# EMPLOYEE BENEFITS UPDATE

**December 16, 2015**

## Time to Review Your Employee Compensation Arrangements


### Executive Summary

- The IRS released nonbinding guidance reinforcing a limited correction opportunity for documentary failures under Section 409A of the Internal Revenue Code ("Section 409A"). Under the guidance, employers and employees can amend unvested deferred compensation arrangements to correct Section 409A documentary failures and avoid Section 409A penalties as long as the deferred compensation is unvested for the *entire year* in which the amendment occurs.
- For the first time in over a decade, the IRS updated its Audit Technique Guide for nonqualified deferred compensation plans, shedding some light on the issues auditors will focus on when reviewing such arrangements. Interestingly, while the amended Guide mentions Section 409A compliance, it is not a significant focus.
- In Niebauer v. Crane, the First Circuit Court of Appeals used a deferential "arbitrary and capricious" standard of review in assessing a "top hat" plan administrator's benefit determination, giving broad discretion to the plan administrator. The First Circuit's use of this deferential standard, instead of a less generous "de novo" standard, hinged on the content of the plan document, which included a broad delegation of discretionary authority to construe, interpret and administer the plan to the plan administrator.
- The Securities and Exchange Commission ("SEC") released its long-awaited proposed rule implementing the clawback requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The proposed rule will require public companies to develop, implement and disclose a clawback policy requiring the recovery from current and former executive officers of certain incentive-based compensation if there is an accounting restatement to correct a material error. The proposed rule will not be effective until released in final form.

## What You Should Do

- Review your unvested deferred compensation arrangements for Section 409A documentary failures. If any are identified, amend your arrangements as soon as possible to take advantage of the limited relief recently released by the IRS.
- Review your "top hat" deferred compensation plan documents and assess the level of discretion delegated to the plan administrator and how it will impact the standard of review a court would use to evaluate your plan administrator's decisions. Consider amending your plan documents if the level of discretion and anticipated standard of review are not consistent with your expectations or desires.
- If you're a public company, begin preparing for the SEC proposed rule implementing the clawback requirements under the Dodd-Frank Act. Now is the time to start thinking about the structure of your clawback policy and to begin socializing the core concepts with your decision makers and executive officers. Time will be limited once the SEC finalizes its guidance and the national securities exchanges adopt required standards reflecting the rules.

While many employers in 2015 have understandably been focused on complying with new requirements under the Patient Protection and Affordable Care Act, it's important not to forget about compliance with other benefit programs, such as employee compensation arrangements. With the New Year quickly approaching, it's a good opportunity to take a fresh look at your employee compensation arrangements and programs, particularly in light of guidance that was issued in 2015 and changes that are expected in 2016. Below is a summary of some key developments that underscore the need to review your existing arrangements with an eye towards compliance with both existing and upcoming requirements.

***Background and Updates on Section 409A***

If you offer employees "deferred compensation," you've likely grappled with Section 409A of the Internal Revenue Code ("Section 409A"). Section 409A is a complex tax provision that contains strict requirements for deferred compensation arrangements and imposes draconian penalties on the employee for noncompliance, including income inclusion in a prior tax year, a 20% penalty tax and interest taxes, and employers may be subject to penalties for failure to withhold and report income properly. Because the IRS defines deferred compensation broadly, Section 409A applies to all sorts of compensation arrangements, ranging from traditional deferred compensation plans to employment and severance agreements with a compensation component and sweeping in some typical equity and long-term incentive plans.

As we mentioned in our April 2015 Employee Benefits Update[1], the Internal Revenue Service (the "IRS") has launched a limited round of audits assessing companies' compliance with Section 409A.

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[1] See "Recent Case Highlights Potential Liability of Employers for Administrative Errors in Deferred Compensation Plans" (April 2015).

News surrounding the audits has been sparse, but there are a few recent developments worth monitoring while we await further details from the IRS.

