COMPENSATING EXECUTIVES

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Introduction

In addition to the oft-stated goal of maximizing shareholder value, in return for their efforts, corporate executives wish to obtain life's luxuries and provide for their families and their futures. In the new "e-commerce" world, the current trend of abandoning high-salaried stable executive positions with "old economy" companies for high risk/high reward equity-based opportunities with "new economy" companies has resulted in somewhat of an upheaval in the executive market. The pedestrian pension plan arrangement has been superseded by more glamorous stock option and restricted stock plans.

Where a compensation program provides incentive for an executive to produce a desired corporate result, or aligns the executive's financial interests with those of the employer's shareholders, such an approach, if successful, should well serve all of the interested parties.

Consequently, a well-structured executive compensation package, which may consist of one or more of an employment agreement, a change-of-control agreement, equity-based and short and long-term non-equity-based arrangements, a non-qualified retirement plan and/or an elective deferred compensation plan, can be expected to benefit the executive, the employer and the employer's shareholders.

Obtaining the Talent

It is interesting that executives often demand employment agreements with their new employers. Ironically, the primary benefit to the executive of receiving an employment agreement is the memorialization of the consequences should the executive's employment terminate under various scenarios, which could be similarly accomplished through the use of a much briefer, less detailed severance agreement. In fact, many if not most of the provisions contained in a well-crafted employment agreement will typically benefit the employer rather than the executive.

For example, the "quid pro quo" for the receipt of a severance benefit is typically the release by the executive of all claims against the employer and/or a series of restrictive covenants undertaken by the executive, *e.g.,* not to compete with the employer or solicit its employees to leave. The typical employment agreement does not truly provide job security, tenure or any notion of guaranteed employment, as both the employer and the executive are free to terminate the agreement, albeit under certain circumstances payment obligations will apply (*i.e.,* the severance issue again).

Often, where an individual's services are needed by a company, an employment relationship may not be desired or perhaps is not yet currently available or workable. Under such circumstances, a written consulting agreement should be implemented. Not only will such an agreement document the terms of the consulting engagement, it will also play an important role in evidencing the intent of the parties that an employer-employee relationship is not contemplated.

For Federal income tax and withholding purposes, this (employee versus independent contractor) is a critical distinction. Further, from an employment law perspective, it is necessary to establish the non-applicability of a company's employee benefits and policies to its non-employee consultants.

Employment Agreements

In general, the most critical aspects of an employment agreement are its term, its provisions relating to severance and any restrictive covenants contained therein.

Term

There are two basic approaches to establishing the term of an employment agreement, the "evergreen" approach and the non-"evergreen" approach.

Under a non-evergreen approach, the agreement would set forth a predetermined term, typically for 1, 2, 3 or occasionally 5 years (generally, the more senior executives will receive the greater term). As the end of the term approaches, the parties would need to renew and/or renegotiate. This creates uncertainty for the executive as the expiration of the term approaches.

The alternative approach, an evergreen arrangement, typically contemplates an initial period, *e.g.*, 3 years, where, if at least X days (60, 90 and 180 days are the most prevalent options) prior to the end of that initial period, the employer has not notified the executive that it will not renew the agreement upon the expiration of its then 3-year term, the term of the agreement would automatically be extended, typically for an additional 1-year period. Consequently, as of the commencement of the extension period, the term of the agreement would now be 1 year, with subsequent 1-year evergreen extensions to continue to be applicable at the end of each then 1-year term, unless the required employer notice is provided. (Occasionally the extension period is longer than 1 year, *e.g.*, for 2 or 3 years or even for the same number of years as the original term.)

For example, an evergreen agreement might provide for an initial 3-year term from January 1, 2010 through December 31, 2012; however, if notice of nonextension was not provided by the employer to the executive by October 31, 2012, the agreement would automatically be extended for the period January 1, 2013 through December 31, 2013. If notice of nonextension was not provided by October 31, 2013, the agreement would automatically be extended for the period January 1, 2014 through December 31, 2014. As discussed below, the term of the agreement is often controlling as to the amount of the executive's severance benefit.

Severance

The two fundamental issues regarding severance to be addressed in an employment agreement are the circumstances under which severance benefits will be provided, and the amount and nature thereof.

Typically, severance benefits will be provided if the executive is involuntarily terminated by the employer other than for "cause." "Cause" standards will vary somewhat from company to company (and industry to industry); however, they frequently focus on willful acts of bad faith, drug or alcohol use and criminal activities, rather than merely on poor performance. Occasionally, severance benefits will be triggered by the employer's determination to not renew or extend the agreement itself.

An often critical consideration is to carve out a termination in the context of a sale of the executive's division under circumstances where the executive's title, compensation, employee benefits, authorities and responsibilities remain intact for the most part (*i.e.,* where the executive's job has not changed but the identity of the executive's employer has changed).

Often, employment agreements will add an additional layer of protection for the executive whereby severance benefits would be payable under circumstances where the executive resigns for "good reason" rather than actually being terminated by the employer (*i.e.*, a "constructive termination"). Without a "good reason" provision in the executive's employment agreement, if the employer wished to rid itself of the executive without incurring a severance obligation, it could likely do so by making the executive's life sufficiently miserable for the executive to have little or no choice but to resign (*e.g.*, by reducing the executive's compensation, duties and/or authorities or by moving the

executive's job location). A well-crafted "good reason" provision offers the executive protection against such a "constructive termination" scenario by entitling the executive to the same severance benefits as if the executive had in fact been involuntarily terminated by the employer.

As to the level of benefits to be provided, there are 2 major trends - the "formula" approach and the "benefit of the bargain" approach.

Under a "formula" approach, the severance benefit is essentially a penalty for early termination without "cause." The formula utilized could be anything from a flat dollar amount to a more complex approach, such as 6 months' base salary, 50% of the executive's "target" bonus opportunity and 6 months of continuing medical, life and long-term disability coverage. The decision of the level of severance benefit to be provided is a matter of negotiation and market standards.

Under the "benefit of the bargain" approach, the applicable concept is "income replacement" rather than penalty. Under this approach, the severance benefit is the base salary, bonus and employee welfare benefits (and often, nonqualified pension benefits, although this treatment cannot be provided with respect to tax-qualified retirement plan benefits – a cash payment or payments may be used where this is the case) the executive would have received for the remaining term of the employment agreement had the executive's employment not been terminated prior to the end thereof.

As mentioned above, under the "benefit of the bargain approach," the remaining "term" of the agreement will be controlling as to the level of severance benefits to be provided. Utilizing the example discussed above, a "3+1 evergreen" term commencing on January 1, 2010 with an October 31 notice deadline, for severance purposes, the remaining "term" would be as follows:

If Notice of Termination Provided:	"Term" Ends:
January 1, 2010 - October 31, 2012	December 31, 2012
November 1, 2012 - October 31, 2013	December 31, 2013
November 1, 2013 - October 31, 2014	December 31, 2014

Under a "formula" approach the same severance amount would be payable at the beginning of the term as would be payable near the end of the term. Therefore, such an arrangement, in comparison to the "benefit of the bargain" approach, becomes more executive-favorable with the passage of time, and conversely, the "benefit of the bargain" approach becomes more employer-favorable.

For example, if the executive in the above illustration was terminated on October 31, 2012, the executive would only be entitled to a 2-month severance benefit. For this reason, a combination of these approaches may be the most equitable formulation, whereby, for example, the "benefit of the bargain" approach would be utilized, but subject to a minimum severance amount, such as 6 months of base salary, bonus and continued welfare benefits.

Obtaining the Talent

An often important issue is the determination of the appropriate "bonus" amount for purposes of the severance calculation. Typical alternatives include the executive's "target" bonus (if one has been established) for the year in which the executive's termination occurs, the last bonus paid to the executive by the employer as of the date of the executive's termination, or an average of the last 2 or 3 bonuses paid to the executive by the employer as of the date of the executive's termination. (Where no bonus has yet been paid, a dollar amount or percentage of base is salary is often utilized for this purpose.)

