Tightening Section 162(m)’s Performance Pay Requirements: Golden Parachutes Take Another Hit

BY JAMES B. BRISTOL AND DAVID PHILLIP TIEMAN

Introduction

Internal Revenue Service Revenue Ruling 2008-13, issued on Feb. 21, 2008, could disqualify many payments that were intended to be performance-based compensation under § 162(m) of the Internal Revenue Code. This ruling marks a shift in IRS policy and is, essentially, another regulatory attempt to put brakes on what has come to be perceived as excessive executive pay practices. As outlined in this article, regulatory hits on executive pay began many years ago but have been coming with much greater frequency in recent years.

Section 162(m) limits the deductibility of compensation paid to executive officers of publicly traded companies to $1 million annually. This limit applies to the chief executive officer and the next four officers ranked by pay.1 The primary exception to this limit relied on by practically all companies subject to § 162(m) is for “performance-based compensation.”2 This exception preserves deductibility of compensation items like stock options, stock appreciation rights (SARs), restricted stock that has performance-based vesting triggers, and cash bonuses paid on achievement of performance goals. To qualify for the exception, the payment or vesting of the award must be conditioned on achievement of the performance goals.3 Stock options and SARs are automatically deemed to be performance based, as payment is conditioned on an increase in shareholder value.4

Achievement of the performance goal must be substantially uncertain at the time the award is made.5 IRS regulations state that this uncertainty requirement is based on facts and circumstances at the time the award is made.6 Awards, however, can guarantee payment without regard to performance on account of death, disability or a change in control of the company.7 Most practitioners have thought that “facts and circumstances” meant that there could be other exceptions to the performance requirement, and IRS private letter rulings supported this view.

One such prior ruling, released in 1999, concluded that an executive’s termination of employment by the employer “without cause,” or by the executive with “good reason,” were permissible to trigger payment of

---

1 I.R.C. § 162(m)(3).
2 § 162(m)(4)(C).
3 I.R.C. § 162(m)(4)(C). These goals must be based on business criteria that are approved by shareholders in advance. Most plans allow a compensation committee of “outside directors” to annually set performance goals based on the business criteria in the plan.
4 I.R.C. § 162(m) includes several requirements for performance compensation plans. The strike price of an option or SAR must be at least the stock’s fair market value on the date of grant. This requirement now applies to all options and SARs due to the addition of § 409A(d)(1) to the tax code.
6 § 1.162-27(e)(2)(v).
7 Id.
performance pay, irrespective of whether performance hurdles were actually met. This ruling affirmed that death, disability, and change in control are illustrative safe harbors of the facts and circumstances where an exception to actual performance can be included in a performance-based award. Many practitioners opined that the common thread was that these events were unforeseeable and involuntary.

This reasoning was taken a step further in 2006. The IRS affirmed in a letter ruling that the reasoning of the 1999 ruling was sound and that voluntary retirement could also be a permissible exception to performance. Unlike the termination without cause/good reason condition, retirement is generally considered voluntary and foreseeable.

The change in analysis found in the February 2008 ruling was foreshadowed by a private ruling released in January. That ruling reversed the positions of the 1999 and 2006 letter rulings. The IRS characterized death, disability, and change in control as involuntary, but determined that they were unrelated to the performance of an executive. While terminations without cause or for good reason are also involuntary, the IRS reasoned that these events could happen when an executive is performing poorly. Presumably, poor performance could be the very reason for a termination without cause or for good reason. The IRS determined that poor performance is antithetical to the standards required by § 162(m).

The Ruling’s Reach

Section 162(m) does not apply to privately held companies. In addition, stock options and SARs should not be affected by this ruling, even if they include performance conditions on vesting, as they are deemed to be performance-based compensation if issued with a strike price that is at least fair market value. The ruling seems to affect only performance-based cash bonus awards, “full value” stock incentives like restricted stock and RSUs with performance-vesting requirements, and similar awards.

