October 29, 2004

**New Deferred Compensation Legislation**

**Corporate and Securities Law Issues for Companies Amending Compensation Plans and Arrangements**

On October 22, the President signed the American Jobs Creation Act of 2004, or "AJCA," which overhauls the federal income tax treatment of a wide variety of deferred compensation arrangements. The new provisions, which will become effective on January 1, 2005, will require companies to amend plans and arrangements containing deferred compensation features to bring them into compliance. If deferred compensation arrangements do not comply with the new provisions, affected participants will be required to include in their current gross income not only the amounts they sought to defer but also an additional interest amount plus 20% of their deferred compensation.

As defined in the AJCA, "deferred compensation" includes not just cash compensation that an executive or employee elects to defer, but also stock appreciation rights, phantom stock, restricted stock units, nonqualified stock options with deferral features and discounted nonqualified stock options. Since it has become increasingly common for stock option plans to include one or more of these features, the impact of the new legislation will be far-reaching. In addition, the legislation applies to supplemental retirement plans (or "SERPs"), certain severance plans and deferred compensation programs for outside directors and independent contractors. Finally, the legislation also applies to individual employment agreements that provide for post-termination payments.

In order to bring these arrangements into compliance, companies will have to amend existing plans and certain outstanding awards, as well as employment agreements that contain deferral provisions, to impose new restrictions on deferral elections, distribution options and the ability to accelerate or postpone payments.

This memorandum briefly analyzes the federal securities law and state corporate law implications of the AJCA's deferred compensation provisions.[1]

**Shareholder Approval**

Of immediate concern given the short lead time will be whether AJCA-mandated amendments will require shareholder approval. In the main, we do not think so but refer to the following factors for consideration.

- *<u>NYSE and Nasdaq Equity Compensation Plan Rules</u>*: Both New York Stock Exchange and Nasdaq Stock Market listing standards require shareholder approval of certain equity compensation plans and of material revisions to such plans. However, both of these self-regulatory organizations have previously issued guidance to the effect that changes to equity compensation plans do not constitute "material revisions," and therefore do not require shareholder approval, if the changes are adverse to the plan participants. We believe that amendments to equity compensation plans solely to comply with the AJCA would be adverse to

[1] For a more detailed analysis of the technical provisions of the AJCA relating to deferred compensation arrangements, see our Employee Benefits Client Alert dated October 12, 2004, which accompanies this memorandum.

the plan participants and thus would not require shareholder approval under relevant listing rules. We have confirmed this analysis informally with representatives of both the NYSE and Nasdaq.[2]

- *Section 162(m) of the Internal Revenue Code*: Section 162(m) of the Internal Revenue Code governs the deductibility of executive compensation in excess of $1 million and requires, among other things, shareholder approval of an executive compensation plan if the company will seek to deduct compensation in excess of that amount. If material terms of a plan or an outstanding award to an executive are amended, Section 162(m) could require shareholder approval. It is unlikely, however, that an amendment designed solely to adopt AJCA-mandated changes would constitute a material amendment requiring shareholder approval under Section 162(m).

- *Rule 16b-3 under the Exchange Act*: Although not frequently relied upon, one provision of Rule 16b-3 permits exclusion from the application of Section 16(b) short-swing profit rules for transactions in securities under equity compensation plans that received shareholder approval. The SEC staff has taken the position that certain material amendments to a plan that has previously received shareholder approval for Rule 16b-3 compliance purposes will also require separate shareholder approval. However, the SEC staff has also stated that shareholder approval of an amendment to such a plan is not required if the amendment does not materially increase the number of shares that may be awarded under the plan, materially increase the benefits accruing to participants under the plan or materially modify the requirements for eligibility for participation in the plan. Therefore, the amendments mandated by the AJCA should not require shareholder approval for purposes of Rule 16b-3.

- *Terms of the Plan; Board Resolutions; Charter and* Bylaws: The terms of an existing equity compensation plan or arrangement, or related board resolutions, may impose shareholder approval requirements for plan amendments. In addition, a company's charter or bylaws could also impose shareholder approval requirements for amendments to existing equity compensation plans.

**Board Approval and Participant Consent**

In general, we expect that board approval will be required for any amendment to an equity compensation plan. This will depend on the corporate law of a company's jurisdiction of incorporation, the terms of a company's charter and bylaws, and whether the initial board approval delegated authority to effect subsequent amendments. If board approval will be required (or appropriate), companies should carefully consider existing board schedules and plan accordingly.

