



American Benefits Council

Benefits Briefing Webinar: Pay Ratio Rules and other Executive Compensation Matters

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Brigen Winters
Groom Law Group

Mark Poerio
Paul Hastings

Overview

- Pay Ratio Rules
- Shareholder Derivative Litigation
- 162(m) Issues
- *Sun Capital Partners* case
- *Sutardja* 409A case
- 409A Corrections Issues

Pay Ratio Disclosure Proposed Rules

- Dodd-Frank Act provision
 - Controversial
 - Many comment letters
- Proposed rule issued September 18, 2013
- Very short rule with very long preamble
- Effective for first fiscal year commencing after effective date of final rule

Overview of Proposed Rule

- Good news / bad news
- Flexibility for each company to identify median employee
- Balances costs and administrative burdens with preserving benefits of disclosure
- Proxy rules only needed for one additional employee
- But some concerns not addressed

Identification of Median Employee

- Requires consideration of all employees
 - Includes seasonal, temporary and part-time employees
 - Includes employees of subsidiaries and non-U.S. employees
- Determination as of last day of fiscal year

Identification of Median Employee

- Flexible definition of compensation to determine median employee
 - Proxy compensation, or
 - Another consistently applied compensation measure
 - Reasonable estimates
 - Statistical sampling

Identification of Median Employee

- May use annual period other than fiscal year if compensation measure recorded on that other basis
- No required or safe harbor methods to identify median employee
- Does not require determination of exact compensation for each employee

Proxy Compensation for Median Employee

- Existing proxy compensation disclosure rules used to determine proxy compensation for median employee
- Company permitted to include perquisites aggregating less than \$10,000, value of non-discriminatory health and welfare benefits
- CEO's proxy compensation must follow same approach
- Explanation of any differences between CEO's proxy compensation for pay ratio vs. SCT

Required Pay Ratio Disclosure

- Required disclosure of
 - (a) Proxy compensation of median employee;
 - (b) Proxy compensation of CEO; and
 - (c) Ratio of (a) to (b) (or in narrative terms where (b) is multiple of (a))
- Brief description of methodology, assumptions and estimates to identify median employee and compensation measure
- Disclosure of any changes to methodology or material assumptions in future years

Supplementing Required Disclosures

- Companies may include additional information to supplement disclosure
- Additional information must be clearly identified and cannot be misleading or displayed more prominently
- Companies may provide alternative pay disclosure ratio

Shareholder Derivative Litigation

- Pay Ratio Disclosures?
- Say on Pay?
 - Failed SOP Litigation – dead?
 - Charter Township v. Martin (9/17/13, CA)
 - 14A Disclosure
 - Clorox (8/27/13, CA)

Shareholder Derivative Litigation

- Code 162(m): Disclosure vs Approvals?
 - Seinfeld v. O'Connor (3/2011 - dismissed)
 - Hoch v. Alexander (7/2011 not dismissed)
 - Freedman v. Redstone (7/2013 - dismissed)
 - Halpert v. Zhang (8/2013 -not dismissed)
 - [https://executiveloyalty.org/XC LIT Plan 162 m .html](https://executiveloyalty.org/XC_LIT_Plan_162_m_.html)

ACA 162(m)(6) – \$500,000 Deduction Limit

- Proposed regulations published April 2, 2013
- Applies to “covered health insurance providers”
- Aggregated group subject to limit
- Relief on who is covered
- Limit applies to “applicable individual remuneration” and “deferred deduction remuneration”
- Detailed tracking and attribution rules

Sun Capital Partners

- Background – PBGC 2001 Letter
- Competing District Court Decisions
- 1st Circuit Decision
- ERISA Title IV Implications
- Implications for Public Employers
 - 409A? WARN?
- Link to decision:

<http://media.ca1.uscourts.gov/cgi-bin/getopn.pl?OPINION=12-2312P.01A>

Sutardja v. U.S.

- Option granted in 2003/2004
- Option exercised in 2006
- IRS claims option was discounted and assesses 409A penalties of over \$3.5M
- IRS prevailed on all legal arguments for 409A coverage of a discounted stock option
- Link to decision:

<http://www.leagle.com/decision/In%20FDCO%2020130227E44>

Sutardja v. U.S.

- Court still needs to rule on whether this option actually was discounted
- Events occurred in the pre-2009 good faith compliance period
 - Assumption has been that IRS will be more lenient for these years
- California state tax consequences
 - Additional penalty tax also at issue

Overview of 409A Corrections

- 409A plans need:
 - Compliant plan documents
 - Operational Compliance
- 409A error results in --
 - Immediate taxation of participant's entire benefit plus 20% additional tax and interest
 - Operational applies just to impacted participant
 - Document impacts all participants
- Good to avoid errors
 - \$3.6 M cost in Sutardja case

General Approach to 409A Errors

- Do I really have a 409A error?
- If yes, can I fix it under an IRS program?
- If I can't fix it under an IRS program, now what?
 - Figure this out before alerting executives involved

409A Error?

– Common Situations

- Distributions
 - Paid too soon
 - Paid too late
- Deferrals
 - Deferred too much
 - Deferred too little
- Document Terms
 - Typically distribution terms

IRS Correction Programs

- Common to both operational and document corrections
 - Mechanical rules, not general correction principles
 - No IRS approval of correction – self-correction
 - But filings with annual tax returns for both company and executive usually
 - No prohibition on grossing-up executive for penalties or costs incurred
 - Not available if under IRS examination
 - Must be inadvertent and unintentional error

IRS Correction Programs

- Operational Correctional Program
 - Can fix certain errors that occurred in current year and two prior years
 - No relief for pre-2011 errors now
 - More recent the error, easier the fix
 - Less flexibility for insiders
 - Generally, whichever party has too much money needs to pay excess to other party
 - Must take reasonable steps to avoid recurrence

IRS Correction Programs

- Document Correction Program
 - Can fix certain errors
 - Cannot fix piggybacks and haircuts
 - All similar document errors in all plans must be corrected
 - No relief for benefits paid before correction occurs
 - May be reduced penalties for certain participants paid benefits shortly after correction

Corrections Outside of IRS Programs?

- Gratuitous payments
- Grace period
- Fungible payments
- Proposed penalty regulations for unvested amounts