Another noteworthy issue is whether part or all of the severance benefit is to be paid in installments (and the timing of such payments) or entirely in a lump sum. Presumably, the executive would prefer to be paid entirely up front, both for "comfort" purposes and to permit the executive to immediately invest the entire amount. Conversely, for cash flow reasons, the employer would prefer to defer payments to the maximum extent possible. Further, holding back some portion of the severance benefit can serve as an incentive for the executive to continue to comply with any post-termination covenant obligations such as a noncompete. A typical interim position is to pay the salary continuation portion at the same times as the executive's base salary would have been paid had the termination not occurred, and to pay the bonus portion at the same time and in the same form (*i.e.,* lump sum or installments) as the executive's bonus would have been paid had the termination not occurred.

If installments are utilized, another important consideration is whether or not continued payment of the severance benefit is to be impacted by the executive's securing new employment following termination. If the severance benefit is viewed as a "penalty" for early dismissal without "cause," then the executive's new employment should be irrelevant. However, if the severance benefit is viewed as "income replacement," if the executive secures new employment for the same or greater compensation, perhaps the benefit should be cut off or subject to offset when the new employment commences.

For example, if the severance benefit is the continuation of the executive's $20,000 monthly salary for the remainder of, *e.g.,* a 12-month term, if, after 6 months of $20,000 payments, the executive begins new employment at $15,000 per month, the remaining 6 months of payments might be reduced to $5,000 per month.

Section 409A and Severance

Section 409A of the Internal Revenue Code provides a myriad of special rules which apply to any "plan," "agreement," or "arrangement" that provides for the deferral of compensation, even from one year to the next (other than tax-qualified plans and tax-deferred annuities, IRAs, SEPs, SIMPLEs, 457(b) plans, and plans providing for vacation, sick leave, disability, compensatory time, and death payments). The hallmark of the Section 409A requirements are the requirements for specificity as to the triggering event (only certain payment triggers are permitted, *e.g*., separation from service) and the timing of the payment of the deferred compensation. Section 409A is not limited to elective non-qualified deferred compensation arrangements but also applies to nonelective supplemental executive retirement plans (SERPs), bonus plans, employment

and consulting agreements, incentive plans, equity plans and other arrangements that provide for deferred payments. Arrangements for employees, directors and independent contractors (unless the independent contractor is providing substantial services to more than one unrelated employer) are subject to Section 409A. Independent contractors providing no more than 70% of their services (other than management services) to a single employer group are not subject to Section 409A. Failure to satisfy applicable Section 409A requirements can result in income acceleration, a 20% penalty and interest to the service provider.

Section 409A is not intended to apply to bonus plans or other compensation arrangements where compensation is paid within two and a half months after the close of the later of the taxable year of the employee or the employer in which the right to the compensation first becomes earned and vested (the "Short-Term Deferral Period"). To the extent a compensation arrangement provides for payments beyond this period, it will be subject to Section 409A. (Even where the arrangement does not specify the timing of the payments and payments are in fact made within the Short-Term Deferral Period, the payments will not be treated as deferred compensation subject to Section 409A.) The Short-Term Deferral Period commences upon the "vesting" of the right to the payment. Vesting occurs when a payment is no longer subject to a "substantial risk of forfeiture." For this purpose, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For this purpose, an amount is not subject to a substantial risk of forfeiture under Section 409A merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. Therefore, non-competes do not constitute a substantial risk of forfeiture for purposes of Section 409A.

As to severance, Section 409A has two primary impacts. The first is that if the severance is paid entirely within the Short-Term Deferral Period, none if it will be subject to Section 409A, *e.g.*, where payable in a lump sum immediately or shortly following termination, and any payable after the end of the Short-Term Deferral Period will, subject to any other applicable exception, be subject to Section 409A. The timing of the termination entitling the executive to the severance payment(s) may result in a relatively brief (75 days) or quite extended Short-Term Deferral Period, *e.g.*, if the termination occurs on December 31, the Short-Term Deferral Period could end as soon as the following March 15th (2-½ months), whereas if the termination occurs on January 1, that entire year plus January 1 through March 15 of the following year (14-½ months) would fall within the Short-Term Deferral Period.

The second applies to "specified employees" (in general, the highest-paid 50 officers having annual compensation in excess of $145,000 – as adjusted) of public companies (where a company's or its parent's stock is traded on an established securities market, even where the parent company is a foreign company) who, for purposes of receiving payments in connection with their termination, are required to experience a 6-month delay for the receipt of those payments (or before those payments can begin, if payable in installments). The good news is that any payments to be made during the Short-Term Deferral Period will be exempt from the delay requirement. Further good news is an

additional exception known as the "two times rule" permits an amount equal to the lesser of two times the specified employee's total prior year compensation or two times the tax-qualified plan compensation limit for the year of termination (currently, 2 x $245,000 or $490,000) to be paid without being subject to Section 409A. Even better, the Short-Term Deferral Period exception and the two times rule can be used in tandem. The bad news is that the termination must be "involuntary" for either exception to apply, which can implicate certain "good reason" terminations (the IRS has provided a "good reason" safe harbor (*i.e.*, if the safe harbor standard is used the "good reason" resignation will be treated as an "involuntary termination" for these purposes) which, if utilized, should address this concern).

Restrictive Covenants

Under general legal principles, employees have a duty of loyalty to their employers. Executives (*i.e.,* corporate officers), due to their level of fiduciary responsibility to their employers, have an even greater duty of loyalty. Therefore, subject to the intricacies of the differing laws of the various states, executives cannot solicit their employers' customers or co-workers or appropriate their employers' property (including intangible property such as their intellectual property).

However, other than with respect to patent-protected inventions, "trade secrets" and "confidential information," many of these restrictions are cut off upon the executive's termination of employment. Consequently, a contractual undertaking will generally be required to extend such restrictions to the post-termination period (and will always be required for purposes of a post-termination noncompete). Further, most employers prefer the additional comfort of a written set of restrictive covenants which have been acknowledged or agreed to in writing by the executive, rather than merely relying on the requirements imposed by applicable law.

It is critical to recognize that the laws regarding the existence and the enforceability of the various types of restrictive covenants in employment agreements differ from state to state. For example, in connection with noncompete agreements, there appear to be at least the following four different approaches currently in effect under state laws:

1. In certain states, the covenant either stands or falls by itself;
2. In certain states, judges are empowered to modify "unreasonable" covenants into "reasonable" ones;
3. In certain states, "reasonableness" is to be used as a criterion for ordering partial enforcement; and
4. In certain states, "partial enforcement" rules apply.

California law is especially noteworthy in that it invalidates any agreement which would (i) prohibit an individual from fairly competing with his or her former employer after termination of employment, or (ii) penalize a former employee for doing so. The necessary lesson is to be sure to review all applicable state laws in fashioning restrictive covenants for use in employment agreements.

Obtaining the Talent

With regard to noncompete covenants, satisfaction of the standard of "reasonableless" is paramount. In other words, to be enforceable, a noncompete must be "reasonable" as to:

1. The needs of the former employer;
2. The hardship it places on the covenanting individual; and
3. Its effect on the public.

To be reasonable as to the needs of the former employer and therefore enforceable, a noncompete must serve a "legitimate interest" which is deserving of protection. The determination of whether such a legitimate interest would be served by the utilization of a noncompete is a function of the employer's business and the employee's role therein.

The case law has traditionally taken the position that preventing "ordinary competition" is not a sufficient "legitimate interest;" rather, the need for the protection afforded by a noncompete is generally limited solely to the following:

1. Protection of trade secrets;
2. Protection of customer good will;
3. Where the employee's services are special, unique or extraordinary; or
4. To protect an extraordinary investment in the employee's training and education.

To be reasonable as to the needs of the covenanting individual, the analysis turns upon whether or not the individual would be able to earn a living if the restriction were to be enforced. The bases for this analysis are generally the reasonableness of:

1. The duration of the noncompete;
2. The geographic area to which the noncompete applies; and
3. The limitation on the individual's activities.

To be reasonable as to the noncompete's effect on the public, it must not contravene public policy. Would the public interest be best served by enforcing the public policy of "freedom of contract" or of an individual's right to earn a living? Clearly, the public interest would not be served if the end result was to cause an individual to become a public charge. The "public interest" analysis is generally not applied by courts; rather, typically, the enforceability decision is attained by balancing the needs of the employer's claim for protection against the burden imposed on the individual.