Most plans provide that the participant must consent to any adverse change in an award that has already been granted. Companies might find it necessary to impose new restrictions on outstanding awards in order to bring them into compliance with the AJCA. Although it is likely that participants will readily consent to these changes (since the alternative is a material increase in their tax liability), companies should consider the need to obtain consent as part of compliance planning.

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[2] We understand that the NYSE intends in the near future to issue formal guidance that shareholder approval of AJCA-mandated amendments is not required.

SECURITIES

**Filing or Disclosure of Amended Benefit Plans and Arrangements in a Company's Exchange Act Reports**

Any material amendment of a material definitive agreement[3] must be disclosed by filing a Current Report on Form 8-K with the SEC. While Form 8-K does not define "material amendment," to the extent that any director or named executive officer (generally the CEO and the four highest-paid executive officers in any fiscal year) is a party to a plan or arrangement, we believe that the AJCA amendments would be deemed to be material. The amended plan is not required to be filed as an exhibit to the Form 8-K on which the amendment is reported. If the amended plan is not filed with Form 8-K, however, it must be filed as an exhibit to the company's Form 10-K or 10-Q for the period in which the amendment is adopted.

**Amendments to a Plan Prospectus or Registration Statement**

The amendments mandated by the AJCA should not require post-effective amendment of a registration statement on Form S-8 pursuant to which a compensation plan was initially registered. Instead, Securities Act Rule 428(b)(1)(i) requires that plan prospectuses be updated in a timely manner to reflect plan amendments.[4] While the updated prospectus must be delivered to each participant who is eligible to participate in the benefit plan, it need not be filed with the SEC.

**Employment Agreements**

Employment agreement provisions relating to post-termination payments, common particularly in senior executive employment agreements, are subject to the deferred compensation provisions of the AJCA. We recommend that companies carefully review all of their existing employment agreements (including any agreements with employees or officers who are not named executive officers) to determine whether these agreements also need to be amended to be brought into compliance with the deferred compensation provisions of the AJCA.[5]

**Financial Statement Amendments**

The amendments to equity compensation plans or arrangements required by the AJCA should not have any impact on a company's previously-reported financial results. However, it is possible that the amendments could affect disclosure contained in the notes to a company's (or plan's) financial statements describing the general terms of equity compensation plans. Companies might wish to inform their independent auditors of the nature of the proposed amendments to allow consideration of whether financial statement presentation may be affected.

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[3] A management contract or compensatory plan or arrangement in which any director or named executive officer (as defined in Item 402(a)(3) of Regulation S-K) participates is by definition a material definitive agreement. Any other management contract or compensatory plan or arrangement in which an executive officer participates constitutes a material definitive agreement unless immaterial in amount or significance. See Item 601(b)(10) of Regulation S-K.

[4] A company could provide the updating information by means of a "sticker" to the prospectus rather than reprinting the entire prospectus, unless delivering a sticker would obscure the readability of the plan information. See Securities Act Rule 428(b)(1)(iv).

[5] To the extent that an employment agreement with a named executive officer is amended, the amendment would be required to be reported by the filing of a Form 8-K.

SECURITIES

**Potential Two-Step Approach to Plan Amendments**

Although the new deferred compensation provisions become effective on January 1, 2005, the deadline for having full-blown amendments in place is likely to be postponed. The AJCA directs the Treasury Department to issue guidance on the new provisions by December 21, 2004. Treasury has indicated informally that its initial guidance will focus on transition issues and that it expects to publish more comprehensive regulations in 2005.

As part of the initial guidance, we expect that employers will be given until the end of 2005 to complete the amendment process for compliance with the AJCA. In the meantime, however, starting on January 1, 2005, employers will need to operate plans, arrangements and contracts in good-faith compliance with the AJCA. In many cases, employers will have to restrict election and distribution rights provided under existing documents in order to comply with the new statutory requirements. Companies that expect to postpone detailed AJCA amendments until 2005 should consider whether it is advisable to adopt a "placeholder" amendment before January 1 that describes the new restrictions in a general way.

A company would be well-advised to consider all of the issues reviewed above, including Form 8-K filings, both in connection with initial compliance measures, including placeholder amendments, as well as the full-blown AJCA amendments. Although the first step might not require extensive changes to written plans, arrangements or contracts, good-faith compliance with the AJCA, to be legally effective, will nonetheless constitute the kind of amendment that raises all of the issues summarized in this advisory.

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