



606 Issues in Employee Compensation

R. Scott Summers
Associate General Counsel
Wal-Mart

Darryl A. Weiss
General Counsel
TVA Fire and Life Safety, Inc.

Faculty Biographies

R. Scott Summers

R. Scott Summers is the associate general counsel of the employment practices division for Wal-Mart Stores, Inc. He provides legal support and counseling to the various human resource functions of Wal-Mart including areas such as policy, compensation, and benefits. Upon joining Wal-Mart, Mr. Summers became the assistant general counsel of employment litigation where he was responsible for the company's employment litigation in all 50 states. During his time at Wal-Mart, Mr. Summers also has served as the director of labor relations where he managed all aspects of the company's labor relations programs, including union avoidance campaigns.

Prior to joining Wal-Mart, Mr. Summers was chairman of the labor and employment section of the law firm Clark, Ward & Cave in Lexington, KY. His practice experience includes federal and state court litigation representing management in an entire range of employment law matters, particularly employment discrimination, wrongful discharge, union avoidance planning, collective bargaining, and arbitration proceedings. Mr. Summers also provided corporate counseling to employers on a wide variety of employment law issues.

Mr. Summers is a member of the Kentucky Bar Association, the ABA, ACC, and the General Counsel roundtable. Mr. Summers is widely published and has been a speaker throughout the country at scores of employment seminars on a wide range of substantive employment matters.

Mr. Summers received his B.A. from Eastern Kentucky and his J.D. from the University of Louisville, Brandies School of Law.

Darryl A. Weiss

Darryl A. Weiss is currently the general counsel, secretary, and vice president of human resources for TVA Fire and Life Safety in San Diego. TVA offers comprehensive fire protection, life safety, security, engineering, risk management, and loss control services to Fortune 500 companies. His responsibilities include providing legal counsel to the organization and board of directors, merger and acquisition, international law, executive compensation, and oversight of the general human resources function.

Prior to joining TVA, Mr. Weiss worked in the aerospace, computer, telecommunications, and biotechnology industries in a variety of legal and human resources roles. Mr. Weiss has worked on site in Canada, England, France, Germany, Hong Kong, Ireland, Japan, Malaysia, Netherlands, Singapore, Sweden, and Switzerland.

Mr. Weiss is currently on the board of directors of ACC's San Diego Chapter as well as ACC's International Law and Employment and Labor Law Committees.



Issues in Employee Compensation **Session 606**

Scott Summers
Darryl A. Weiss

ACC's 2005 Annual Meeting: Legal Underdog to Corporate
Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott
Wardman Park Hotel



Topics

- Elements of executive compensation
- International options
- Legislative impact

Executive Compensation

- Who is an executive?
- Concepts of executive pay
- Short term incentives
- Long term incentives
- Perquisites and supplemental benefits
- International issues



Who is an Executive?

- Corporate officers
- SEC “insiders”
 - BoD
 - Executive officers in policy making roles
- Have significant impact on the results of the enterprise
- Generally included in both annual and long-term incentive pay plans
- Whomever the company decides is an executive
 - Salary grade
 - Salary level



A word means exactly what I want it to mean and nothing else.

H. Dumpty
CEO Wonderland Enterprises



Our Founder



Concepts of Executive Pay

- Business enterprises have life cycles
- Where a company is in the cycle will impact the pay methodology
- Executive pay is shaped by the company's philosophy and culture



Four Cycles

- Threshold (start up)
 - Casual atmosphere, intuitive management, high risk, few products
- Growth
 - More complex management, slower decision processes, more procedures



Four Cycles (cont.)

- **Maturity**
 - Emphasize market share, more staff functions, committees, decisions slow, productivity stressed, low profit lines abandoned

- **Decline**
 - Decline in market for products, cost improvement critical, book value may exceed market value, focus on short term survival



Pay Emphasis by Market Stage*

<i>Compensation Element</i>	<i>Threshold</i>	<i>Growth</i>	<i>Maturity</i>	<i>Decline</i>
<i>Salary</i>	Low	Moderate	High	High
<i>Employee Benefits</i>	Low	Moderate	Moderate	Moderate
<i>Short Term Perquisites</i>	Low	Moderate	High	Moderate
<i>Long Term Perquisites</i>	High	High	Moderate	Low
<i>Perquisites</i>	Low	Low	Moderate	High



Impact on Individual Executives

<i>Compensation Element</i>	<i>Attract</i>	<i>Retain</i>	<i>Motivate</i>
<i>Salary</i>	High	Moderate	Low
<i>Employee Benefits</i>	Low	Low	Low
<i>Short Term Incentives</i>	High	Moderate	High
<i>Long Term Incentives</i>	High	High	Moderate
<i>Perquisites</i>	Low	Moderate	Low

What behavior are you trying to motivate regarding your strategy?



Company Pay Philosophy

- Company culture and Human Resource goals
- Labor market definition and pay relation to the market
- Short term versus long term
- Salary/bonus mix



Short Term Incentives

- Management incentive plan
 - Eligibility-key managers with impact
 - Performance measures
 - Support business objectives
 - Quantitative, financial, non-financial
 - Equal stretch
 - Not an entitlement

Management Incentive Plan (cont.)

- Size of awards
 - Significant, related to performance
 - Potential amount known by participants
- Award Determination
 - Formula rewards achievement and penalizes failure
 - Recognizes balance between individual and company performance



Management Incentive Plan (cont.)

- Form and Timing
 - Form
 - Cash
 - Stock
 - Both
 - Timing
 - Current
 - Deferred



Management Incentive Plan (cont.)

