CFO

Ghost of Enron Wreaks New Havoc on Exec Pay

A law enacted years ago poses new task risk for deferred compensation in the early days of the say-on-pay era.

Andrew Liazos - June 13, 2011

It's reasonable to expect that directors and senior management at many public companies will be considering changes to executive pay packages in the coming months. As of June 6, there were more than 30 public companies with failed "say-on-pay" votes and several others with significant levels of negative shareholder votes.

These results can be attributed partly to evolving corporate-governance standards for executive compensation. Executive pay practices that have been labeled by Institutional Shareholder Services as "problematic," and likely are driving some of the negative say-on-pay results, include:

- Excessive Supplemental Early Retirement Plans (SERPs) and perquisites;
- Liberal triggering events for large severance benefits;
- Tax gross-up payments for golden-parachute payments and perquisites; and
- Multiyear guaranteed incentive-compensation awards.

But in yet another lesson why the Internal Revenue Code is a poor vehicle for regulating executive pay, tax legislation enacted in response to the Enron debacle — referred to as "Section 409A" — is now creating yet more problems for public companies.

Section 409A restricts when and how nonqualified deferred compensation may be paid without triggering immediate tax upon vesting. Once a permissible payment event is in place, there are very few opportunities to change it. Unless an exception is available, accelerating payment of a scheduled deferred-compensation benefit will violate Section 409A. Further deferring a scheduled payment is permissible only under certain conditions, including that the deferral for a specified payment event be for at least another five years.

"This is yet another instance of Congress creating unnecessary complexity for public companies."

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End-run Defense

Congress enacted Section 409A following published reports that Enron accelerated payment of unfunded retirement arrangements to its executives shortly before filing for bankruptcy. But instead of amending the Bankruptcy Code or allowing the Internal Revenue Service to publish regulations to address targeted situations, Congress decided to impose new strict payment requirements to a broad range of compensation arrangements as a condition for continued tax deferral. Failure to follow those requirements results in not only the immediate taxation to the executive of vested rights under covered compensation arrangements prior to payment but also a 20% penalty and interest.

Particularly challenging about Section 409A, when considering changes to executive pay in response to shareholder concerns, is the so-called substitution rule. The IRS was apparently concerned that employers would be able to do an end-run around the Section 409A payment restrictions by terminating nonqualified deferred-compensation arrangements and then later establishing other types of compensation arrangements.

To close that perceived loophole, IRS final regulations broadly provide that compensation extended in "substitution" for forfeited or forgone payments of deferred compensation that are subject to Section 409A will themselves be treated as an immediate payment of that forfeited or forgone deferred compensation. There is no exception for changes due to legitimate business considerations, and it doesn't matter whether the substituted amount is paid earlier or later than the original deferred compensation. The result is that it may prove difficult to replace problematic deferred-compensation arrangements without triggering adverse tax consequences for executives.

Intentions Gone Awry

To illustrate the complexity of the interaction between Section 409A and corporate governance, let's say there's a negative say-on-pay vote against XYZ Corp. that appears to result, in part, from the CEO having accrued a $20 million vested SERP benefit. In order to convince shareholders that their concerns have been properly taken into account, the compensation committee negotiates a $5 million reduction to this SERP benefit with the CEO. This reduction, if implemented, would result from disregarding certain types of incentive pay that had counted as eligible compensation when calculating the SERP.

As a practical matter, XYZ's compensation committee intends to make larger annual equity compensation awards in future years based on the company meeting objective and challenging performance goals. The awards would allow the executive an opportunity to make up for the loss of the $5 million through future performance. It would seem that this type of negotiation and restructuring is what Congress had in mind when it enacted the say-on-pay provisions in Dodd-Frank.

Well, not so fast. The CEO could be stuck with a significant tax bill. As noted above, the SERP is nonqualified deferred compensation subject to Section 409A. So, if the later performance share awards are viewed as a substituted payment for the forfeited portion of the CEO's SERP, then there will be a Section 409A violation. Whether the larger performance share awards made after the change to the SERP's definition of eligible compensation will be considered a substitute for the forgone SERP is to be determined based on all the facts and circumstances. In part, the answer depends on whether any new right to payment is "proximate" to the forfeited deferred compensation, but there is no definition in the IRS final regulations what "proximate" means in this context.

Broad Applicability

This issue is not limited to SERPs. The scope of what will be considered nonqualified deferred compensation for purposes of Section 409A is quite broad. In general, an arrangement will be covered under the section if the executive has a legally binding right to compensation in a later taxable year, unless an exception is available (such as when the compensation is paid shortly after initially vesting). Other types of compensation that are subject to Section 409A include:

- Severance benefits subject to walk-away or liberal good reason provisions;
- Certain types of tax gross-up provisions;
- Delayed incentive payments due to adding or changing vesting conditions after grant;
- Time-based restricted stock units with stock issued after March 15 of the year immediately following vesting; and
- Perquisites in the nature of an employer reimbursement payable over more than one year.

Similar problems with the inflexible nature of Section 409A were uncovered after Congress enacted the Troubled Asset Relief Program legislation. Some TARP recipients reportedly changed how and when deferred-compensation payments were made in connection with receiving a favorable advisory opinion from the Office of the Special Master for TARP Executive Compensation.

For example, deferred compensation might not be paid until repayment of some or all of the financial assistance received by the TARP recipient. Recognizing that Section 409A could inhibit desirable restructuring of executive pay, a 2009 notice from the IRS stated that "the application of 409A(a) in these circumstances would produce a disincentive for TARP recipients to comply with the Special Master's advisory opinions and act in accordance with the public interest, severely diminishing the Special Master's ability to fulfill his intended role and damaging the entire TARP program." This special relief was specifically limited to TARP recipients under certain conditions.

It remains to be seen whether the IRS will provide relief that will be helpful in facilitating the restructuring of executive pay packages following negative or unfavorable say-on-pay votes.

This situation is yet another instance of Congress creating unnecessary complexity for public companies by enacting ill-conceived tax legislation in reaction to perceived abusive executive pay practices. Great care is required to navigate the conflict between Section 409A and evolving corporate-governance standards for executive compensation.