

October 11, 2005

12 Action Steps on Deferred Compensation Regulations

On September 29, Treasury and IRS released long-awaited proposed regulations under Code section 409A. The regulations provide guidance on the scope of section 409A, as well as the rules for deferral elections and distributions under plans subject to section 409A. Significantly, the proposed regulations also extend much of the transition relief for section 409A compliance an additional 12 months, to December 31, 2006. We attach a summary of the key new guidance in the regulations, and describe below steps that employers should take soon.

1. Identify Affected Plans – In addition to typical elective deferral plans and defined benefit plans ("SERPs"), the regulations make clear that section 409A affects various equity compensation awards, severance arrangements, post-retirement reimbursements and other arrangements that have not generally been considered deferred compensation plans. However, many arrangements, including short-term bonuses and long-term incentive plans, may be excluded from coverage under the regulations' short-term deferral exception.

2. Actions Required by End of 2005 – Employers that utilize the transition relief in IRS Notice 2005-1 to take any of the following actions in 2005 will need to document the action (e.g., amendments, Board resolutions, election forms) in 2005:

- Allowing participants to make new 2005 deferral elections by March 15, 2005;
- Allowing participants to cancel or revoke deferral elections;
- Terminating an individual's participation in a plan and distributing the amounts subject to 409A by the end of 2005; or
- Terminating a grandfathered plan and distributing all benefits by the end of 2005.

3. Consider Securities Law Issues for Public Companies – The establishment or material amendment of a deferred compensation plan by a public company will generally need to be reported to the SEC on a Form 8-K within four business days. The new plan or amendment will typically need to be included with the next Form 10-Q or Form 10-K filed by the company. The NYSE and NASDAQ corporate governance rules and shareholder approval requirements (for plans that provide for the distribution of employer securities to participants) should also be considered.

4. Identify Key Employees – Publicly traded companies could use transition relief under Notice 2005-1 (specifically, the participation termination provision) to avoid compliance with the six-month delay on payments to key employees who terminated in 2005. However, publicly traded companies will need to know who their key employees are in 2006 so that they can comply with the six-month rule. The proposed regulations provide guidance on identifying key employees and other aspects of the six-month rule.

5. Avoid Material Modifications – While the regulations provide further clarification about what constitutes a material modification and some relief for inadvertent "material modifications," employers should continue to avoid any such modifications which could destroy the grandfathered status of a plan.

6. Determine Necessary Changes to Affected Plans – An employer will need to determine the changes to deferral election and distribution rules that the regulations require for its existing plans. The regulations limit options in some areas, but offer flexibility in others. Employers should also consider whether to amend plans so that they may fit within the short-term deferral exception or another exception from coverage under section 409A (e.g., limit maximum severance payments to total of \$420,000, as adjusted).

7. Change Election Forms and Employee Communications – Deferral election forms and other materials provided to employees at the end of 2005 should be revised to reflect relevant changes to the plan.

8. Consider Impact on Equity Compensation Awards – An employer will need to consider the impact of section 409A on its equity compensation practices. Revisions may be necessary to equity awards to ensure that they are exempt from section 409A. Provisions that allow deferral of equity awards will need to be carefully analyzed.

9. Consider Contractual Restraints on Amendments – Because deferred compensation plans are typically exempt from most substantive requirements of ERISA, they are analyzed as contracts between the employer and plan participants. Thus, an employer should consider contractual restraints on its ability to amend an existing plan (e.g., to remove distribution rights), particularly with respect to vested deferred amounts.

10. Consider Ability to Reduce or Eliminate Liabilities – If a plan or arrangement provides an employer with clear authority to reduce or eliminate benefits, the employer should consider how the plan or arrangement will be treated under section 409A and the impact of a decision to reduce or eliminate benefits.

11. Amend Plan Documents – An employer's Board of Directors (or a committee) will need to approve plan changes required for section 409A compliance by the end of 2006.

12. Review Service Provider Agreements – An employer should review service provider agreements (e.g., rabbi trust or recordkeeping agreements) for any changes required for section 409A compliance, including reporting requirements, or as necessary to reflect new plan terms and procedures.

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Please call one of the following, or the firm attorney you regularly contact, if you have any questions about the new regulations or their impact on your executive compensation arrangements.

Liz Dold..... (202) 861-5406
Lou Mazawey (202) 861-6608
John McGuinness (202) 861-6625
David Powell..... (202) 861-6600
Chuck Sherman..... (202) 861-6631
Bill Sweetnam (202) 861-5427
Brigen Winters (202) 861-6618