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Executive Compensation: Issues And Answers

*The Editor interviews **Robin M. Schachter**, Partner, Akin Gump Strauss Hauer & Feld LLP.*

Editor: Please describe your practice.

Schachter: It's a comprehensive employee benefits and executive compensation practice. I do both qualified and non-qualified executive compensation as well as broad-based employee benefit plans, equity compensation plans, a lot of executive employment agreements and separation agreements. I address associated securities law and labor issues, as well as tax issues.

Editor: What components are most frequently found in executive compensation plans?

Schachter: The components have been fairly consistent over the years. The key elements have always been base salary, bonus, and equity. At various times, you have a mix of other perquisites.

Editor: With respect to the benefits and key issues, please describe the applicable ERISA or tax considerations.

Schachter: From the tax and compliance standpoint, the key issue with respect to base compensation is reasonableness. Compensation that is guaranteed and not subject to contingencies is taxable as ordinary income when received. It is usually a significant – but not necessarily the most significant – component of the package at many companies. Bonuses, which are typically performance driven and may be subject to significant contingencies, are also taxed as ordinary income. Neither base salaries nor bonuses are subject to ERISA.

If the executive chooses to defer some portion of base salary or bonus, then you may have ERISA considerations. If amounts are paid currently, they are taxable currently and deductible currently by the company.

As to amounts that are deferred, including elective deferrals by an executive who is entitled to payment but makes an election in advance not to be paid currently, the employer will not be able to deduct those amounts currently and, if the program is structured properly, the executive is not required to pick them up in current income until they're actually paid out. On the equity compensation side, the rules are based on the type of equity compensation.

Robin M. Schachter

Stock options are treated differently than restricted stock. The typical design is to give restricted stock that is subject to a risk of forfeiture if either the employee's company does not achieve specified performance objectives or if the employee's employment is terminated and is subject to transfer restrictions during the vesting period. That type of arrangement is not taxable to the employee until it's no longer subject to a substantial risk of forfeiture. And that's the point in time when it becomes deductible by the corporation.

A "Section 83(b) election" allows an executive to make an election within 30 days of a transfer of stock or other property to recognize ordinary compensation income equal to the fair market value of the stock at the time it is transferred, prior to the lapse of the substantial risk of forfeiture. The theory is that an employee may wish to elect to recognize the taxable income at a time when the stock has a low fair market value where the employee anticipates that it will increase in value.

A Section 83(b) election results in the long-term capital gain holding period beginning at the time of the transfer, rather than at the time the substantial risk of forfeiture lapses. If the employee decides to retain the stock for at least a year after making the election, a subsequent sale will be eligible for long-term capital gains treatment.

The rules are a little different for stock options. Stock options are taxable as ordinary income equal to the difference between the fair market value of the stock when the employee exercises the stock option and the amount the employee pays to exercise the option. The employer is entitled to a deduction at that time equal to the amount the employee includes in income.

Editor: What trends are you seeing today in executive compensation?

Schachter: The biggest trend is gearing compensation to performance. Companies, particularly public companies, are facing pressure to align their compensation programs so that they're consistent with the interests of shareholders. There is a trend away from the use of stock options and more interest in using restricted stock for equity-based compensation because restricted stock does not produce the same level of potential shareholder dilution. With restricted stock, you can provide an incentive of comparable value with fewer shares if the employee can satisfy the vesting requirements. Restricted stock generally continues to have value even if the stock price goes down.

Editor: What strategies are being adopted to better align executive compensation with the interests of shareholders?

Schachter: There is a trend to adjust incentive compensation (bonuses and equity awards) so that it is geared to pay for performance. Typically this is accomplished by establishing performance-based vesting metrics at the beginning of a specified performance period. Companies, particularly public companies, are facing a lot of pressure to align their compensation programs so that they're consistent with the interests of shareholders. Thus, we are seeing greater efforts to link executive compensation to company performance.

Most companies are adopting equity ownership guidelines for their executive group

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that are intended to encourage executives to maintain a certain level of ownership so that they have an identity of interest with the shareholders, but also to encourage those executives to hold their stock for an extended period instead of just churning these awards and treating them more like current compensation.

Companies are adopting executive stock ownership guidelines that typically provide required levels of stock ownership based on a multiple of salary. Depending on the level of the executive, there may be a requirement that they hold three to six times annual compensation in some form of equity or equity incentives. There may be a transition period of time to permit the executive to achieve that goal. There may also be exceptions to the holding requirements that will permit them to sell for tax liquidity purposes. The biggest incentive to comply with these policies is that, if you don't comply with them, it will have an impact on your ability to get future awards. In addition, companies are adopting policies to limit the use of shares in hedging strategies.