With regard to nondisclosure covenants, they may only be used to protect the trade secrets and/or confidential information of the employer. Whether or not a trade secret exists is a factual matter; therefore, courts will examine the conduct of the parties to determine whether or not a trade secret exists as well as the nature of the alleged secret. Typically, more than a mere intent to keep something a secret will be required by a court

for it to conclude that a trade secret exists. Consequently, courts will consider both the steps which have or have not been taken by the employer to protect its alleged secret.

Activities that have been found to be significant in this regard as part of a court's review of an employer's internal security measures are as follows:

1. Having employees working with confidential materials enter into nondisclosure agreements with the employer;
2. Advising employees of the confidential nature of the product on which they are working;
3. Restricting dissemination of confidential material solely on a "need to know" basis;
4. Physically securing buildings, equipment, etc.;
5. Describing in detail to each employee the scope of the job and the scope of access they are to have within the system;
6. Placing proprietary notices on important documents;
7. Securing the premises so that trade secret material is separated by locked doors from the general employee population;
8. Establishing and utilizing security audit measures;
9. Keeping track of the numbers of copies made;
10. Establishing a standard by which employees identify their work products;
11. Assigning specific individuals and departments explicit ownership, custody accountability and usage rights to certain types of information;
12. Establishing a method of destroying documents before discarding them;
13. Requiring that all materials containing trade secrets or confidential materials be locked up after work hours;
14. Changing locks to doors, file cabinets, etc., on a semi-regular schedule;
15. Establishing a review panel for all outside advertising and publications; and
16. Establishing a procedure to recover documents supplied to outsiders.

An important issue is whether or not customer lists are protectable as trade secrets. As a general rule they are not, especially if they are readily identifiable in the professional and telephone directories or are otherwise easily discoverable, the information taken is based upon casual memory or the client had a family or personal relationship with the former employer.

To obtain the desired protection, the employer will be required to demonstrate that (i) the former employee took additional protectable information, (ii) but for the employment, the

employee would not have known of the client or (iii) the customer relationship was akin to being "permanent."

Remedies

A court will enforce restrictive covenants by the use of any appropriate and effective remedy. It is well-settled that injunctive relief is the typical and "favored" remedy to enforce compliance with a restrictive covenant contained in an employment agreement, because monetary damages for breach of restrictive covenants are often difficult to ascertain. Parties to an employment agreement often utilize restrictive covenants that include a "liquidated damages" clause. Liquidated damages provide certainty as to the value of a contract in the event of a breach.

Without such clauses, parties may expend significant resources attempting to prove actual damages. Where such damages are speculative, recovery may be difficult or impossible, absent a liquidated damages clause. The difficulty with liquidated damages clauses, however, is that courts will generally hold them invalid unless (i) the damages for breach are not readily ascertainable at the time of contracting, (ii) the damages provision is not disproportionate with the probable injury likely to result from the breach and (iii) the contract does not provide for other remedies in addition to the liquidated damages. Injunctive relief, however, may still be available notwithstanding a liquidated damages clause.

A further reason underlying the use of injunctive relief is the immediacy with which the relief, if any, can be implemented. A party may choose to file a breach of contract claim against the party against whom the restrictive covenant is sought to be enforced; however, that action may take many months if not years to wind its way through the court system.

Injunctive relief, on the other hand, may be obtained in a matter of hours or days. For an injunction to be issued, a party must present evidence of immediate, irreparable harm and the likelihood of success on the merits of the claim. If an injunction is issued, generally a bond will be required of the party seeking to enforce the restrictive covenant. In some states, the bond is not subject to waiver even where the contract containing the restrictive covenant contains a provision waiving the requirement of an injunction bond or limiting the amount of such a bond.

Consulting Agreements

Often a company will locate an individual who possesses certain skills needed by the company; however, for one or more of numerous possible reasons, the company, the individual or both do not wish to establish an employer-employee relationship. In light of the substantial income and payroll tax issues, employment law concerns and employee benefits issues, the utilization of a written consulting agreement can be beneficial to both parties.

Employers are required to withhold income and payroll taxes from the compensation they pay to their employees (many tax withholding statutes impose secondary liability for

failure to withhold sufficient amounts upon the party having the withholding obligation). In addition, employers are obligated to pay certain statutorily-mandated amounts on behalf of their employees, *e.g.*, Social Security and unemployment taxes. Conversely, employers are not subject to such obligations and expenses with respect to the services provided by and the remuneration they pay to non-employee consultants. Therefore, an inadvertent misclassification of an individual's status as an employee or independent contractor can be a substantial tax issue.

Another critical element is the individual's entitlement (or lack of entitlement) to participate in the employee benefit plans maintained by the employer for its employees. Historically, some companies concluded that while they were able to afford the salaries of employees or new groups of employees, they were not financially willing (or able) to incur the additional expense of providing them with employee benefits as well. In an attempt to achieve significant cost savings in connection with their workforces, these employers simply classified such individuals as "consultants" or "independent contractors."

Modern courts have rejected this approach and have required such companies to provide benefits to all of their employees, regardless of any attempted characterization of them as something other than "employees." Finally, it should be noted that, absent written agreement otherwise, independent contractors will neither be subject to the engaging company's employment policies and practices nor entitled to the protections under federal and state law applicable to true "employees."

The Internal Revenue Service has promulgated a list of the 20 factors it considers in determining whether sufficient control exists to establish the existence of an employer-employee relationship. The IRS' list, as set forth below, is utilized by most experts as the basis for analyzing the status of a particular individual as an "employee" or "independent contractor":

1. A worker who is required to comply with another person's instructions about when, where, and how to work is generally an employee. This factor is present if a company has the right to require compliance with instructions.
2. A worker who is trained by the employer is generally an employee.
3. A worker whose services are integrated into a company's operations is likely subject to the company's direction and control and is generally considered an employee.
4. A worker whose services must be rendered personally, or whose work is non-delegable, is generally an employee.
5. A worker who has support staff hired, supervised and paid to assist him or her is generally an employee.
6. A worker involved in a continuing relationship with a company is generally an employee.

7. A worker whose hours of work are set by the company is generally an employee.
8. A worker who is required to work full-time is subject to the company's control and is generally an employee.
9. A worker who is required to perform work on the employer's premises is generally an employee.
10. A worker who is required to perform services in the order or sequence set by the company is generally an employee.
11. A worker who is required to submit regular oral or written reports is generally an employee.
12. A worker who is paid by the hour, week or month is generally an employee. A worker who is paid by the job or on a straight commission is generally an independent contractor.
13. A worker whose business and/or traveling expenses are paid is generally an employee.
14. A worker who is provided tools, materials and equipment is generally an employee.
15. A worker's lack of investment in facilities necessary to perform services indicates an employment relationship. If a worker invests in facilities that are used by the worker in performing services and that are not typically maintained by employees, this factor indicates an independent contractor.
16. A worker who cannot realize a profit or loss as a result of his or her services is generally considered an employee.
17. A worker who performs services for only one company is generally considered an employee. Even if a worker performs services for more than one company, the worker may be an employee of each company if the companies are part of the same industry or service.
18. A worker whose services are not available to the general public on a regular and consistent basis is generally an employee.
19. A company's right to terminate a worker indicates an employee relationship.
20. A worker's right to terminate the employment of another worker indicates an employment relationship.

The IRS takes the position that the relative degree of the importance of each of the above individual factors varies depending upon the particular occupation and the context in which the services are performed. For example, the IRS has opined that it does not matter that an employer provides an individual with great latitude as to his or her actions where the employer nonetheless has retained the authority to control both the method and the result of the services provided.

Obtaining the Talent

The critical elements to be addressed in a written consulting agreement, primarily to document the status of an individual as an "independent contractor," are as follows:

1. The consulting agreement should set forth the intentions of the parties that the individual is to be providing services to the company in the capacity of an individual contractor and not as an employee.
2. The consulting agreement should set forth as specific a description of the services to be performed as possible.
3. The amount and payment terms of the engagement should be set forth in the consulting agreement.
4. The consulting agreement should provide that no income or payroll taxes will be withheld or paid by the company.
5. The consulting agreement should provide that the consultant will not be eligible for participation in or under any of the company's employee benefit plans, policies, practices or arrangements.
6. As evidencing other than an "at-will" employment relationship, the consulting agreement should set forth the term of the consulting engagement.

