December 31, 2009 Deadline Approaches for Amendments to Comply with Section 162(m) and to Correct Certain Section 409A Operational Failures

November 17, 2009

OVERVIEW

As discussed in greater detail in this memorandum, this memo is intended to alert our clients that December 31, 2009 is the deadline by which:

- publicly traded corporations must amend certain "good leaver" severance provisions in bonus plans, performance-based restricted stock and restricted stock unit awards[1], employment agreements and severance arrangements to comply with Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), unless the limited grandfather treatment discussed below continues to apply, and
- employers must act to correct, under the IRS's operational failures corrections program, certain operational failures that occurred before January 1, 2009 with respect to non-insider employees (but only if the deferred compensation arrangement under which the failure occurred is otherwise in documentary compliance with Code Section 409A).

CHANGE IN IRS POSITION AFFECTS PERFORMANCE-BASED COMPENSATION EXCEPTION TO $1 MILLION DEDUCTION LIMIT

Publicly traded companies should consider whether they need to amend the "good leaver" provisions contained in their executive compensation arrangements to comply with Code Section 162(m) before the upcoming December 31, 2009 deadline. Code Section 162(m) imposes a $1 million cap on tax deductions for compensation paid to a publicly traded corporation's principal executive officer and its three most highly compensated officers (other than the principal executive officer or principal financial officer) in any taxable year ("covered executives"). However, an exception to this limitation is available for "performance-based compensation," which is compensation that is paid under a shareholder-approved plan solely on account of the attainment of one or more pre-established performance goals set by a committee of the Board of Directors that satisfies the requirements of Code Section 162(m). Compensation is generally not considered "performance-based" if a covered executive would receive all or part of the compensation even if the applicable performance goals are not attained. The regulations issued under Code Section 162(m) provide that compensation does not fail to be

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1 Options and stock appreciation rights whose vesting is based on a performance goal other than an increase in stock price may also contain "good leaver" severance provisions that may need to be amended to comply with the requirements of Code Section 162(m).

"performance-based" merely because the plan provides for a payment on death, disability or a change in control of the company. Based on prior private letter rulings issued by the IRS, this exception was also understood to apply to plan provisions for payment on a termination without cause or a resignation for good reason.

However, in a reversal of its previous long-standing position, the IRS issued Revenue Ruling 2008-13 (the "Revenue Ruling"), which provides that a deduction for compensation payable to a covered executive that otherwise qualifies as performance-based compensation under Code Section 162(m) will be disallowed if any plan or agreement covering that executive provides for the possibility of payment, irrespective of actual performance, upon the covered executive's termination of employment without cause, resignation for good reason or voluntary retirement, even if the executive remains employed and ultimately earns the compensation based on actual performance. For example, if a covered executive, on a termination without cause, is entitled to receive a pro-rata portion of an annual bonus at the target level of performance, or accelerated vesting of a performance-based award regardless of performance, such bonus or award will not qualify as performance-based compensation even if the executive works the whole year and all the performance goals are achieved.

EXPIRATION OF TRANSITION RELIEF ON DECEMBER 31, 2009 FOR COMPLIANCE WITH REVENUE RULING

As transition relief, the Revenue Ruling provided that such "good leaver" payment rights would not disqualify an otherwise compliant performance-based compensation arrangement if (1) the performance award related to a performance period commencing on or before January 1, 2009 (the "Exempted Performance Period") or (2) the payment was made pursuant to an employment agreement that was in effect on February 21, 2008 (which does not include an agreement that was in effect on that date but has since been or will be subsequently amended or renewed for any reason) (the "Grandfathered Arrangements").

Due to the pending expiration, at year end, of the Exempted Performance Period described above, publicly traded companies should immediately review their employment agreements, severance and/or change of control agreements and arrangements, short- and long-term cash incentive plans, equity incentive plans and agreements and other performance-based awards to determine if such arrangements are and will remain Grandfathered Arrangements, or whether such arrangements need to be amended by December 31, 2009 to comply with the Revenue Ruling. An example of such a compliant amendment would be to provide that the amount of a pro-rata bonus due upon a termination without cause will be based upon the actual level of achievement of the applicable performance goals for the year of termination.