<u>Nonbinding IRS Guidance Supports Limited 409A Correction Opportunity for Unvested Compensation</u>

The IRS recently published Chief Counsel Advice Memorandum 201518013 ("CCM 201518013"), which formally endorses a limited correction procedure allowing employers and employees to correct certain Section 409A documentation errors for unvested amounts, free from Section 409A penalties, as long as the corrective efforts are undertaken before the year the compensation vests.

Compliance with Section 409A is two-fold; deferred compensation arrangements must include both Section 409A-compliant provisions in their plan documents (documentary compliance) and be administered in a manner that complies with those requirements (operational compliance). As a result, deferred compensation arrangements can run afoul of Section 409A, even in the absence of an operational issue, if their documentation does not comply with the letter of the law.

In the years immediately following the enactment of Section 409A, transition relief allowed employers and employees to amend their deferred compensation arrangements to bring them into documentary compliance, but since that guidance expired, the process has become less clear. There are official correction procedures in place addressing certain documentary errors, but those procedures can be onerous and do not apply to all situations, leaving some failures without a practical remedy. The ambiguity has proven particularly challenging in the context of mergers and acquisitions and other corporate transactions, where companies perform extensive due diligence to uncover Section 409A documentary errors, only to be faced with the uncertainty of addressing these failures without a clear correction mechanism.

In light of these challenges, practitioners have relied on language in the proposed regulations to support a theory that such arrangements can be amended before the compensation in question vests, without triggering penalties under Section 409A. Under this reading of the proposed regulations, relief is available for documentary failures as long as the plan documents are corrected at a time when the compensation is still subject to a substantial risk of forfeiture. IRS officials have informally supported this interpretation, but in the absence of formal guidance there was still some uncertainty, including an open question regarding whether deferred compensation arrangements could be amended to be brought into compliance immediately prior to vesting or if some period of time had to pass between amendment and vesting.

The IRS weighed in on the issue in CCM 201518013, which supports the conclusion that deferred compensation arrangements with Section 409A documentary failures can be amended before the amounts vest to avoid triggering penalties under Code Section 409A, with one significant caveat: relief is only available if the amounts in question are unvested for the entire year in which the amendment occurs. To accommodate this caveat, any amendment to correct a Section 409A documentary error in accordance with CCM 201518013 must be accomplished during the year prior to the year in which the substantial risk of forfeiture lapses and the amounts vest. The arrangement cannot be amended during the same year it vests, according to the guidance.

CCMs are nonbinding, but the IRS frequently uses them to provide some comfort when more formal guidance is unavailable. If your employees have unvested deferred compensation, you should consider taking this opportunity to review your deferred compensation arrangements to

identify any Section 409A documentary failures and, if they are found, address them in a year before those amounts vest.

The IRS Updates its Audit Technique Guide for Nonqualified Deferred Compensation Plans

For the first time in over a decade, the IRS recently updated its Audit Technique Guide for nonqualified deferred compensation plans. IRS auditors use the Guide when reviewing nonqualified deferred compensation plans. Prior to the most recent update, the Guide had last been revised in February 2005, shortly after Section 409A was adopted, to add a short and fairly generic section referencing Section 409A and noting that further updates would be added once comprehensive regulations had been issued.

The updated Guide discusses Section 409A in broad strokes, but it notably provides very little guidance on how the IRS will review nonqualified deferred compensation plans for Section 409A compliance as part of the audit process. This omission is surprising given the outsized role Section 409A compliance has played with respect to such plans in recent years. Instead, the Guide focuses on other compliance issues, including:

- Income inclusion and constructive receipt;
- Proper FICA and FUTA tax withholding procedures for payments from such plans; and
- The contingent benefit rule, which prohibits employers from conditioning an employee's participation in a nonqualified deferred compensation upon his or her participation, or nonparticipation, in a 401(k) plan.