Motivating the Talent

Tensions continue to rise in connection with executive compensation, especially at the public company level. Although shareholders certainly want the companies in which they have invested to be in a position to attract and retain talented executives, they are demanding greater accountability for corporate decisions relating to executive compensation. Institutional shareholders have been especially vocal in criticizing companies that have been paying substantial amounts of compensation to their executives at times when the companies' stock prices were depressed.

For example, shareholders and shareholder advocacy groups generally oppose the repricing of "underwater" stock options for executives while companies have argued that such actions are necessary to motivate management. The NYSE and Nasdaq listing requirements (no such requirement for OTC companies) require shareholder approval for stock option repricings, unless the plan permits them by its terms, and stockholder advocacy groups/proxy voting advisors staunchly oppose the adoption of option plans which specifically permit repricings without shareholder approval.

Congress and the regulators have responded to these concerns with more stringent requirements as to public company shareholder disclosure and approval requirements and as to the deductibility of certain levels of compensation paid to certain executives for federal income tax purposes.

In connection with U.S. tax law, Section 162(m) of the Internal Revenue Code limits the deductibility of compensation paid to certain senior executives of public companies to $1 million per year, except to the extent that some or all of the compensation qualifies as "performance-based" compensation. In general, to be "performance-based":

1. The compensation must be paid solely on account of the satisfaction of one or more pre-established performance goals;
2. The performance goals must be established in writing by a committee consisting solely of 2 or more outside directors;
3. The material terms of the performance goals must be adequately disclosed to and approved by shareholders prior to payment; and
4. The compensation must not be paid until after the committee has certified in writing that the performance goals were satisfied.

Clearly, base salary and discretionary bonuses are not "performance-based." Conversely, an important exception exists for stock options and stock appreciation rights which, for purposes of Section 162(m), are generally deemed to be "performance-based" because the benefits derived therefrom are based upon an increase in the value of the underlying stock. It is also noteworthy that restricted stock is not deemed to be "performance-based" unless it vests pursuant to the satisfaction of appropriate preestablished performance goals rather than merely on the basis of the provision of services over time.

It is important to note in this regard that should a severance arrangement for an executive to whom Section 162(m) applies provide for full vesting and/or payment at "target" levels should the executive's employment be terminated by the employer without cause or should the executive resign for good reason, this would render all compensation payable thereunder as ineligible for the "performance-based" exception (*i.e.*, the payment would not be contingent upon performance, as required).

Equity-Based Compensation

Compensating executives with stock of the employer (or stock-related benefits) is a popular approach for both large publicly-owned and small privately-held companies. In large companies, the use of equity-based compensation is often perceived by management as a means of providing additional incentive for executives whereby the executives expect that their performance may enhance the value of their stockholdings in the company. With regard to smaller companies, especially "start-up" companies, the executive is often the party that requests compensation in the form of an equity interest in the employer.

A newly-organized "new economy" employer may not be able to offer talented potential executives the same salary level as major corporations, but can offer such individuals the opportunity to profit greatly should the endeavor succeed and the business ultimately go public. The form of stock compensation to be used is generally determined on the basis of federal income tax considerations although corporate law, securities law and accounting rules are often of significance as well.

Restricted Stock

A relatively straightforward approach to compensating an executive with employer stock is to either award the stock to the executive outright or sell it to the executive at a bargain price. These arrangements generally involve the receipt by the executive of stock which is subject to restrictions, the most common of which being that such stock (i) cannot be transferred by the executive for a stated time period, and (ii) must be returned to the company (*i.e.,* forfeited) if the executive's employment should be severed by either party within said stated time period.

Restricted stock grants permit a company to provide an executive with the incentive to perform to the best of his or her ability (due to the executive's equity stake in the company's performance) while also permitting the company to retain an interest in the stock (*i.e.,* should the executive leave employment during the restriction period), and as an attempt to ensure the future employment of the executive for at least the specified number of years (*i.e.,* a "golden handcuff"). (A key element of restricted stock is that, unlike a stock option, if after the restrictions lapse the stock has depreciated in value, provided that it still has some value, the executive has benefited from its receipt. Conversely, with a stock option, the executive will only realize a benefit if the value of the underlying shares increase after the grant of the option – a very different incentive.)

For Federal income tax purposes, if stock (or other property other than money) is transferred to an executive in connection with the performance of services, no amounts are included in the executive's income until the first year in which the property either (i) becomes "freely transferable" or (ii) is no longer subject to a "substantial risk of forfeiture." In the year in which either or both of the above requirements are satisfied, the executive will have ordinary income in an amount equal to the difference between the then fair market value of the stock and the amount, if any, which he or she had paid for the stock (the so-called "bargain element").

Thus, the executive must acquire a beneficial ownership interest in the stock (*i.e.,* it must be transferable by the executive) before he or she will be subject to tax. In the year in which the executive realizes ordinary income, the employer is entitled to deduct the same amount which the executive was required to include, provided that it properly reports the appropriate amount of taxable income realized by the executive.

The cost of an executive's delaying inclusion of the value of the stock for income tax purposes is that any appreciation prior to vesting will be ordinary income and only the remaining appreciation after vesting will be taxed as capital gain upon disposition of the stock. This concern can be dealt with by the use of a mechanism known as a "Section 83(b) Election," whereby an executive who believes that the stock he or she has received is going to significantly appreciate during the restriction period can elect, within 30 days of the executive's receipt of the stock, to pay tax at ordinary income rates on the amount of the "bargain element" measured on the date of the executive's receipt of the stock (*i.e.,* rather than in the future when the executive's rights in the stock become vested but the stock may have appreciated greatly in value) and thereafter, the future appreciation will be taxable to the executive as capital gain when he or she disposes of the stock.

Thus, the Section 83(b) Election mechanism is a means of converting higher-tax ordinary income into lower-tax capital gain. However, the drawback of making a Section 83(b) Election is that should the executive forfeit the stock, he or she will not be entitled to a loss deduction for the amount included in the executive's income as a result of making the election (*i.e.,* the executive's loss would be limited to the amount which the executive actually paid for the stock).

Incentive Stock Options

An Incentive Stock Option ("ISO") is a stock option granted to an executive which, if the applicable Federal tax law requirements are met, will provide the executive with special tax treatment. The principal advantage of utilizing ISOs is the potential conversion of the executive's ordinary income into capital gain. However, from the employer's perspective, it is important to note that ISOs do not provide the employer with a tax deduction.

An executive is neither taxed at the time of the grant of an ISO nor upon its exercise. If the executive holds the shares received pursuant to the exercise of the ISO for at least 2 years from the date of grant and for 1 year from the date on which the stock was transferred to the executive, the executive will have no compensation income attributable to the bargain element under the ISO. The employer is not entitled to a deduction for its

transfer of stock to the executive. When the executive disposes of the stock, any gain thereon will be long-term capital gain.

However, if the executive disposes of the stock before satisfying the aforementioned holding periods, the transfer triggers a "disqualifying disposition" and the executive is generally required to include in income as compensation (ordinary income) the excess of the fair market value of the stock at the time of exercise over the exercise price.

It should also be noted that in the year of exercise of an ISO, the spread between the fair market value of the stock on the date of exercise and the exercise price is a tax preference item for Alternative Minimum Tax purposes.

There are a number of specific requirements which a stock option must satisfy for ISO treatment to be available. The most critical requirement is that the exercise price under an ISO may not be less than the fair market value of the underlying stock on the date on which the ISO is granted.

Another noteworthy requirement is that the aggregate fair market value of the stock with respect to which ISOs become exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer, its parent and its subsidiaries) cannot exceed $100,000 (stock in excess of the first $100,000 is required to be treated as stock obtained by the exercise of a non-qualified stock option).

ISOs are excluded from coverage under Section 409A.

Non-Qualified Stock Options

Non-Qualified Stock Options ("NQOs") are stock options which do not qualify for ISO treatment. NQOs do not entail special tax requirements because they do not provide special tax benefits. Therefore, for tax purposes, the employer is free to design its NQO arrangements as it wishes, although there may be restraints imposed under securities law and/or general corporate law. Unlike ISOs, NQOs do provide the employer with an income tax deduction.

