



# Benefits Alert

## Legal developments affecting employee benefits

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### The Present and Future of Executive Compensation Regulation

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As we informed you in our previous Benefits Alert on the federal bailout or “rescue” legislation, perceived excessive executive compensation is one of Congress’ primary concerns as a result of the current financial crisis. Most of the executive compensation provisions of the final legislation only apply to troubled firms that sell assets to the Department of Treasury and only while the Department of Treasury holds a significant equity or debt position in a firm. However, in the final legislation Congress added new limits on deferred compensation paid by certain foreign entities and partnerships owned by tax-exempt investors. In the current environment, these limits on executive remuneration (i.e., salary, incentive compensation, and benefits) may signify just the beginning of a new era in executive compensation regulation.

Like the original proposed legislation, the final legislation (entitled the Emergency Economic Stabilization Act of 2008) applies different standards to firms whose assets are directly acquired by the Department of Treasury and those whose assets are acquired at auction. For firms acquired directly by the Department of Treasury, the Secretary of Treasury shall establish appropriate executive compensation standards that:

- Provide limits that exclude incentives for “senior executive officers” to take unnecessary and excessive risks that threaten the value of the institution.
- Permit “claw-backs,” i.e., the recovery of any bonus or incentive compensation paid to a senior executive officer based on materially inaccurate statements of earnings, gains, or other criteria later proven inaccurate.
- Prevent any golden parachute payment to any senior executive officer.

For companies that sell more than \$300 million in assets to the Department of Treasury at auction, the Secretary of Treasury is required to adopt rules that: prohibit any *new* employment contract with a “senior executive officer” that provides a golden parachute upon an involuntary termination, bankruptcy filing, insolvency, or receivership. In addition, the final legislation amends Internal Revenue Code § 162(m) so that a company acquired by the Department of Treasury at auction cannot deduct more than \$500,000 in executive remuneration for any tax year. The legislation also limits the deduction on “deferred executive remuneration” for a tax year to \$500,000 minus the sum of executive remuneration for the current tax year and the deferred deduction executive remuneration that was taken into account in a preceding tax year. In effect, this limits the deduction

of deferred compensation to \$500,000 in the aggregate per covered executive.

Notably, the Secretary's standards for limits on taking unnecessary and excessive risks, "claw-backs," and golden parachute payments only apply to "senior executive officers." The legislation defines a "senior executive officer" as one of the top five executives in a public company whose compensation must be disclosed under the Securities Exchange Act of 1934 and non-public company counterparts. On the other hand, the deduction limits on executive remuneration apply to "covered executives." "Covered executives" are the chief executive officer, chief financial officer, and the other top three highest compensated employees. Once a person becomes a "covered executive," he or she will remain a covered executive for all future tax years, including for the purposes of determining the deferred deduction executive remuneration limit in later years.

But the new Emergency Economic Stabilization Act did not stop with regulating executive compensation of firms that are being bailed out or rescued. The Act has provisions that in effect prohibit deferred compensation being paid to US taxpayers by certain tax haven corporations or partnerships. These provisions may affect management fee deferral agreements with an offshore private investment fund or a fund substantially all of which is owned by tax-exempt investors.

The new Internal Revenue Code Section 457A focuses on certain entities that are indifferent with respect to whether a tax deduction is available for deferred compensation or not. These "tax indifferent" entities are typically entities that are structured so as to escape both U.S. and foreign income tax. Under the legislation, effective January 1, 2009, nonqualified deferred compensation from a "nonqualified entity" will be taxed when there is no substantial risk of forfeiture. In other words, the tax becomes due when the right to payment vests even if it is an unfunded and unsecured promise to pay. The law also provides that difficult to value compensation from a nonqualified entity will be taxed at payment, but it will be subject to a 20% excise tax and an interest tax calculated from the time of deferral. A "nonqualified entity" subject to the new restrictions generally includes any foreign corporation or any partnership unless the corporation is (or in the case of a partnership, substantially all of the partners are) subject either to U.S. taxation or comprehensive foreign taxation (such as taxes from a country with which the U.S. has a tax treaty).

These rules can impact individuals or firms subject to U.S. tax that have deferred fee or other deferred compensation agreements with entities that are organized in tax havens exempt from U.S. and foreign income tax or with partnerships substantially all of which are owned by tax-exempt investors. Such individuals and firms may need to restructure these agreements in order to make them currently taxable in the U.S.

However, company executives, boards of directors, and compensation committees should not rest easy in thinking this is the end of the story. The current crisis on Wall Street has brought to the surface a bubbling populist anger over perceived pay excesses and has stirred a debate on executive compensation in Washington. As a result, Congress is likely to be under increased pressure to enact even more significant executive compensation guidelines.

In fact, there have been proposals to expand the scope of regulation of executive compensation to cover companies other than those impacted by the legislation described above. These proposals can include limiting tax deductions for excessive compensation, requiring shareholder review and/or approval of compensation arrangements, and placing further limits on severance benefits. Entities organized as partnerships have been targeted for their "carried interest" deferred compensation

techniques. Moreover, the new rules effectively eliminating deferred compensation from certain foreign entities is a model that could be expanded to domestic businesses.

In anticipation of future legislation and/or regulation, companies should now review their compensation practices and procedures for executives. In particular, boards of directors and compensation committees should examine closely existing arrangements for incentive forms of compensation, caps on total compensation, and levels of severance and change of control benefits. The goal of this review process is to be fully prepared to quickly and effectively enact any changes made necessary by new legislation or regulation. At the same time, this review provides an opportunity to ensure compliance with all current legal requirements.

For more information on the executive compensation limits in the revised bailout bill or any other employee benefits law matter, please contact the attorneys below or your regular Nixon Peabody attorney:

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*This is one in a series of alerts addressing the 2008 bailout legislation and the nation's current credit crisis. To view related alerts, and to see how Nixon Peabody can help you anticipate and respond to the challenges and opportunities facing businesses in these uncertain times, please visit our [Financial Recovery Team website page](#).*