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Current Issues In Employee Benefits And Executive Compensation

The Editor interviews ***Richard S. Chargar,*** *Managing Partner of the Stamford office of Kelley Drye & Warren LLP, and the Chair of the Employee Benefits and Executive Compensation practice group, and* ***Victoria H. Zerjav,*** *a Partner in the same office and practice group.*

Mr. Chargar represents clients in all aspects of executive compensation. He has extensive experience advising on the employee benefits of mergers and acquisitions and on the implementation and administration of tax-qualified employee benefits plans. Highlights of Ms. Zerjav's experience include advising clients on deferred compensation, supplemental executive retirement plans, incentive plans and equity-based compensation (including securities laws issues) and employment and severance agreements.

Richard S. Chargar

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Editor: In 2012, the Department of Labor's Employee Benefits Security Administration ("EBSA") will require retirement plans to provide extensive disclosure of fees and expenses so participants can assess and compare the costs of investment options. What are the real implications for fiduciaries? Investment managers?

Chargar: The goal of the new participant fee disclosure requirements is to ensure that participants in self-directed individual account plans (e.g., 401(k) plans) have access to basic plan and investment information, including information about fees and expenses. The disclosure requirements are twofold: (i) Plan service providers (e.g., recordkeepers, investment advisors, etc.) must disclose to plan sponsors information about the services they provide and the fees they expect to receive for those services to enable plan sponsors to make informed decisions when selecting and monitoring service providers, and gather the information needed to make required disclosures to participants; (ii) Plan sponsors must provide participants with sufficient plan-related and investment-related information to make informed decisions.

Failure to satisfy the disclosure requirements can result in civil penalties for plan fiduciaries as well as excise taxes in the case of plan fiduciaries who are service providers. Disclosure is intended to help fiduciaries assess the reasonableness of their arrangements with service providers and potential conflicts of interest that may affect the service providers' performance.

The adoption of the new fee disclosure rules has heightened scrutiny of investment fees and administrative costs. Plan fiduciaries who do not act prudently in reviewing investment management and plan administration fees may be at risk for claims of breach of their fiduciary duties to the plan.

The new disclosure rules can be beneficial for investment managers who are able to provide low fees. Plan fiduciaries will have to keep in mind that lower rates do not equal better management. This will increase the burden for plan fiduciaries to be prudent in selecting investment managers, as cost is only one of the factors in assessment of an investment manager.

Editor: What are some strategies to reduce overall costs in benefit programs?

Zerjav: Some employers have moved to outsourcing benefits administration; other employers have brought plan administration in-house. It depends on the size of the company and the skill set of their employees that administer in-house. Companies that outsource plan administration need to be cautious and ensure their internal administrators are on top of things – it is all about processes, systems and data retention.

There also appears to be an increased use of PEOs, professional employment organizations, which could facilitate getting better medical and other benefit rates for smaller employers.

Editor: Are target areas emerging as a result of regulatory and legislative developments?

Zerjav: Employers are devoting more resources to data privacy and security, not just of health care data, as there is increasing legislation and regulation in these areas and increasing use of electronic forms of communication and third-party data retention. Much of the benefits process – from enrollment to claims processing – is performed electronically, so although there is anonymity within a company, there is a risk that employee data may be compromised.

Editor: What are the ongoing challenges posed by integration of PPACA with existing employee health plans?

Chargar: For many large companies, enhanced benefit coverage required by the PPACA is not an issue. But for many employers, especially smaller companies, who can't afford to provide enhanced benefits and seek continued grandfathered plan status, discerning when that status is lost can be challenging. Employers maintaining grandfathered plans that recognize that their plans will eventually lose their grandfathered status should begin to analyze the

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alternatives. Also, as long as they are retaining grandfathered status, any plan amendments must be carefully examined to determine whether the amendment will jeopardize grandfathered status and the extent to which provisions of the PPACA apply. It is also important to remember that there may be little advantage from retaining a plan's grandfathered status due to limitations on changing the scope and costs of coverage.

Retiree medical coverage promises to employees present challenges in integrating the PPACA rules relating to plan nondiscrimination requirements. Generally, employees entitled to retiree medical coverage under an employment agreement (versus collective bargaining agreement or historical arrangement) are highly compensated, complicating compliance with the agreement and health plan rules.

Editor: What are the major compliance issues arising from ongoing legislative and regulatory developments under PPACA?