In addition, any new compensation arrangements being established or entered into on or after January 1, 2010 should be designed to ensure compliance with the Revenue Ruling.

CORRECTION OF CERTAIN OPERATIONAL FAILURES UNDER CODE SECTION 409A

Although December 31, 2008 was the deadline for bringing all deferred compensation plans and agreements into full documentary compliance with the regulations under Code Section 409A, there are still opportunities to correct or mitigate certain operational failures made under arrangements that are in documentary compliance with Code Section 409A. IRS Notice 2008-113 (the "Notice") sets forth the terms of the current corrections program, which provides relief from the adverse tax consequences imposed under Code Section 409A for certain unintentional operational failures involving plans, agreements and arrangements that constitute non-qualified deferred compensation under Code Section 409A. Without this relief, such inadvertent violations of Code Section 409A would: (1) require acceleration of the recognition of income tax to the year of the operational failure on all of the affected employee's deferred compensation amounts which are vested under the applicable deferred compensation arrangement, and all other deferred compensation arrangements that are aggregated with that arrangement under Code Section 409A, and (2) impose an additional 20% tax and retroactive interest at a premium rate on all such amounts.

Relief under the terms of the Notice is available for the following categories of operational failures:

1) Payment prior to the taxable year in which an amount of non-qualified deferred compensation was required to be paid;
2) Payment more than 30 days before the date in the taxable year in which non-qualified deferred compensation was required to be paid;
3) Deferral of compensation less than or in excess of the amount that should have been deferred;
4) Payment of non-qualified deferred compensation to a "specified employee" of a publicly traded entity within the six-month period following such employee's separation from service; and
5) Issuance of a discounted stock right (e.g., an option or stock appreciation right with an exercise price less than the fair market value of the underlying stock on the date of grant).

Generally, to be eligible for full relief, correction of the operational failure must be made in the manner specified by the Notice no later than the year following the year in which the operational failure occurred (a "Subsequent Taxable Year Correction"). However, if the employee is an "insider," correction may only be made before the end of the year in which the operational failure occurs. Generally, insiders are directors, officers and beneficial owners of more than 10% of any class of equity security of the employer.

SPECIAL TRANSITION RELIEF FOR OPERATIONAL FAILURES RELATING TO NON-INSIDER EMPLOYEES EXPIRES DECEMBER 31, 2009

The Notice contains a special transition rule that is available only for employees who were not insiders at any time during the employee's taxable year in which the failure occurred. Under the transition relief, for purposes of correcting an operational failure of the type described in clauses (1), (2), (3) or (4) above (but not (5)) that occurred on or before December 31, 2007, the employee's taxable year ending in 2009 will be treated as the taxable year next following the taxable year in which the failure occurred. Accordingly, an employer may correct before December 31, 2009 an error that occurred before January 1, 2008 and treat this correction as a Subsequent Taxable Year Correction (thereby allowing the non-insider employee to avoid the 20% additional tax otherwise imposed under Code Section 409A), if all the other necessary steps to correct an operational failure set forth in the Notice are satisfied.

In addition, employers who wish to make a regular Subsequent Taxable Year Correction for an operational failure occurring in 2008 with respect to non-insider employees will need to make the correction by December 31, 2009.

Note that the IRS corrections program discussed above only applies to operational failures under plans that are in documentary compliance with Code Section 409A. Although the IRS has announced that it intends to implement a documentary compliance program in the future, there is currently no program for correcting a failure to amend a non-qualified deferred compensation arrangement to comply with Code Section 409A on or before December 31, 2008. However, it may be possible to amend the terms of certain arrangements to comply with Section 409A if no amounts payable under such arrangement (and any arrangement aggregated with such arrangement) will have vested before the end of the year in which the amendment is made.

Finally, employers should be aware that the IRS has begun auditing compliance with Code Section 409A, thereby making ongoing monitoring of both operational and documentary compliance with Code Section 409A a priority for purposes of managing exposure to the risk of tax penalties.

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