It seems that termination without cause or resignation for good reason can be permissible conditions if tied to another permissible event such as change in control. This type of “double-trigger” provision that conditions change in control payments on actual termination should be permissible. Otherwise, the mere inclusion of any impermissible exception to achievement of the performance goals will disqualify the award at the time it is made. Even if the performance goals are actually achieved, the possibility that a payment could have been made following termination without cause without achievement of the goals would make the payment not performance-based and, potentially, nondeductible compensation. Performance goals that are based on business criteria, death, disability, and change in control might be the only exceptions that should be included in the award.

This ruling may have the practical effect of limiting what would be otherwise permissible under the regulation. As noted above, a literal interpretation of the language only requires that payment under the award be substantially uncertain at the time the award is made. In theory, perhaps there could be other unforeseeable conditions that, like death, disability, and change in control, are unrelated to performance. The trend against excessive executive pay serves as caution against creative solutions that could be interpreted as aggressive or improper in the current environment.

Traversing the New 162(m) Landscape

Awards with a “performance period” that begins before 2009 are grandfathered, as are employment agreements that were in place before Feb. 21, 2008. This transition period approximates the transition relief provided under § 409A of the code for bringing deferred compensation arrangements into compliance. However, the new rule applies immediately to any existing agreement that is renewed or extended. This includes automatic renewals written in the contract, which means that many companies will have a very short transition period. These priorities are recommended for the transition period:

- Modify the terms of all employment agreements that are under negotiation and provide an exception to the performance requirements due to termination for cause, good reason, or retirement. Often, this type of provision is expressed as rights to payment upon termination of the executive and is not directly linked to performance-based pay or a 162(m) plan.
- Review all executive agreements for automatic renewals or other extensions. Many executive employment agreements automatically renew each year. “Evergreen” agreements will lose grandfather treatment upon renewal.
- If contract modifications are needed, present and discuss the change with the executive and compensation committee. Lowering or removing without cause and good reason payments will certainly be a change from the expectations of many executives and will likely require negotiation.
- Review awards and agreements with securities counsel. Many changes to executive compensation arrangements require disclosure on Form 8-K or Form 10-K. Revisions in proxy disclosures may also be needed.
- Prepare to amend performance compensation plans and change the terms of future performance awards. Shareholder approval may be needed for such amendments.
- Privately held companies that could become publicly traded should undergo a similar review prior to an IPO. The early feedback indicates that this review can be tedious for some companies. An executive will often be a party to an employment agreement, annual stock in-
centive agreements, a SERP, and change in control and severance agreements. Language that would disqualify performance based-pay is not always obvious on the surface, and may be hidden in a document that is separate from an award with performance-based vesting. For example, severance agreements that provide a multiple of “base salary and bonus” without regard to actual performance may violate the revenue ruling, even if the performance bonus award documents are otherwise compliant. For some companies to “fix” the problem, there may be time needed to negotiate and deliberate the appropriate modifications to the compensation agreements. Simply put, the transition period through the end of 2008 for correcting agreements may be less than ample time.

The January Ruling Prompted Request For Relief

Revenue Ruling 2008-13 is applicable to all taxpayers, but the change in the IRS position originated in a private ruling letter issued in January. According to public comments made by the IRS author, the revenue ruling project was initiated and put on a very fast track in response to a loud outcry from the executive compensation community. The January letter ruling eliminated the ability to rely on the 1999 and 2006 private rulings (discussed above), and companies were forced to re-examine prior tax positions, due to an accounting rule for uncertainty in tax positions. No matter that a company had in good faith interpreted 162(m) to permit parachute payments under the terms of their employment agreements. Simply put, the transition period through the end of 2008 for correcting agreements may be less than ample time.

A Change in Policy, Not a Regulatory Interpretation

The change to 162(m) seems to be a shift in policy rather than a reasoned interpretation of the language in the regulation. The ruling does not address the requirement that payment under the performance goal be “substantially uncertain” at the time the award is granted. In contrast, the analysis in the 1999 and 2006 rulings discussed above was that termination without cause or resignation for good reason, like death and disability, did not change the uncertainty of payment. This position was abandoned in the January private ruling letter ruling and the revenue ruling. In these, the IRS emphasized that payment must be based on achievement of performance goals to be deductible. Exceptions for termination without cause or for good reason do not diminish the uncertainty of payment, but those events can happen when an executive has performed poorly. In the IRS’s view, the 1999 and 2006 private rulings go against the policy that underlies § 162(m).