Zerjav: All the noise about health plans and how it will affect coverage has employees focused on what the changes mean for them. Uncertainty about whether the law will be modified or repealed and the lack of final guidance has created an employee relations issue. When PPACA was enacted, everyone was in a rush to understand it. But guidance has come in pieces, which has made it challenging to make design changes and to determine the cost of coverage. Many plan administrators made decisions in 2010 as to what they would focus on; now it is a matter of implementation. Ideally, employers will be able to modify plans on an integrated basis so employees can be provided with consolidated, understandable explanations of the changes and their rights to coverage. It is confusing for participants, as well as plan administrators, when these changes happen after implementation of initial rules that are no longer compliant.

Editor: What are your thoughts on the current proxy season's results of the Dodd-Frank Wall Street Reform Consumer Protection Act Say-on-Pay requirements?

Zerjav: In a number of cases, companies that did not gain shareholder approval of the pay programs also received recommendations of a negative vote on pay from ISS. Overall, only a very small percentage of companies have failed to attain shareholder approval of pay. What is interesting is how the companies – both companies that "passed" and companies that did not – are responding to the shareholders' votes.

Companies are using additional filings to explain compensation programs to shareholders where ISS or other proxy advisers have recommended a negative vote on pay. Companies are also using executive summaries to explain their performance over the year – making the connection between pay and performance for the shareholder. Some companies are reaching out to large shareholders – before and after the vote – to explain their compensation program and to gain a better understanding of the shareholders' positions and why they hold those positions.

Editor: Are there emerging trends in executive compensation as a result of full implementation of the Say-on-Pay provision?

Chargar: There is a pre-vote trend towards adjusting compensation or removing compensation elements (in particular in renegotiated contracts) that proxy advisers, such as the ISS, disapprove. Undesirable forms of compensation include tax gross-ups, golden parachute and supplemental pensions and perquisites for former executives, to name a few. Consultants are focusing companies on pay-for-performance elements and making the relationship between pay and performance more transparent. The trend also seems to be towards longer-term performance-based compensation measures.

Editor: What procedural adjustments do you anticipate corporations will make for next season?

Zerjav: Companies should build on the process started this year by establishing or maintaining a dialogue with major shareholders. By understanding the positions of shareholders, management and board members can speak to shareholder concerns while educating shareholders on the company's policies and reasoning for the compensation programs. This issue should not be ignored until next proxy season. If appropriate, companies should engage proxy advisers in a conversation to see if the company's policies and programs differ from those preferred by the proxy advisers and why. Being armed with understanding will help companies to address the issues directly with shareholders through the proxy materials next year.

Editor: Will companies implement new compensation programs in response to this proxy voting season? What are the lessons for employers and executives?

Chargar: Companies are already implementing new programs. New legislation is expected regarding the relationship between compensation and company performance. Also, Dodd-Frank requires companies listed on a U.S. exchange to develop and implement a clawback policy applicable to current and former executive officers. Rules relating to clawback policies and officer and director hedging policies, which are also expected in the next year, are expected to address materiality standards for triggering a clawback and the mechanics of effecting the clawback. Companies will also need to address potential tax implications for employees affected by clawbacks.

Adjustments will be made to comply with new disclosure requirements, including forthcoming guidance. Adjustments made to compensation programs in response to proxy votes this year should be made by boards – not by shareholder popularity – because the board has a fiduciary duty to exercise its business judgment. At least for now, the "business judgment rule" remains alive and well.

This is one lesson for employers and executives alike – the shareholders are still not the ones making these decisions and are not liable to other shareholders for improper decisions. Board members, who were elected by the shareholders, are expected to apply their judgment to the compensation arrangements, and that judgment should not be unduly influenced by advisers who may not have (i) explained the basis for their critique, (ii) disclosed their conflicts of interest, (iii) properly analyzed the compensation program or (iv) understood the underlying business drivers. This is not intended to diminish the important message that shareholders are delivering when they do not support pay programs – this is why a dialogue is so important. The message to boards is this: Go forth cautiously but confidently and do what you were engaged to do.

Editor: Will companies focus on "marketing" their compensation strategies to their voting shareholders?

Zerjav: Companies with the resources and time will likely market their compensation strategies to shareholders. Marketing may not be practical with smaller shareholders, however. Some consultants recommend campaigns designed to proactively inform shareholders by presenting easy to understand summaries and explanations of executive pay on the company's website, among other popular media-based promotions. This practice would appear to create more of the desirable transparency, but must be done cautiously so as not to mislead or overwhelm investors.