Pursuant to Federal tax law, an executive to whom an NQO has been granted will have ordinary income on the date he or she exercises the NQO in the amount of the difference between the fair market value of the stock and the price the executive paid for it. Provided that the employer properly reports the appropriate amount of taxable income realized by the executive, it will then be entitled to a corresponding income tax deduction. If the stock received by an executive pursuant to the exercise of an NQO is subject to a "substantial risk of forfeiture" (*i.e.,* a vesting schedule), the executive will not be taxed upon exercise but rather, will be taxed when such risk lapses (*i.e.*, when the executive becomes vested).

An important issue with regard to NQOs is that because the executive is taxed at the time of exercise, and because he or she may not want to sell the stock immediately, the executive may encounter a cash flow problem (*i.e.*, the executive will need to have sufficient funds available to pay both the exercise price under the NQO as well as the

income tax thereon). Should the executive not have adequate funds available, this may pose a dilemma for the employer as well because the executive's need to immediately sell the shares may defeat the reasoning underlying the employer's granting of the NQOs — its desire to provide the executive with an ongoing equity interest in the company. In these circumstances, employers can provide cash bonuses in tandem with the grant of NQOs. The employer may also consider lending the necessary funds to the executive, but care must be taken to avoid the adverse consequences of the Federal income tax law "below-market loan" rules applicable to employer-to-employee loans. Another approach is a cashless exercise mechanism, whereby the number of shares received upon exercise is reduced by the value of the required exercise price and/or the required tax withholding amount.

Nondiscounted NQOs (*i.e.*, NQOs with a per share exercise price which equals or exceeds the fair market value of a share of the stock underlying the NQO as of the date of grant) are excluded from coverage under Section 409A.

Stock Appreciation Rights

The grant of a Stock Appreciation Right ("SAR") provides the executive with the right to receive a payment equal in amount to the appreciation of the fair market value of the employer's stock, measured from the date of grant to the date of exercise. Instead of requiring a cash payment from the executive, SARs provide the executive with a cash (or stock) payment. SARs provide an obvious advantage for the executive because he or she need not make an immediate cash outlay to be able to benefit under the arrangement. SARs are often provided in tandem with stock options to provide the executive with the cash needed thereby to exercise the option and purchase the underlying stock.

Upon the grant of an SAR, the executive will have merely received an unfunded and unsecured promise by the employer to pay money or property in the future and because such a promise does not constitute "property" under Federal tax law, taxation will not apply at the time of grant. The employer is not entitled to an income tax deduction when the SAR is granted. Upon exercise, the executive must include all amounts he or she receives (*i.e.,* the appreciation in value of the stock) as ordinary income. The employer is entitled to an income tax deduction for the amount of the payment in the year in which the payment is made (unless the executive receives stock which is not vested and is subject to transfer restrictions, which will serve to delay the employer's deduction until the executive is taxable).

Nondiscounted SARs are excluded from coverage under Section 409A.

Phantom Stock

Under a Phantom Stock arrangement, "units" corresponding to shares of the employer's stock on the date of grant are granted to the executive by the employer. The units are mere book entries which are credited to "paper" accounts for the executive to whom they are granted. Under these arrangements, no stock is actually issued. Once the units are credited to the executive's account, unlike SARs, they generally carry dividend

equivalent rights under which an amount equal to the employer's dividend per share may be credited to the executive's account per each unit therein upon the employer's issuance of a cash dividend.

Phantom Stock arrangements, like SARs, provide the executive with the appreciation in value of the employer's stock. Such appreciation may be measured in terms of fair market value, book value, by formula price or as a percentage of market appreciation. Benefits are generally paid in cash, employer stock or a combination of both.

In general, Phantom Stock is accorded the same tax treatment as SARs.

Non-Equity-Based (Performance-Based) Compensation

Often used in tandem with equity-based benefits and opportunities, non-equity-based arrangements are very common. These arrangements typically focus on the satisfaction of predetermined company and/or individual goals and may be short-term (typically, 1 year) or long-term (typically, 3-5 years) in duration. Because a Phantom Stock arrangement can be used where the amount of the benefit earned is to be based upon the appreciation of the employer's stock value, for purposes of a non-equity-based arrangement, the goals typically utilized will focus on other important measurements which may be general (*e.g.,* return on equity, revenues growth or profits) or industry-specific (*e.g.,* insurance premiums written, number of widgets sold or customer satisfaction).

Performance Units Plans

Performance Units plans are goal-oriented compensation arrangements, the eligibility for which is generally confined to senior executives who have a direct impact upon the employer's earnings. Under such an arrangement, "units" are granted to the executive (valued at a designated amount) contingent upon the successful attainment of earnings or performance goals (individual, divisional, business, company-wide or a combination), which are measured over a set time period. Typical goals that are used include - (i) a defined increase in earnings per share of the employer's common stock; (ii) a defined increase in surplus or stockholders' equity; (iii) the achievement of cost savings or the increase of the earnings of a division; and (iv) a rate of earnings which exceeds those of a select group of competitors. The performance cycle is typically for a period of between 3 and 5 years.

If at the end of the cycle the executive's goals have been met, the units are earned and the executive is paid in cash (as a lump sum or by installments). The payment of awards is generally further contingent upon continued employment throughout the performance period although exceptions are typically provided for termination of employment due to death, disability or retirement. The principal advantage of Performance Units arrangements is that they encompass a direct correlation between executive gains and company performance. Their primary disadvantages are that executive gains may not necessarily parallel shareholder gains and the difficulty in selecting appropriate performance targets and hurdles.

Performance Units are subject to the same tax treatment as SARs.

Comforting the Talent

Executives of companies within consolidating industries are expected to perform their corporate duties to the best of their abilities, regardless of their very substantial personal distractions in connection with their potentially uncertain futures, should a change of control of their employer occur. Not as an impediment to possible transactions but rather, to provide executives with the additional psychological comfort they need to "remain at the helm" during such potentially critical times (*e.g.,* to permit management to focus fully on negotiating an acquisition rather than being distracted by their personal concerns for their own financial security), companies utilize "change of control" agreements and/or clauses in severance and employment agreements.

For those executives who do not have employment agreements, change of control protection will typically be afforded through special change of control-triggered enhancements under existing severance plans or policies under which they are covered or by providing them with separate change of control agreements or participation in special change of control-triggered plans. Executives with employment agreements typically have the change of control-triggered provisions incorporated within their employment agreements. In addition, external plan documents providing for equity-based or non-equity-based benefits will often contain change of control-triggered provisions.

Finally, change of control protection can be in the form of change of control-triggered funding of various compensation and retirement benefits, in an effort to ensure the ultimate payment thereof to the covered executives.

Change of Control Agreements and Change of Control Provisions in Employment Agreements

Change of control-triggered benefits, often referred to as "Golden Parachutes," can be "single-triggered" or "double-triggered." Under a "single trigger" arrangement, the occurrence of the change of control itself will trigger the benefit. Under a "double trigger" arrangement, the benefit will not be payable unless, following the change of control, which itself constitutes the first trigger, the executive's employment terminates, thereby constituting the second trigger. Under most such arrangements, the termination can be pursuant to the executive's resignation if for "good reason" (as such concept is discussed above under "Employment Agreements") or the executive's involuntary termination other than for "cause" (as such concept is also discussed therein). A board's decision to provide change of control-triggered benefits is typically covered by the "business judgment rule," pursuant to which a court will not substitute its judgment for that of the board where the board's action can be attributed to "any rational business purpose." It should be noted, however, that heightened scrutiny should be anticipated where a single-triggered approach is utilized and/or the change of control protections are adopted by the board at a time when the company is already "in play."