While employers should not lose sight of Section 409A compliance, the updated Audit Technique Guide should serve as a reminder that Section 409A is only one of many areas of focus for the IRS when it comes to nonqualified deferred compensation.

***First Circuit Applies Deferential "Arbitrary and Capricious" Standard of Review to "Top Hat" Plan Where Plan Administrator is Given Broad Discretion in the Plan Documents***

One of the most significant issues for any litigation involving a plan administrator's decision making is the standard of review the court will use to assess the administrator's decision. The standard of review can determine the outcome of the case – a court may very well come to a different conclusion if it is using a highly deferential "arbitrary and capricious" standard, which requires the court to give deference to the administrator's decision unless it determines the decision was arbitrary and capricious, as opposed to a "de novo" standard, under which the court assesses the administrator's decision for reasonableness. You should know the standard of care courts will use if asked to evaluate your plan administrator's decisions and, if you want the court to use a deferential standard with reviewing your decisions for your "top hat" plans, make sure your plan documents are structured accordingly.

The standard of review applicable for benefit claims under "top hat" plans has been an issue of contention, with different federal circuit courts coming to different conclusions. A "top hat" plan is an unfunded plan maintained by an employer to provide deferred compensation for a "select group of management or highly compensated employees." Many employers structure their deferred compensation plans to qualify as top hat plans, which allows them to avoid many of the requirements that would otherwise apply to these plans as "pension plans" under the Employee Retirement Income Security Act of 1974 ("ERISA"), including the requirement to file annual IRS Form 5500 filings.

In the Seventh[2] and Ninth[3] Circuits, "top hat" plan administrator decisions have traditionally been evaluated using an "arbitrary and capricious" standard. This is the same standard generally applied to administrator decisions under ERISA plans, which provides that where a plan delegates to the plan administrator the discretion to construe the plan, a decision made under the plan will be upheld unless it was arbitrary, capricious, or an abuse of discretion. However, the Third[4] and Eighth[5] Circuits have traditionally applied a "de novo" standard, under which the court analyzes the administrator's decision to determine if it was reasonable. Of course, plan administrator decisions are more likely to be upheld under the more deferential arbitrary and capricious standard than the relatively more stringent de novo standard.

In Niebauer v. Crane,[6] the First Circuit[7] declined to take a position on the split among circuit courts, instead coming to a notable conclusion that may give employers some control over the standard of review that will be used when a court evaluates their "top hat" plan administrator's decisions in the First Circuit and beyond. Instead of relying on general principles to settle on a standard of review, the court looked to the text of the plan itself, which included a clause reserving for the plan administrator "full discretionary power and authority to construe, interpret and administer the Plan [and] to make Eligibility determinations." Based on this reservation of discretionary power, the First Circuit concluded that the deferential arbitrary and capricious standard of review was applicable in this case. Interestingly, the First Circuit also noted that, even in the circuits that typically review "top hat" plan administrator decisions using the de novo standard, a more deferential standard may be appropriate when the plan grants the plan administrator discretion to interpret the plan.

In light of the Niebauer decision, you should review your plan documents if your company sponsors, or is considering adopting, a top hat plan in order to identify what level of discretion is delegated to the plan administrator and assess how this delegation will impact the standard of review a court would use to evaluate your plan administrator's decisions.

## SEC Proposes Dodd-Frank Clawback Rules for Public Company Executive Compensation

The SEC recently released its long-awaited proposed rule implementing the clawback requirements of the Dodd-Frank Act. The guidance will only apply for public companies and is not effective until re-issued in final form, but employers potentially subject to the rule should begin making preparations now, since employers will only have a few months to put a clawback policy in place once the SEC publishes its final rule.