Editor: How influential are the proxy advisory services on executive compensation?

Schachter: A number of the institutional shareholders rely heavily on their recommendations. The advisory services have metrics they use to evaluate compensation programs that are often different from the ones the company uses. Failure to be within these metrics or the use of techniques that the advisory firms view as poor pay practices may result in a negative recommendation on proxy proposals such as say-on-pay, the adoption of a plan that requires stockholder approval or even the election of board members. This presents a very significant issue for a lot of companies, where the ISS or Glass-Lewis selection of an applicable peer group may be substantially different than the peer group that the company feels is its competition for executive talent. Sometimes a company may be larger in terms of its revenues than the ISS- or Glass-Lewis-selected peer group. Larger companies typically pay more. What often happens is that the advisory service may pick a peer group that consists of a predominance of companies that are not as large as the company in question or are located in a geographical area where compensation levels are lower. Companies need to make sure that they're in contact with their key institutional shareholders to explain any discrepancies.

Editor: What is your role in discussions with a company's executives or its board about fixing executive compensation and covering questions that might be raised by shareholders?

Schachter: We are frequently asked to advise boards and compensation committees on issues relating to setting executive compensation and will often work with other advisors, like their compensation consulting professionals. And sometimes we'll work with their proxy solicitation firms to help them understand their client's compensation arrangements. Our role is to advise, not just on the compliance side from a securities law and tax standpoint, but also to give them our insights about how shareholders are going to view their executive compensation programs and to help them structure those programs in a way that is most likely to be accepted by both proxy advisory services and ultimately the shareholders of the company.

Editor: What role does say-on-pay play?

Schachter: An increasingly significant one. So far this year, there are over 40 companies that had negative say-on-pay votes. Although the vote is non-binding, most companies respond. Shareholder advisory groups can be helpful in shaping an appropriate response.

Editor: What about special situations where a company might have to pay more than shareholders might have anticipated?

Schachter: We frequently play a role in the process of helping companies craft the compensation committee's Compensation Discussion and Analysis that goes into the proxy statement. This is the primary vehicle for explaining the compensation committee's decisions and how they impact these special situations.

Editor: What about clawbacks?

Schachter: All public companies are adopting clawback policies. Under such policies, clawbacks occur when a company restates the financial statements upon which the compensation was based, although some companies have even broader policies than that. One of the issues raised by clawbacks is their enforceability. Many states have wage payment laws that prohibit the clawback of compensation after it's been paid.

Most public companies that have clawback policies are asking executives to agree in advance to such policies. There are strong arguments in support of such policies, particularly where the executive subject to the clawback was personally involved in the behavior that generated the compensation being clawed back and that behavior was the product of malfeasance of some type. However, clawbacks are not limited to executives who directly engaged in culpable behavior. More generally, it can be argued that clawbacks are justified where there is a restatement that results in amounts that have been paid being an overpayment because the restatement of the financial results would not have triggered the incentives that were actually paid. So it is an area where that is a clear trend, not only among public companies, but also in the privately held sector as well.

Editor: Have you seen significant litigation challenging executive compensation?

Schachter: We have seen an increasing number of cases challenging executive compensation over the last several years. Cases challenging the amount of compensation often have a difficult time getting past the business judgment rule. I have also seen a number of recent cases attacking compensation on the basis of Section 162(m) of the Code, which makes compensation in excess of one million dollars nondeductible, unless it's performance-based.

Editor: You mentioned the importance of the business judgment rule. Do you assist boards in documenting compliance with it in connection with committee and board deliberations concerning compensation?

Schachter: In the role of outside counsel, we will, in connection with compensation matters, frequently assist corporate clients as acting secretary of meetings of the board and its compensation committee and in drafting minutes to make sure that issues that need to be addressed are reflected and that the proceedings are accurately and adequately documented.

Editor: Is there anything on the horizon that companies should be sensitive to right now?

Schachter: Companies should focus on issues that they will face in their broader-based group health plans as a result of the Affordable Care Act. The Shared Responsibility Employer Mandate becomes effective in January 2014. At that time, companies are either going to have to provide group health coverage that provides minimum essential coverage satisfying certain affordability and minimum value requirements to all full-time employees who are working 30 or more hours a week or they're going to have to pay excise taxes on behalf of those employees. The ACA also has nondiscrimination requirements that may require changes to existing executive-only group health plans.