Typical change of control-triggered severance benefits are as follows:

Comforting the Talent

1. **Base Salary** - A lump sum cash payment is made (or installment payments are made at the same times the executive's base salary would have been paid absent the termination) equal in amount to 100-300% of the executive's base salary in effect as of the date of termination or the date of the change of control.
2. **Bonus** - A lump sum cash payment is made (or installment payments are made at the same time the executive's bonus(es) would have been paid absent the termination) equal in amount to 100-300% of the executive's bonus amount. The basis for the bonus amount is typically the "target" bonus for the year of termination, the last bonus paid prior to termination or an average of the last 2 or 3 years' bonuses paid prior to termination.
3. **Stock Options** - Unexercisable options (or portions thereof) become fully exercisable.
4. **Restricted Stock** - Nontransferable/unvested shares become transferable/vested.
5. **Stock Appreciation Rights** - Unvested amounts become vested and payment is accelerated.
6. **Performance Plans** - Payments are accelerated and made as if all goals were met at the "target" level (can create a Section 162(m) issue, as discussed previously).
7. **Nonqualified Retirement Plans** - Unvested benefits become vested and immediately payable or funded. Benefits may also be enhanced by adding additional years of service (typically 2-5 years) as if the termination had not occurred.
8. **Deferred Compensation Plans and Arrangements** - Payment is accelerated or funded.
9. **Qualified Retirement Plans** - Unvested benefits become vested.
10. **Welfare Plans** - Continued coverage under the employer's life insurance, medical, dental and disability plans, typically for 6 months to 3 years.
11. **Outplacement** - Outplacement services are provided to the executive at no charge.
12. **Golden Parachute Excise Tax Protection** - See next section entitled "Golden Parachutes Considerations."

For purposes of compliance with Section 409A, where the occurrence of a change of control would trigger the payment of deferred compensation subject to Section 409A, the "change of control" standard (*i.e.*, the definition used) must meet certain definitional standards (*e.g.*, minimum percentages of sale interest required).

Comforting the Talent

Golden Parachutes Considerations

The "Golden Parachutes" rules under Federal tax law were enacted as an attempt to restrict the use of certain severance arrangements in change of control situations which were viewed as potentially detrimental to the interests of shareholders in favor of those of the corporations' executives. Congress was concerned that corporate executives who were covered by parachute agreements might inhibit or aid a takeover of their employers on the basis of their expected severance payments, rather than on the basis of the best interests of the shareholders.

The level of parachute payments is rarely material in determining whether a friendly or unfriendly change of control will occur, and such arrangements can offer management the financial security it needs to fight, on behalf of the shareholders, for the best possible purchase price. Perhaps without such protection management might be unwilling to contest a below-value bid out of fear that should the raider be successful, their jobs would be lost.

In general, if an executive receives an "excess parachute payment," the executive's employer loses the right to deduct the excess parachute payment and the executive is assessed a nondeductible 20% excise tax on the amount of the excess parachute payment (in addition to the ordinary income tax which would otherwise be applicable).

A "parachute payment" is any payment in the nature of compensation to a person who performs personal services for a corporation and who is an officer, shareholder or highly compensated individual, if the payment is contingent upon certain regulatorily-defined changes of control or ownership or sales of substantial portions of the assets of the corporation, and if the aggregate present value of the payment equals or exceeds the "safe harbor amount." The "safe harbor amount" is equal to 300% of the executive's "base amount," which is the executive's average annual taxable compensation for the five-year period immediately preceding the year in which the change of control occurs.

Recognizing when a Golden Parachute issue will arise may appear straightforward; however, regardless of the seemingly clear applicable Internal Revenue Code provisions, the mire of proposed treasury regulations and interpretive IRS rulings may have resulted in the Golden Parachute rules having become a trap for the unwary. Employers are often surprised when they learn, for example, that the definition of "change of control" in the IRS' regulations, rather than the definition in their change of control agreements, will be determinative as to when a change of control has occurred for tax purposes, that the value attributable to accelerated vesting of stock options can be parachute "payments" even though no "payment" is in fact made or that severance payments are treated as contingent upon a change of control even when the agreement providing the payments does not contain any "change of control" language.

Because the regulations treat payments and benefits as "contingent on a change of control" even when the payments or benefits might not be directly triggered by a change of control, recognizing the existence of a "parachute payment" can be difficult. In general, a payment is treated as contingent on a change of control if the recipient either

acquires the right to receive the payment or receives the payment sooner than he otherwise would have (i) as a result of the change of control, (ii) as a result of events that are closely associated with a change of control (the regulations contain a nonexclusive list of such events, including a termination of employment and a reduction in job responsibilities occurring within the one-year period before or after a change of control), or (iii) (if the taxpayer fails to rebut the presumption) pursuant to a contract entered into or amended within one year before the occurrence of a change of control.

Thus, a severance payment made pursuant to an employment agreement upon a termination of employment occurring within one year before or after a change of control can constitute a parachute payment even if the agreement does not require a change of control as a precondition to payment. Similarly, a bonus or other incentive payment paid pursuant to an arrangement entered into within the one-year period immediately preceding a change of control would be presumed to be contingent upon the change of control even if payment thereof is not contractually contingent thereupon.

It is clear, however, that a termination of employment is not required in order to have a parachute payment, nor is it required that an actual "payment" be made. In fact, the regulations define "payment" to include benefits not typically thought of as payments at all. For example, the imputed value (or a portion thereof, depending on the situation) of accelerated vesting of stock options or restricted stock, the value of continuation of health benefits or the value of additional credited age or service under a retirement plan may be considered parachute "payments." Employers need to be wary of the expansive net which the Golden Parachutes regulations have cast on payments and benefits made at or near the time of the occurrence of a change of control.

In general, if a payment exceeds the safe harbor amount, all amounts in excess of reasonable compensation (100% of the executive's base amount) are "excess parachute payments" subject to the excise tax and nondeductibility rules. To rebut, the executive must establish by clear and convincing evidence that the amounts in excess of his or her base amount constitute reasonable compensation for personal services actually rendered.

Exclusions exist for payments to executives of (i) "small business corporations," and (ii) corporations not having publicly-traded stock, where certain shareholder approval requirements (75% shareholder approval following adequate disclosure) have been met.

To the extent a payment constitutes reasonable compensation for services to be performed after the change in control, it is excluded from consideration as a parachute payment, including the determination of the safe harbor amount (reasonable compensation for services rendered prior to the change of control continues to be applicable for purposes of the safe harbor test).

It is critical to note that if an "excess parachute payment" is made, the nondeductibility rule and the excise tax apply to all amounts in excess of the base amount (*i.e.,* not only the amount which equals or exceeds the "300% of base amount" safe harbor). For example, if an executive's base amount is $100,000 and a parachute payment equal to $300,000 is made, $200,000 (not merely $1) would constitute the "excess parachute

payment." Conversely, if such executive's parachute payment totaled $299,999, it would not constitute an "excess parachute payment."

It is also important to note that a payment that is merely accelerated by a change of control is not a parachute payment if the acceleration does not increase the present value of the payment. For example, the exercise of a currently vested and exercisable stock option, the original receipt or vesting of which was not treated as a payment in the nature of compensation, does not constitute a parachute payment merely because a change of control determines the time at which the stock option is exercised, because the change of control does not affect, in any way, the present value of the option.

The punitive consequences of the Golden Parachutes rules require employers to plan accordingly. Some have responded by imposing a ceiling or "cap" on the benefits provided under a parachute agreement to avoid the parachute tax penalties. The most basic form of cap is a provision which provides that if any payments would trigger "excess parachute payments," such amounts will not be paid. The most significant tax drawback of this approach is that the existence of such a provision in an agreement may be used by the IRS as evidence that certain payments are indeed parachute payments.

Another approach is a safe harbor cap, which provides that payments to an individual which are contingent upon a change of control will not exceed such individual's safe harbor amount (*i.e.,* the payments are limited to the product of the individual's base amount multiplied by 2.99). The same drawbacks apply to this approach.

An executive with a parachute agreement may negotiate an attendant tax gross-up allowance, the purpose of which would be to provide sufficient additional cash to be used by the executive to pay any parachute tax imposed on the benefits to which the executive is entitled without the gross-up payment, as well as the parachute and income taxes on the gross-up payment, with the intended result that the executive's net after-tax position be equal to what it would have been had there been no parachute penalty tax imposed.

This result can be accomplished through two alternative approaches. The first simply provides that the payment will be large enough to eliminate the impact of the penalty and is intended to place the executive in the same financial position as if no tax had been imposed. The other approach is intended to deal with the situation where certain payments are unexpectedly determined to be contingent upon a change of control and provides the executive with a limited gross-up allowance only if this should occur. Tax gross-up allowances are typically very expensive for the employer and are ill-received by shareholders and shareholder advocacy groups.

