THE WAGES OF CRISIS:
Executive Compensation Under Attack

By Steven Andersen

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Public consternation over executive compensation turned to outrage on the news that Wall Street execs took more than $18 billion in bonuses at the end of a financially catastrophic 2008. For average Americans, the enduring image of private-jet-set CEOs collecting windfall bonuses is at sharp odds with the fear they feel about the deepening recession.

In February, President Barack Obama responded with a $500,000 pay cap for top executives at companies receiving federal bailout money. Senators including Claire McCaskill, D-Mo., took it one step further, offering an amendment to the stimulus bill that would cap compensation at the $400,000 salary the U.S. president earns. Such public attacks on corporate compensation are just a taste of what's to come.

"We can expect new regulation of executive compensation, both as a part of bailout activities and as stand-alone legislation," says Gordon S. Kaiser Jr., a corporate partner at Squire, Sanders & Dempsey L.L.P. "We have the attention of the new administration, and the president himself, on the subject in general. It is certainly an issue that will be in the spotlight for every public company."

That means general counsel must be sure their clients are well-positioned to deal with new levels of scrutiny of compensation packages, from regulators and shareholders alike.

Assess and Advise

"Counsel should take the time to look at the whole executive compensation picture in their company so they have an idea of the issues that might come up, even if they haven't been brought to the fore yet," Kaiser says. "They should focus on any programs up for renewal in the near future, because anything that requires a shareholder vote is likely to be a more interesting process than it was in the past."

Any executive compensation assessment should consider the full compensation spectrum—including equity-based pay, incentives and bonuses, stock and options—with a particular eye toward how compensation relates to shareholder value. And don't overlook severance.

"Many companies are going through reductions in staff," Kaiser says. "Some review of severance policy is necessary because some important tax rules have changed already."

It's not a simple compliance matter, because so many parties are tracking the issue. The Internal Revenue Service, Securities and Exchange Commission and shareholders all have a keen interest in compensation issues, and for some companies public opinion is important as well. The list doesn't end there.

"The way you treat your compensation issues can affect your debt/capital relationships," Kaiser says. "It may involve covenant changes, and it may involve a change in the tenor of your credit relationships. There are financial

institutions that look at how companies deal with compensation as part of an overall assessment."

Tax Abrasion

The easiest and most direct way for the federal government to affect executive compensation is through tax laws. There are three major sections of the Internal Revenue Code that apply, and at least two of them will be hot topics in the current climate.

Section 162(m)—the "million dollar cap"—limits the deductions for public companies to $1 million per year per executive for nonperformance-based compensation. The rule was implemented more than 15 years ago as a performance incentive, but there's no hit for the executive if the rule is violated. The company merely loses a tax deduction.

"It has had some effect on companies, but I don't know that it has really limited compensation," says Michael G. Meissner, a tax partner at Squire Sanders who focuses on executive compensation. "Some companies just take the hit and pay their CEOs however they see fit."

Section 280G—the "golden parachute rule"—stipulates that if the buyout an executive gets as a result of a takeover exceeds three times their previous compensation, there are two penalties: the loss of a deduction for the company and a 20 percent tax on the executive.

This rule initially had little effect, as most companies just tacked on an extra payment to cover the new tax, a so-called gross-up payment. But that has changed.

"The trend in recent years is to not have those sorts of gross-ups," says Meissner. "Companies now often let the chips fall where they may, and the executive pays the tax."

Section 409A covers deferred compensation. Enacted in 2004, the rule went into full effect just this year.

"The interesting thing about 409A is that if you violate it, the penalty—also a 20 percent tax—is all on the executive," Meissner explains. "It's sort of the reverse of 162(m) where the penalty falls on the company. As a result, there is a very strong interest in compliance."

The IRS considers any form of payment not received in the year it was earned to be deferred. That includes stock options, bonuses and severance agreements.

"By virtue of a very broad definition, they swept a lot of agreements into the web of 409A. One of the things these laws have taught is that if you put the penalty on the executive, you will foster greater compliance."

That type of leverage is not lost on lawmakers. Congress's first step has been to sharpen these existing rules for bailed-out companies.

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For example, under 162(m), in certain circumstances, if you received TARP money, the cap is $500,000, not a million. TARP also extends 280G to general severance payments, not just a change in control of the company.

"There is a desire on the part of Congress and the general public to go after executive compensation one way or another, either by prohibiting certain kinds or putting special taxes on others," says Meissner.

Proxy Battle

And then there are the shareholders. Compensation structures will be on the agenda for every public company at their annual meetings this year. The time has already passed for shareholders of many companies to submit proposals that must be included in proxy statements under SEC rules, but shareholders are still going to have a lot of questions, and general counsel need to be sure they can provide answers.

"Shareholders will be asking how their company has performed," says Thomas R. McGuigan, a finance and governance partner at Squire Sanders. "Have they done better than other companies in the same industry? Have they done worse? How is compensation related to that performance?"

Proxy statements must discuss compensation for the prior year, as well as any changes under way in the current year needed for shareholders to understand that compensation. That means the focus is not just on what's already on the books, but also on how structures are changing to meet current conditions.

"Shareholders will be keeping a very close eye on what compensation was in 2008 and what adjustments have been made for 2009," McGuigan says. Like the government and the general public, they will be looking for compensation structures that are transparent and clearly tied to performance. A direct approach is the only one likely to put these issues to rest in the current economy.

"Nobody wants the president of the United States talking about their pay policies," Kaiser says. "That's never a good thing."

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