- Basis for setting goals
 - Historical performance
 - Look back
 - Current business plan
 - Look forward
 - Peer company comparison
 - Look around
 - Fixed formula
 - Look inside – shareholder protection



Long Term Incentives

- Stock Options
 - ISO
 - Nonqualified options
 - Restricted Stock
 - Performance shares
 - SARS
 - Phantom
- Deferred Compensation



Long Term Incentives

- Design Issues
 - Eligibility
 - Length of performance period
 - Size of award
 - Performance measures
 - Forfeiture provisions
 - Taxes, Taxes, Taxes



Perquisites and Supplemental Benefits

- Car
- Medical
- SERP
- Top hat
- Airline clubs
- Country clubs



International Issues

- Off shore funds
- Statutory benefits
 - Termination
 - Clubs
 - Meals
 - Cash
- Leave entitlements
- Number of months paid



American Jobs Creation Act of 2004

- 274 Amendments to the tax code
- 34 new code sections
 - Repeal of the Extraterritorial Income Exclusion (ETI)
 - Deduction for Domestic Manufacturing Activity (Manufacturers' Deduction)
 - Incentives to Repatriate Foreign Earnings
 - Continued Asset Depreciation Incentives
 - S Corporation Simplification and Reform
 - Enhanced Foreign Tax Credits
 - Tax Shelter Restrictions
 - Nonqualified Deferred Compensation Plan Restrictions
 - Deduction for State and Local Sales Taxes
 - Limitation on Charitable Contributions of Vehicles



IRS Code Section 409A

- Deferred Compensation Plan
 - Any agreement, arrangement or method under which compensation earned in one calendar year is paid in a later calendar year.
 - A deferred compensation plan can exist even if the plan does not have a formal written plan document and even if the agreement or arrangement is not called a “plan.”



Non Qualified Deferred Compensation

- Any deferred compensation plan that is not specifically excluded under Code Section 409A is an NQDC plan



Typical NQDC's

- Supplemental executive retirement plans (providing benefits in addition to benefits provided through the employer's regular pension plan).
- Supplemental executive savings plans (allowing an executive to defer compensation in addition to compensation the executive can defer under the employer's Code Section 401(k) plan).
- Stock option plans not subject to Code Section 422 and stock appreciation rights if the exercise price is less than the fair market value of the underlying stock on the date the option is granted.
- Phantom stock plans.
- Deferred compensation arrangements subject to Code Section 457(f) maintained by tax-exempt and governmental employers.
- Severance pay plans.
- Deferred compensation plans for non-employees (e.g., fee deferral arrangements for members of a corporation's board of directors).



Deferred Plans That Are NOT NDQC's

- Qualified retirement benefit plans that comply with Code Section 401(a) (including traditional pension plans, cash balance plans, profit sharing plans, money purchase plans and Code Section 401(k) plans).
- Tax-sheltered annuity plans subject to Code Section 403(a)
- Tax-sheltered annuity contracts subject to Code Section 403(b) purchased by employees of tax-exempt entities and public schools
- Deferred compensation plans subject to Code Section 457(b) maintained by tax-exempt and governmental employers
- Qualified governmental excess benefit arrangements subject to Code Section 415(m)
- Simplified employee pension plans subject to Code Section 408(k)
- Simple retirement accounts subject to Code Section 408(p)



Effects of §409A

- Prior to enactment the IRS took the position that any election by an employee to defer compensation must be made before the end of the calendar year prior to the calendar year in which the compensation would be earned
- 409A formalizes the IRS position with respect to an employee's regular compensation and requires that any election by an employee to defer compensation for services to be performed in one calendar year must be made before the end of the preceding calendar year
- Separate rules for performance based compensation



Newly Prohibited Deferral Elections

- 401(k) excess plans
- NQDC plans MUST:
 - Make an independent deferral election for the NQDC plan that satisfies the Code Section 409A timing and irrevocability requirements
 - The NQDC plan must also be amended to require participants to make these independent deferral elections



Funding Issues

- “Rabbi” Trust
 - NQDC plan cannot provide that any assets in a rabbi trust will become restricted to providing NQDC plan benefits and unreachable by the employer’s general creditors because of a change in the employer’s financial health
 - Prohibits any rabbi trust or any other vehicle that holds assets to fund NQDC plan benefits from being located outside of the United States
 - **Any NQDC plan benefits funded by assets held in a non-U.S. rabbi trust or other funding vehicle, or any NQDC plan benefits funded by assets transferred outside of the United States, immediately become taxable income to the NQDC plan participants**



Stock Option Gain and Restricted Stock Deferrals Prohibited

- Deferral elections must be solicited no later than the last day of the taxable year preceding the date the option or award was originally granted



Stock Appreciation Rights Taxed Upon Vesting

- Stock appreciation rights (“SARs”) may be classified as a form of deferred compensation
- an employee’s decision not to exercise a SAR immediately upon vesting would amount to an election to defer compensation in violation of the new legislation



Discounted Stock Options Treated as Deferred Compensation

- The new rules apply to below-market stock options and other similar section 83 arrangements
- The full value of the below-market stock option (and not merely the discount amount) would become taxable upon vesting



Certain Attempts to Protect Assets Prohibited

- Assets that are set aside in an offshore trust for the purposes of paying deferred compensation will become subject to immediate taxation when vested



Penalties

- Failure to report a transaction
 - \$10,000 for individuals
 - \$50,000 for business entities
- Failure to report a “listed transactions”
 - \$100,000 for individuals
 - \$200,000 for business entities
- Loss of deferral of the income