Securing the Promise

Executives' concerns regarding the financial viability of their employers and the potential impact of a change of control or other acquisition can lead to doubts as to whether or not they will receive their nonqualified retirement benefits, deferred compensation and severance benefits. Pursuant to Federal tax law, once vested, an executive will only be entitled to deferral of income taxation on his or her benefit if the employer's promise to

pay is not funded by a trust or other similar security arrangement. Therefore, the classic tax-effective approach is that the employer's promise to pay is merely a naked contractual obligation, with the source of the payments being limited to the general assets of the employer.

Consequently, the employer's assets intended to be used in the future to provide such benefits remain subject to the claims of the employer's creditors. The mere purchase of an annuity contract provides little assistance in this regard because if the executive is the owner of and beneficiary under the annuity, he or she will be taxable on the amounts of the premiums paid (even though no payments thereunder may have yet been made to the executive), and if the employer is the owner and beneficiary, the annuity continues to be subject to the claims of the employer's creditors. Thus, the competing interests of tax deferral and executive security must be considered.

Third Party Guarantees and Letters of Credit

A technique that may be used to provide additional security is for a member of the employer's affiliated group (*e.g.*, the much larger parent of the executive's employer) to provide an unfunded, unsecured guaranty of payment. The IRS has ruled that such an arrangement will not accelerate the executive's taxability until such time as the actual payments are received. The tax implications of attempting to assure payment by utilizing a letter of credit, surety bond or similar financial instrument are less clear.

Trusts

The most prevalent approach is to establish a funding vehicle to hold assets of the employer sufficient to support the employer's payment obligations. However, if utilization of a trust causes the particular plan or arrangement to become "funded" for ERISA purposes, many of ERISA's onerous requirements (*e.g.,* its fiduciary obligation requirements) would become applicable thereto. There are 2 basic types of trusts used for these purposes — "Rabbi Trusts" and "Secular Trusts." As discussed below, a Rabbi Trust provides less security, greater tax protection and should not cause ERISA "funding," while a Secular Trust provides complete security, no tax protection and will result in ERISA "funding."

Rabbi Trusts

The IRS has consistently ruled that the use by employers of fully revocable trusts to hold assets supporting a contractual deferred compensation obligation for the benefit of its executives will not give rise to current taxation, as the assets in such trusts can be taken back by the employer at any time. However, such arrangements fail to provide the executives with assurances that the funds will be available in the future, due to the possibility of certain contingencies (*e.g.*, a hostile takeover). The use of so-called "Rabbi Trusts" (the first such arrangement to be addressed by the IRS was a trust established by a congregation to fund deferred compensation for its rabbi) represents an attempt to deal with the problem of providing sufficient security for the executives but in a manner that will not trigger immediate taxation.

Comforting the Talent

A "Rabbi Trust" is an irrevocable grantor trust (*i.e.,* in general, once funded by the employer for the executive's benefit, the assets cannot be diverted for the employer's use unless and until the executive's benefit has been fully paid), except that the trust assets, in addition to being accumulated to pay the promised benefit, may be used where the employer has become insolvent and needs them to pay its creditors having rights enforceable under federal or state bankruptcy or insolvency law. Therefore, the current position of the IRS permits a Rabbi Trust to be structured in a manner that offers executives added security that their promised benefits will be paid (even in the event of a change of management or control of the employer), but does not provide protection against the employer's insolvency. (Once again, if the funds were irrevocably set aside in a trust, the amounts therein would be immediately taxable to the executives, as discussed above.)

Finally, the employer is taxed on the income of the trust under the grantor trust rules, to the extent that it would be taxed had it directly held the trust assets. The employer is not entitled to an income tax deduction for the amount contributed to the trust (nor for the earnings thereon upon which it is taxed under the grantor trust rules) but is entitled to a deduction in the year amounts are paid by the trustee to the beneficiaries of the trust for the amounts so paid.

Section 409A precludes the use of off-shore or "springing" Rabbi Trusts which utilize distribution triggers intended to protect executives against adverse changes to their employer's financial condition.

Secular Trusts

Under a "Secular Trust," the employer funds an irrevocable trust for the executive and the executive is immediately vested in the trust corpus. (This distinguishes Secular Trusts from Rabbi Trusts, which are subject to creditors' claims and have proved to be vulnerable in bankruptcies.) The executive is immediately taxable on the trust's assets because of the executive's fully vested status and, consequently, the employer is entitled to an immediate tax deduction. The employer then typically pays the executive, either directly or through the trust, the additional amount necessary for the executive to meet his or her tax liability for both the contribution and for the additional gross-up payment (which is also deductible by the employer). The executive is typically taxable on the earnings of the trust's assets as well.

Timing of Funding

Often an employer will establish a Rabbi or Secular Trust with a minimal amount of funding. Only upon a change of control (or sometimes an earlier event, often referred to as a "potential" change of control) will the employer fund the trust. Such an approach can be very beneficial for purposes of the employer's cash flow (*i.e.,* it need not divert funds from its business activities until they are truly needed). Consequently, such an approach can result in the covered executives fearing that there will be no one, or that no one will have the courage, to "push the funding button."

Providing for the Talent's Future

Many statutory limitations apply to the benefits that may be provided under tax-qualified retirement plans. The hallmark of these requirements is the broad concept of nondiscrimination as to levels and amounts of tax-qualified plan benefits. These nondiscrimination requirements generally provide that benefits accrued by and contributions made under a tax-qualified plan may not discriminate in favor of "highly compensated employees" (as contrasted to "non-highly compensated employees"). (The "highly compensated employee" test is currently generally based upon having annual compensation in excess of $110,000 or "officer" status.) However, the law does not preclude discrimination against "highly compensated employees."

For example, under current law, no more than the first $245,000 of an employee's compensation may be taken into account under a tax-qualified plan. Therefore, if under such a plan the employer's obligation was to contribute 5% of each employee's compensation, consider the contrasting treatment of 2 employees, one earning $75,000 per year and the other earning $350,000. The non-highly compensated employee earning $75,000 would receive the full contribution, *i.e.,* 5% of the amount of his or her full compensation. Conversely, the highly-compensated employee could only receive a contribution equal to 5% of the first $245,000 of his or her compensation ($12,250), which equates to only 3.5% of his or her actual $350,000 compensation.

To address the impact of the tax-qualified plan requirements on executives, companies often utilize nonqualified plans.

Nonqualified Retirement Plans

Under a tax-qualified plan (i) employer contributions are deductible for the year for which they are contributed; (ii) the employees are not taxable on the employer's contributions and the investment earnings realized thereon are not taxable until distributed to them from the plan; (iii) the plan's funds are held in a trust which cannot be reached by the employer or its creditors; (iv) numerous technical nondiscrimination requirements apply to the terms and operation of the plan; (v) statutorily-mandated minimum vesting schedules apply; and (vi) the plan will be subject to ERISA'S reporting, disclosure and fiduciary obligation requirements.

Under a nonqualified plan (i) the employer may not deduct the amounts of its contributions until the plan benefits are distributed to the employees; (ii) if plan investments are established, the earnings will be fully taxable on a current basis (to the employer or to the employees depending upon the funding mechanism utilized, if any); (iii) the plan's funds typically are reachable by the employer or its creditors; (iv) no nondiscrimination requirements are applicable; and (v) if participation in the plan is limited to "a select group of management or highly compensated employees" (as discussed in greater detail below under "Application of ERISA Requirements to Nonqualified Plans"), any vesting schedule may be used and the plan will be exempt

from the majority of ERISA's most onerous requirements. There are 2 fundamental types of nonqualified retirement plans — "excess benefit plans" and "SERPs."

Excess Benefit Plans

Perhaps the most significant nondiscrimination requirements applicable to tax-qualified plans are the so-called "415 Limits." For defined benefit tax-qualified plans (*i.e.,* where the retirement benefit rather than the contribution amount is determined by formula), the 415 Limit is currently the accrual of a maximum annual retirement benefit of not more than $195,000. For defined contribution tax-qualified plans (*i.e.,* where the annual contribution amount rather than the retirement benefit is determined by formula), the 415 Limit currently requires that the aggregate of employer contributions, employee contributions and reallocated forfeitures to an employee's account under all tax-qualified defined contribution plans for a year may not exceed the lesser of $49,000 or 25% of the employee's compensation (with the employee's compensation again being currently limited to $245,000).

