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Executive Compensation Group Advisory

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NEW IRC SECTION 409A DEFERRED COMPENSATION PROPOSED REGULATIONS: On September 29th, the IRS issued a 238-page release of proposed regulations under IRC Section 409A (which imposes, among other things, a 20% penalty tax on the individual taxpayer). It addresses many of the questions raised by IRS Notice 2005-1 (released last December). Of particular importance are the following:

- The deadline to amend "deferred compensation plans" (which may include certain employment agreements) in order to bring them into Section 409A compliance has been extended from December 31, 2005 to December 31, 2006.
- Participants in existing non-compliant deferred compensation plans who want to terminate their participation in such plans must do so by December 31, 2005.
- The last date to make deferral elections for non-performance-based 2006 compensation is December 31, 2005.
- The last date to make deferral elections for annual performance-based 2006 compensation (for calendar year companies) is June 30, 2006 (i.e. – 6 months before the end of the applicable performance period).
- Public company *and* private company stock appreciation rights (SARs) – whether settled in cash or in stock – will be treated like stock options (so a "plain-vanilla" SAR should not be treated as deferred compensation under Section 409A):
  - note that the valuation of private company stock must meet certain standards specified in the proposed regulations.
- Severance will not be treated as deferred compensation under Section 409A if:
  - the severance is paid in a lump sum within the 2-1/2 month period following an involuntary termination of employment; or
  - the severance is fully paid by December 31st of the year following the year of termination *and* the amount of the severance generally does not exceed the lesser of (i) 2x the recipient's annual cash compensation or (ii) 2x the annual qualified plan limit (currently $210,000).
- The proposed regulations have raised a serious issue whether severance paid with respect to a "good reason" termination of employment by an executive will be treated as deferred compensation under Section 409A, and if paid to a public company executive, then whether the severance payment is subject to the mandatory 6-month delay of payment requirement.
- The last day to make transitional changes to payment dates for already deferred compensation has been extended from December 31, 2005 to December 31, 2006 (other than with respect to deferred compensation payable in 2006 or accelerated into 2006).
- Notice 2005-1 is still in effect (presumably including the "good-faith" compliance standard) unless the Notice conflicts with the new proposed regulations.

The above are just a few of the new rules, which have (as expected) raised many questions. Over the next few weeks, Treasury and IRS officials will be discussing these proposed rules with practitioners, and we would expect more answers and clarification to these questions. Meanwhile, it is important to now carefully review existing deferred compensation arrangements, SERPs, employment agreements, severance plans, split-dollar arrangements, and cash-based and equity-based incentive compensation plans.

DISNEY CASE: Chancellor William B. Chandler III of the Delaware Chancery Court ruled in August that Disney's directors did not breach their corporate fiduciary duties in the hiring and firing of Michael Ovitz. However, this 174-page decision is being interpreted every which way. Some find that the *Disney* decision supports directors and their use of the "business judgment rule" against shareholder derivative lawsuits, taking the "wind out of the sails" of the "duty of good faith" argument put forth by former Delaware Supreme Court Chief Justice E. Norman Veasey in the January 2003 *Harvard Business Review*. Others say to be careful because Chancellor Chandler decided this case using a historical perspective (the events occurred during 1995 and 1996) when directors would not have been held to today's higher (and post Sarbanes-Oxley) corporate fiduciary standard. We note that Chancellor Chandler repeatedly refers to the concept of "best practices" in his decision.

FAS 123R: As a reminder, the day of mandatory options expensing will soon be here (it's here for some already). Before this day occurs, some companies are taking a good hard look at vesting currently unvested options (the rationale – which some shareholders are also embracing – is why take a charge to earnings if you don't have to). Also, the "grant-date" controversy – where the FASB had stated that the grant date of an equity award occurs only when the grantee "agrees" to the terms and conditions of the grant – has now been clarified, with the FASB staff stating that the grant date occurs when the terms and conditions of the grant are no longer negotiable and the award is communicated to the grantee within a short period of time.

NEW EXECUTIVE COMPENSATION DISCLOSURE: Finally, ever since Sarbanes-Oxley, we've been hearing talk about the "new" executive compensation disclosure rules (i.e. – changes to Item 402 of Regulation S-K), but generally this has been limited to just that – talk. However, in September, as reported by *The Wall Street Journal*, new SEC Chairman Christopher Cox added his voice to the fray and said that the disclosure of executive compensation "clearly needs to be addressed." So it's likely we will see new SEC executive compensation disclosure rules in the near future (most certainly with respect to SERPs and perks), but perhaps not in time for the upcoming 2006 proxy season.

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