The proposed rule directs national securities exchanges and associations, including the New York Stock Exchange and NASDAQ, to establish listing standards requiring public companies to develop,

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[2] Covering Illinois, Indiana and Wisconsin

[3] Covering Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington state, Guam, and the Northern Mariana Islands

[4] Covering Delaware, New Jersey, Pennsylvania, and the Virgin Islands

[5] Covering Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota

[6] Niebauer v. Crane & Co., Inc., No. 14-2059 (1st Cir. 2015)

[7] Covering Maine, Massachusetts, New Hampshire, Rhode Island, and Puerto Rico

implement and disclose clawback policies requiring the recovery from current and former executive officers of certain incentive-based compensation if there is an accounting restatement to correct a material error. For purposes of the clawback obligation, the SEC modeled its "executive officer" definition on the "officer" definition public companies are already familiar with under Section 16 of the Securities Exchange Act of 1934. It includes the following company officers:

- President;
- Principal financial officer;
- Principal accounting officer;
- Any vice-president who is in charge of a principal business unit, division or function;
- Any other officer who performs a policy-making function; and
- Any other person who performs similar policy-making functions.

The proposed rule does not list the types of compensation that will qualify as incentive-based compensation, instead opting for a principles-based approach under which "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure" is included. The term "financial reporting measure" is purposefully broad, but the SEC has clarified that it is intended to include:

- Measures based on the accounting principles used in preparing the company's financial statements;
- Measures derived from such information;
- Stock price; and
- Total shareholder return ("TSR").

Following an accounting restatement to correct a "material" error, the company will need to recover any "excess incentive-based compensation" for the preceding three years, which means the amount, if any, by which the incentive-based compensation that the executive actually received exceeds the incentive-based compensation that he or she would have received based on the accounting restatement, all calculated on a pre-tax basis. Whether an accounting restatement corrects a "material" error will be determined based on the specific facts and circumstances. Since an accounting restatement does not lend itself to a mathematical recalculation for financial reporting measures based on stock price or TSR, companies will have to make a "reasonable estimate" of the effect the restatement would have had on the stock price or TSR under those circumstances. There are a number of possible methods that employers could use to reach this reasonable estimate, and companies will need to weigh the costs of implementing any methodology against the complexity of the price estimate and the potential need to justify that estimate, under their unique facts and circumstances. One method the SEC has suggested is an "event study," which is a process designed to capture the market's view of the valuation impact of an event or disclosure, but this can be costly. The SEC is currently considering what documentation, if any, companies will need to retain or provide to their exchange to substantiate their reasonable estimate. We expect more guidance on this point in the final rule.

Unlike the Sarbanes-Oxley Act clawback which currently applies to public company CEOs and CFOs if the restatement is caused by misconduct, the Dodd-Frank clawback will apply regardless of whether the executive is in any way responsible for the restatement and regardless of whether any misconduct has occurred. The proposed rule does give companies the discretion to not recover excess incentive-based compensation in limited circumstances, including when the direct expense of

enforcing recovery would exceed the amount to be recovered or, for certain foreign private issuers, where recovery would violate the law of their home country.

The proposed rule also includes disclosure requirements, which will require public companies to file a copy of their clawback policy as an attachment to their annual filing on Form 10-K and, following a restatement that requires recovery of excess incentive-based compensation, disclose certain pertinent information in the company's next annual proxy statement and any future annual proxy statement until the full amount of excess incentive-based compensation has been repaid. Once the clawback rule is finalized, failure to comply with any of its requirements may result in delisting.

For public companies, it's not too soon to begin working on your Dodd-Frank clawback policies and socializing the core concepts with your compensation decision makers and the affected executive officers. Now is also the time to consider any tweaks you may want to make to your compensation structure for the coming years to address the SEC's new requirements. For instance, you may want to consider whether the financial reporting metrics used in your executive compensation program are appropriate for all executive officers who will be covered by your Dodd-Frank clawback policy or whether any executive officers who have limited control over the performance of the company with respect to specific financial reporting measures should instead be compensated based on metrics that are not tied to any financial reporting measure.

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If you have any questions about how these developments impact your compensation arrangements, or about your compensation plans in general, please let us know.


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