An "Excess Benefit Plan" is a nonqualified plan that provides solely those benefits that would be provided under a tax-qualified plan but for the application of the 415 Limits. Thus, an Excess Benefit Plan can be a defined benefit or a defined contribution form of nonqualified plan. Employers that utilize Excess Benefit Plans "piggyback" them upon their tax-qualified plans with the goal of providing the full benefit that would have been afforded under the tax-qualified plan pursuant to its formula, but for the application of the 415 Limits, through a combination of both the tax-qualified and nonqualified plan benefits.

It is noteworthy that there are numerous other nondiscrimination requirements and limitations applicable to tax-qualified plans, such as the current $245,000 compensation limit discussed above and the current limitation of $16,500 on annual employee elective deferrals (increased by an annual "catch-up" contribution opportunity for participants age 50 and over – currently to a maximum of $5,500) under a "401(k) plan"; however, the benefits under an Excess Benefit Plan may be based solely upon the 415 limits.

SERPS

A SERP ("Supplemental Executive Retirement Plan") is a catch-all for any type of nonqualified plan that is not an Excess Benefit Plan. Thus, many SERPs function precisely the same as Excess Benefit Plans, but may address nondiscrimination requirements other than the 415 Limits (a SERP can also provide benefits on the basis of the 415 Limits). Under such circumstances, SERPs, like Excess Benefit Plans, are used to "piggyback" the underlying tax-qualified plan. However, a SERP can provide for virtually any benefit and, unlike an Excess Benefit Plan, need not be used as part of a "piggyback" formulation.

For example, a company that provides solely a defined contribution tax-qualified plan for its employees might also provide a nonqualified defined benefit plan for its senior executives. This type of blatant discrimination is perfectly legal, as the nondiscrimination

requirements applicable to eligibility for participation in tax-qualified plans do not apply to nonqualified plans. In general, Excess Benefit Plans can involve less exposure to the requirements of ERISA than do SERPs; however, as various nondiscrimination requirements have proved to be substantial operational obstacles to providing sufficient retirement benefits under tax-qualified plans, Excess Benefit Plans have been replaced and/or complemented by SERPs, as addressing solely the 415 Limits has increasingly become an outdated practice.

Application of ERISA Requirements to Nonqualified Plans

ERISA imposes stringent vesting, benefit accrual, benefit payment and funding rules, as well as reporting and disclosure obligations, on pension plans subject thereto. However, a pension plan that is unfunded (*i.e.,* which must be a non- qualified plan because a tax-qualified plan, by definition, is required to be funded by a trust) and maintained primarily for the purpose of providing deferred compensation for "a select group of management or highly compensated employees," a so-called "Top-Hat Plan," will be exempt from most of ERISA's onerous requirements.

There is no "bright line" numerical test as to what constitutes a "select group" for these purposes. On the basis of U.S. Department of Labor Advisory Opinions issued during the 1980's (the DOL discontinued rendering such advice in the early 1990's), it would appear that if less than 10% of the employer's workforce were covered under an unfunded nonqualified plan, that plan would have a good chance of being viewed by the DOL as a Top-Hat Plan. The DOL's current position is that Top-Hat Plan participation should be limited to financially sophisticated employees who, by virtue of their positions with their employers, have the ability to influence or negotiate the terms of the plan and therefore are less needful of ERISA's protections. For all companies, nonqualified plan participation should be as limited as possible to protect against ERISA exposure.

Elective Deferred Compensation Plans

In addition to or in lieu of the use of employer funds to provide nonqualified retirement benefits, if established and administered properly, executives can elect in advance to defer a portion of their compensation under deferred compensation plans maintained for their benefit by their employers.

The key to effective deferral of compensation is compliance with the special requirements for deferral elections under Section 409A.

There are two fundamental sets of requirements applicable to deferral elections - the requirements applicable to initial deferral elections, and those regarding changes to existing deferral elections. As to the initial election, it must be made in the year before the services giving rise to the compensation are to be performed – an exception is available for an executive who first becomes eligible to make a deferral election, in which case the executive may so elect during the same year as the services are performed, provided that the election is made within 30 days of the executive's initial eligibility and provided further, that the election may apply solely to compensation earned after the date

of the election. The initial election must specify the time and form of the future payment(s). Under another exception, an executive can elect to defer the receipt of a payment within 30 days of the date the executive obtains a legally binding right to the payment, provided that the right to the payment is conditioned on the continued service of the executive for the employer for a period of at least 12 months from the date the executive obtains the legally binding right to the payment. A special rule applies to performance-based compensation determined over a 12-month period, permitting the deferral election to be made by no later than 6 months before the end of the performance period, provided that the executive performs service continuously from the later of the beginning of the performance period and the date the performance criteria are established though the date of the election, and in no event may the deferral election be made after the amount of the compensation is readily ascertainable.

As to changes to existing deferral elections, including changes in payment form, commencement and/or timing, the subsequent deferral election must be made at least 12 months before the existing scheduled payment date, may not go into effect for at least 12 months after the date of the election, and any new payment date must be at least 5 years after the originally scheduled payment date. The payment date cannot be accelerated.

Once the compensation has been deferred, the next issue is that of crediting earnings or investment results to the deferred amounts. From the executive's perspective, he or she would typically prefer to be able to select his or her own investments, perhaps from a menu of mutual fund options, similar to the operation of a "401(k) plan." Such an approach, however, is generally viewed as overly risky, on a "dominion and control" theory (*i.e.,* an executive would only be able to exercise investment control over his or her own funds — thus, if the executive does have such control, the funds must belong to the executive rather than to the employer, and current taxability of the executive should apply).

The most prevalent approach currently in use is that of "hypothetical" investment elections, where the executive advises of his or her investment preferences among a menu of choices but the party with the actual authority (typically, a committee) is not bound thereby and is free to invest differently. In theory, this should not violate the "dominion and control" standard. A simpler, but less executive-desirable approach is for the employer to simply credit the deferred amounts with a stated rate of interest (*e.g.,* the Prime Rate) or with the rate of return realized by a particular investment, such as a mutual fund or stock index, selected by the employer.

A critical issue is for the employer to actually invest its own funds in the investments being used for deferred compensation benefit measurement purposes. If the employer does take this precaution, it will be assured of having most of the funds necessary to provide the benefit (it will only have "most" of the funds because it will be taxable on the earnings generated by the deferred amounts). If the employer does not set up such "shadow" investments (*i.e.,* to permit it to utilize the funds for other corporate purposes), it risks being in a shortfall position when the benefits become payable, especially in regard to equity-based investments in times of an escalating stock market.

Loeb & Loeb’s Executive Compensation Practice

Loeb & Loeb’s Executive Compensation team advises both employers and employees on a wide range of executive employment matters including:

- Employment, Consulting and Severance Agreements and Arrangements
- Equity and Incentive Compensation Plans
- Deferred Compensation and Retirement Plans
- Welfare Benefit Plans

We advise clients in sophisticated employment negotiations, executive terminations and severance arrangements, with an emphasis on preventing disputes. Our experience includes the scope and enforceability of non-competition and non-solicitation agreements; the use of trade secrets and other confidential information; interference with business relations; and entitlement to bonuses, golden parachutes and other compensation.

We also design and implement equity compensation arrangements to incentivize senior executives and broader groups of employees, as well as align their interests with that of the business's owners. These plans include long- and short-term incentive plans and non-qualified stock options, restricted stock, stock appreciation rights and phantom stock arrangements, and other types of arrangements. We also address repricing and other adjustment issues that arise as a company goes through various economic phases.

Our group advises clients regarding the tax, ERISA, labor, securities, bankruptcy and estate planning issues relating to non-qualified deferred compensation arrangements and supplemental retirement plans. We are particularly well-versed in the funding of deferred compensation arrangements through Rabbi Trusts and/or corporate owned life insurance products, including variable and universal life insurance products specially designed for such purposes. Our experience also includes designing and structuring life, disability and long term care plans, including split dollar life insurance, and combo or carve-out life insurance and long term disability plans.

In addition, we advise compensation committees regarding director responsibilities, charters and oversight of executive compensation policies and arrangements. We also provide advice on compensation and benefit issues arising in the context of mergers and acquisitions and other corporate events.