

Executive Compensation Under Attack

A wave of executive compensation earthquakes has created a tsunami that now is flooding the board rooms and executive suites of public corporations. Shareholders and the general public are expressing outrage at what has been termed excessive compensation of top executives.

An early warning tremor came during President George Bush, Sr.'s trip to Japan in January 1992. While the trip unfortunately is best known for the embarrassing incident in which President Bush upchucked into the lap of the Japanese Prime Minister, others of us remember the scolding Japanese business executives gave President Bush about the excessively high compensation of America's corporate executives.

This criticism led to the addition of Section 162(m) to the Internal Revenue Code in the Omnibus Budget Reconciliation Act of 1993 (P.L. 108-357). Effective Jan. 1, 1994, executive compensation in excess of \$1 million would have to be incentive compensation approved by a compensation committee of the board made up of independent board members, or it would not be allowed as a tax deduction.



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Another jolt came with the Enron scandal in 2001. A spotlight was turned on the fact that top executives escaped the collapsing company by accelerating their deferred compensation and got cash, while the employees left behind were stuck with their 401(k) plans funded with Enron stock. This and other scandals led to the addition of Section 409A to the Internal Revenue Code in 2004, greatly restricting deferred compensation plans.

Then, the financial meltdown of 2008 provided a tremor that now has added both momentum and volume to the tidal wave of attack on excessive executive compensation. The general public, politicians, and shareholders alike are outraged with large bonuses paid to executives of failed and bailed out companies.

We see stories daily in the business news about companies refusing to give their top executives raises or bonuses. Angry shareholder groups are demanding "say on pay." At least 28 bills are pending before the House and Senate with proposals that will affect executive compensation. On Dec. 17, 2009 the Securities and Exchange Commission approved new regulations – which went into effect on Feb. 28, 2010 – for enhanced proxy disclosure of compensation arrangements.

Special focus is not only on the chief executive officer and the next four most highly paid officers (NEOs), but now the scope is larger and includes directors and other highly paid officers. Greater disclosure now is required for all employee compensation.

Nimble companies see the tsunami coming and have jumped up

on their surfboards to ride the wave. The companies with their backs to the wave will be inundated.

Here are a few frequently asked questions for the CEO of a public company. While this discussion is hardly comprehensive, it provides some food for thought.

Question: I understand the term base pay, but where has my annual bonus gone?

Answer: Don't even whisper "bonus;" it is a bad word that is no longer politically correct. Instead, look for something now called annual incentive compensation or annual at-risk compensation. Also, there is a whole new concept called maximum annual at-risk or annual incentive compensation. For example, the CEO of American Express had his 2009 annual non-equity incentive compensation capped at just under \$23 million. American Express shareholders must feel relieved to know their CEO has his non-equity annual incentive compensation capped; it was so much easier when this was called a bonus.

Question: What happened to my stock options, and why have they been cut back?

Answer: Stock options are not PC. They allow the executive to participate in the upswing in stock value with no investment in the stock itself. The new trend is for the executive to actually own shares of stock – in other words, to have skin in the game. Some companies require their top executives to own shares that have value equal to some multiple of their base compensation – a gift from the company in the form of Restricted Stock Awards (RSA) or Restricted Stock Units (RSU).

RSA is actual stock given to the executive with a vesting over some period of time or upon the occurrence of certain incentivized events at the company. As the shares vest a portion can be sold off to pay the taxes triggered by the vesting. Ironically, stock ownership is generally more desirable than stock options. Stock will hold value unless the company goes bankrupt. The sale can be taxed at capital gains rates. Options are worthless once the stock is below strike price, and exercise is usually taxed as ordinary income.

For example, shares given to an executive worth \$10 each at the time of vesting will still have value whether the stock goes to \$3 a share or \$30 a share. A stock option granted at \$10 a share, however, gives the executive the right to buy at \$10, but is worthless when the stock drops to \$3.

RSUs are deferred compensation plans measured by the value of the company's stock and may be paid out in actual shares or in cash upon termination of employment or some other event.

Question: What happened to my golden parachute payment in the case of change in control or my being fired?

Answer: Golden parachutes are not PC. However, you likely will see that your retirement and pension plans have been beefed up. You will see an acceleration of vesting upon change in control, your being terminated, or your actual retirement. You will see they have a SERP



(Supplemental Executive Retirement Plan) to get you benefits comparable to those allowed your employees under qualified plans which otherwise would limit your benefits or participation.

Question: Where are all my old buddies on the compensation committee of the board?

Answer: The members of the compensation committee need to be independent trustees, not employees of the company. These committees now hire compensation consulting firms to aid in the design of your compensation plan and to provide benchmarking data. In this era, the compensation committee would be foolish to go it alone. (You might want to invest in a compensation consulting firm!)

Question: What are the compensation tables I see in the proxy materials? Am I now merely a spreadsheet?

Answer: The SEC is now requiring that all forms of compensation for top executives be disclosed in table form. The tables must show all forms of compensation including cash, equity, deferred, retirement, stock options, and fringe benefits. If there are ele-

ments which will depend on future events the company is now required to make a reasonable estimate of what the payments will be worth. You now live in a fish bowl!

Question: Can I still choose to travel on the corporate jet and be driven around in a corporate limo?

Answer: You may no longer have a choice. They company may require you to travel on a corporate jet or limo for security purposes. (This provision is borrowed from the Boeing executive compensation plan.) Not so bad. When you go to Washington, D.C. to testify and the senator asks if you came in a corporate jet, you can say, "I had to. It is in my compensation agreement and is for security purposes."

Question: What is this "say on pay" business?

Answer: Not only is every element of your compensation going to be on display, so is the background and compensation of the board members who set your pay. Soon shareholders may have the right to vote on executive compensation. Wells Fargo made the news recently when they said they would subject their executive compensation plan to a shareholders' "advisory-only" vote on corporate compensation.

A friend of mine suggests that the CEOs of the big bailed-out banks should have their "bonuses" paid from a pool of toxic assets. While this idea still has not been proposed, it is clear that the tsunami is arriving upon corporate shores.

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