Meanwhile, down the street at the congressional hearing room . . .

At the time that the IRS was deliberating on its 162(m) ruling, the staff to the House Committee on Oversight and Government Reform was preparing a report chronicling compensation practices in the mortgage lending industry. The report was issued in conjunction with a March 8, 2008, hearing in which the committee heard testimony regarding executive pay practices. Angelo Mozilo, Stanley O’Neal and Charles Prince (i.e., the chief executive officers of Countrywide, Merrill Lynch, and Citigroup) were questioned regarding severance and other payments. According to the committee report, these three CEOs were paid $460 million between 2001 and 2006 when the mortgage business was booming. When the firms lost a combined $20 billion in the last six months of 2007, these gentlemen lost their positions but were entitled to handsome parachute payments under the terms of their employment agreements. O’Neal, for example, received over $160 million due, following a loss of more than $2 billion in one quarter. Poor performance at Merrill Lynch was apparently not grounds for “cause” termination.

The hearing itself generated little more than a single day of questioning down partisan lines. Nevertheless,
the policy enunciated in Revenue Ruling 2008-13 certainly picks up on the theme of the committee report. Presumably, the payments to O’Neal and Prince may not have been deductible under § 162(m) if Revenue Ruling 2008-13 had been in effect.28 Regardless of what Congress does to address executive pay issues, the IRS has now embraced the tax policy that executives should not be paid fabulous sums when performance is poor.

Politics and Say on Pay

In isolation, Revenue Ruling 2008-13 is no more than a minor technical ruling. Viewed in historical context, however, it is a symbol of the regulatory counter-trend to increasing executive pay. As noted below, Congress and the regulators have been scrutinizing executive pay practices with increasing frequency in recent years. There is even a prospect that executive pay will get some attention during the current presidential election season.29 All three leading candidates have blasted the current state of affairs. The Republican contender, Senator John McCain, has called the executive payouts at Bear Stearns and Countrywide “outrageous” and “unconscionable.” The pro-business senator repeated this criticism a few days later, saying “There is a backlash in America today against corporate greed.” While McCain urges the private sector to curb its appetite, one of the Democrats seeking party nomination, Senator Barack Obama, has come out in strong support of mandatory shareholder approval of executive pay, which has been dubbed “say on pay.”30

Congress has been considering say on pay legislation since last year.31 Whether or not Congress can manage to enact this legislation, many companies are already considering shareholder proposals and some are adopting say on pay policies.32 For example, after approval of an advisory proposal in 2007 by 50.18 percent, Verizon Communications adopted a policy permitting shareholder input on executive pay.33 Perhaps these voluntary moves are an attempt to preempt Congress, the IRS, the Securities and Exchange Commission and FASB from stepping further into the board room. As outlined below, executive pay issues have resulted in significant incursions in the last few years.

Constraint by Regulation and Prosecution

The following is a partial list of laws and regulatory actions taken to curb executive pay. In general, actions become more severe as the time line progresses:

- 1982 – Congress reacts to large change in control payments in some well-publicized transactions and adds §§ 280G and 4999 to the Internal Revenue Code to tax “golden parachutes.” The payments that raised the ire of Congress at that time are paltry by today’s standards. As a result, many executives are given golden parachute tax “gross up” payments to offset their tax.

- 1993 – Congress reacts to charges that executive pay is out of control, adding § 162(m) to the Internal Revenue Code to limit deductibility of compensation to $1 million for executive officers of publicly traded companies. Because of these new rules, most companies obtain shareholder approval to adopt plans that work around the restrictions by providing performance-based compensation.34

- 1996 – FASB adopts FAS No. 123 to required companies to expense stock option awards, superseding treatment under APB No. 25 that allowed companies to issue an unlimited number of stock options with no compensation charge. Proponents argued that accounting practice allowed executives to receive enormous equity awards with little accountability to shareholders. After much debate and political maneuvering, FAS No. 123 is reduced to a footnote disclosure.

