying with the SEC's final rules governing disclosure of executive compensation, which included new rules designed to increase the clarity and transparency of tabular disclosure regarding director and named executive officer compensation and post-

employment compensation. If they have not already begun, public companies are encouraged to begin drafting the tabular disclosure of executive compensation early, taking into account SEC guidance regarding compensation disclosures in the form of frequently asked questions and its October 2007 report.

B. Compensation Discussion and Analysis

The SEC issued comment letters to 350 companies regarding compensation discussion and analysis (CD&A) disclosures in the 2007 proxy season and the SEC's October 2007 report summarized principal areas of comment. There were two main themes. First, the SEC indicated that the CD&A should include more analysis, with emphasis on "how" and "why" compensation committees arrived at specific forms and amounts of compensation. Second, the SEC indicated that the CD&A should be in plain English and include charts and graphs where appropriate. The upshot of the SEC's comment letter and guidance process is that most issuers' CD&A disclosures will merit review and revision to reflect analysis of both 2007 compensation decisions and the SEC's description of best practices. Public companies should begin the CD&A drafting process early and ask key participants in the company's compensation decision-making process

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to think about the “hows” and “whys” of compensation decisions.

Related Persons Disclosure Rules

The SEC now requires disclosure of a public company’s applicable policies and procedures for reviewing transactions with related persons. Companies must also describe transactions that were not subject to review under company policies and any circumstances in which the policies and procedures were not followed. Because of these new requirements, public companies should review their policies, whether such policies are written or unwritten.

In particular, all executive officer compensation should be approved by the compensation committee (or the full Board in lieu of the compensation committee) whether or not the executive officer is a named executive officer and included in the Summary Compensation Table. If an executive officer’s compensation is not so approved, it must be disclosed as a related party transaction, if not otherwise disclosed in the Summary Compensation Table.

Qualifying Deductible Compensation Under 162(m)

IRS Code Section 162(m) generally limits a publicly held company’s deduction for compensation paid to each of its chief executive officer and its next three most highly compensated officers (but excluding, in all cases, the CFO) (covered officers) to \$1 million per year. However, “performance based compensation” (PBC) that is paid pursuant to a bonus or other plan that only pays the compensation if the covered officer attains objective performance targets set by a committee of two or more “outside directors” based on shareholder approved performance goals is not subject to the \$1 million cap. As officer base compensation and bonuses have increased, more

and more officers are approaching or exceeding the \$1 million cap and more companies are adopting or amending their plans to provide for PBC bonuses, restricted stock, etc. Stock options and stock appreciation rights (SARs) will constitute qualified performance based compensation under 162(m) without satisfying the generally applicable rules if (i) they are made by “outside directors” under a shareholder approved plan which contains an award limit and (ii) the grants have an exercise price not less than the fair market value of the stock subject to the award on the grant date.

A. Changed IRS Views Relating to 162(m) Qualified Performance-Based Bonuses Paid Upon “Involuntary Termination”

On January 25, 2008, the IRS released a private letter ruling (PLR) holding that in the event that an executive has a right to be paid all or a portion of compensation that was otherwise intended to be 162(m) PBC upon an involuntary termination without cause or for good reason (severance right), the severance right will render unavailable the PBC exception under 162(m) for such compensation, even if the severance right is never triggered. The PLR demonstrates a change in the position of the IRS on this issue. Although private letter rulings are binding only upon the taxpayer to which the ruling is issued, such rulings are considered to be “substantial authority” for purposes of avoiding penalties. In light of the PLR, companies should review the termination provisions of their plans and agreements.

B. Shareholder Reapproval of PBC Plans Approved in 2003

The 162(m) regulations require that shareholders reapprove the performance goals every five years with respect to which PBC (other than stock options and SARs) is paid. This means that companies that obtained shareholder

approval of such goals in 2003 must resubmit the goals for shareholder approval in 2008, generally by having the shareholders reapprove an updated and improved plan. This requirement does not apply to stock options and SARs; however, because some public companies have adopted omnibus equity plans in 2003 which permit grants of options, SARs and other forms of equity awards, such as restricted stock, unless such a plan's performance goals are reapproved in 2008, the other equity grants made after the 2003 shareholder meeting will not qualify as 162(m) PBC.

C. Consider Adopting PBC Plans

Companies which pay PBC bonuses or equity-based compensation other than options and SARs should consider adopting PBC plans and submitting them to shareholders for approval in 2008. If a company is submitting other option or omnibus equity plan amendments to shareholders for approval this year, such company should consider adding a few simple provisions to qualify other equity compensation payable under the plans as PBC.

D. Review Outside Director Status

Compensation only qualifies as PBC if it is awarded and administered by "outside directors," generally defined as Board members who are not employees, or current or former officers and who do not receive remuneration other than director compensation from the company (directly or as paid to entities of which such directors are employees or owners) unless it qualifies as "*de minimis* remuneration" under narrow and tricky rules. Public companies should make certain at least annually that the directors administering their PBC plans continue to qualify as "outside directors."

E. Review Status of Grandfathered Plans

Under certain circumstances, compensation plans which are effective before a company becomes publicly held are subject to special transition rules which defer compliance with 162(m) for between one and three years after the company becomes publicly held, depending on whether the company becomes public through an initial public offering, spin-off or otherwise. Adoption of material amendments to such grandfathered plans can truncate the transition period. Companies that went public in 2007 or earlier should check to see whether compliance is now required for 2008 and thereafter.

409A Documentary Compliance by Year-End 2008

Plans and arrangements subject to 409A must be in documentary compliance with 409A by December 31, 2008. Prior to then (and since January 1, 2005) issuers are obligated to operate such plans and arrangements in good faith compliance with 409A. In the course of reviewing compensatory plans and arrangements this proxy season, issuers should consider whether any amendments are necessary to bring the plans and arrangements into compliance with 409A and determine how best to draft and implement any required amendments before year-end.

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Latham's Benefits and Compensation Group is working closely with clients to assist with all proxy executive compensation and related persons disclosure and 162(m) and 409A compliance issues. Please feel free to call any of us if we can be of assistance.

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