American Benefits Council

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

October 21, 2013

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
- 1\textsuperscript{st} 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](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