- 2004 – § 409A is added to the Internal Revenue Code to substantially restrict deferred compensation practices for executives and add a 20 percent tax for violations. IRS regulations treat stock options as “deferred compensation” if the exercise price is less than 100 percent of fair market value on grant date. Deferred compensation payments to key executives are subject to 20 percent tax if paid within six months of separation from employment.

- 2005 – Wall Street Journal publishes analysis of University of Iowa professor Erik Lie on stock option practices suggesting companies engaged in backdating option grants to take advantage of lower historical market values.35 SEC begins investigating stock option practices at United HealthGroup in 2006, resulting in resignation of its CEO and a $468 million fine.36 SEC and DOJ undertake widespread investigation of backdating practices.37

- 2006 – FAS No. 123-R is adopted to replace APB No. 25 and impose recognition of compensation expense for all equity awards.

- 2007 – Proxy disclosure requirements for executive compensation are overhauled to include detailed information on pay practices, including total payments due

---


33 The SEC issued public correspondence to the accounting profession confirming its ongoing investigation and guidelines for the accounting profession in determining when backdating had taken place. Letter from Conrad Hewett, SEC Chief Accountant (Sept. 19, 2006) is available at http://www.sec.gov/info/accountants/staffletters/fei_aicpa01906.htm and in the Practice Aids section of the Library.
under hypothetical change in control, retirement, and similar events.38

■ 2007 – Gregory Reyes, former CEO of Brocade Communications, is convicted on multiple counts involving stock option backdating. Sentence is 21 months and $15 million.39

**Conclusion – The Past Is Not Prologue**

There is little doubt that executive pay practices will continue to receive rigorous scrutiny. In the not too distant past, executive pay received little attention beyond lip service. Compensation survey could be used to justify a CEO’s pay as long as it was in the top quartile of companies that were deemed to be similar. In that environment, board review could at times look like a rubber stamp when viewed in hindsight. The bar has definitely been raised and boards will be well-served to link compensation to performance.

The new standard for board conduct is enunciated in a 2005 decision of the Delaware Court of Chancery.40 The case involved a board-approved severance package for Michael Ovitz, who served as president of the Walt Disney Company for less than one year. The reason for his short tenure was that performance was less than stellar. Nonetheless, Ovitz walked out the door with a package worth $140 million. The court criticized the board’s apparent lack of deliberation and over-reliance on the recommendations of the company’s CEO, Michael Eisner. In this instance, the court let the board off the hook because, it concluded, its high-level approval process was typical for the times. The court gave hints that this case could have been decided differently and would have been if the situation occurred today. One passage in particular shows a recognition that a higher standard of conduct is needed: “[f]or the future, many lessons of what not to do can be learned from the defendants’ conduct. . . .”41

Many so-called “activist” shareholders have embraced the Disney decision and encouraged companies to embrace a compensation policy like that illustrated in Revenue Ruling 2008-13, i.e., that pay should be more clearly tied to performance.42 The State of Connecticut has taken up the causes of internal pay equity (the ratio of CEO pay to other executive pay) and compensation consultant independence (addressing potential conflicts when a consultant that advises the board also advises management on other nonexecutive compensation issues).43 RiskMetrics Group, formerly Institutional Shareholder Services (ISS), a firm that advises institutional shareholders like mutual fund companies on proxy voting, has been developing policies on executive pay and equity compensation for several years and has had a profound impact on corporate practices that went unnoticed a few years ago.44

Congress, the regulators, the judiciary, the accountants, shareholders and, even, prosecutors all have a keen eye on pay practices. Viewed in this context, it is hardly surprising that the IRS reversed course on its prior rulings and has set a new standard based on policy in Revenue Ruling 2008-13, i.e., that extraordinary compensation should be linked to actual performance.

41 Id. at 760.
42 For example, the California Public Employees Retirement System (CalPERS) has actively sought corporate change through a three-year “Executive Compensation Plan.” See http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200712/item08b-00.pdf The materials indicate that CalPERS has sought to work closely with Congress and the SEC in adopting policy changes.