Negotiating Severance Agreements with Multi-Faceted Compensation

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The following is a guide to helping a client through a severance negotiation involving deferred compensation, equity compensation, bonus programs, or other compensation besides the usual salary and employee benefit plans. In particular, this guide focuses on questions to ask and discuss with your client in formulating a strategy.

These negotiations are not drastically different from any other severance negotiation, but the multi-faceted nature of the compensation program creates more moving parts than a negotiation based on, for example, an exchange of cash for a release of claims. This is mostly good – there are more opportunities to get value for your client. But it can also present pitfalls.

Many of the employees with such complex compensation programs are higher-level executives who may have an employment contract or market power sufficient to negotiate severance even without reliance on the existence of a meritorious legal claim. Equity compensation is also very common in the technology industry and has unique qualities when offered by privately held companies, especially early-stage start-ups. These issues are discussed below.

Major steps

1. Identify the primary interests of the employee.

What are the employee's greatest needs at this time? What is her risk profile? For example, does she primarily need cash to replace the income lost from the job? Or is she particularly interested in maximizing her ability to invest in the company via her stock options and reap the possible rewards? Still others may urgently need continuity in affordable health coverage while others may have access via a spouse or other program, or simply less urgency in that need. How important to the client's search for her next job is reputational protection and access to positive references from this particular employer? Does she care about whether or not she must keep the severance confidential? Is she concerned that the employer might bad mouth her or fail to give a reference that helps her get her next job? Or is the employee actually near retirement or beginning a transition into disability leave, in which case a job search may be wholly irrelevant, but protecting access to income benefits and health care benefits through disability or retirement programs may be critical.

2. Identify the primary interests of the employer.

Is this company flush with cash or running close to the bone? Who is handling the negotiation on the other side, and do they have biases for or against cash vs. other benefits? Is the company in a tight-knit industry or in a competitive recruiting environment, such that there is value to them in ensuring that any story about how they handled your client is positive? Do they shy away from litigation or are they litigious? Do they value handling things the same way for all employees, or do they fly by the seat of their pants?

3. Develop strategy by balancing the importance of each interest against the difficulty of achieving it.

If the client needs a lot of cash severance but the company is tight on cash and/or the players involved in the negotiation have a hard time letting cash go, the odds of maximum achievement of that goal are lower. If the client really wants her stock options accelerated but the company doesn't want to spread investment around, those odds are lower. In contrast, if the company is low on cash and the client wants to invest, gaining value through increased equity might be a good way to capture value for the client in a way that is easier to get the company to agree to. Is there a potential claim for wrongful termination that adds leverage to the negotiation? The leverage can potentially be applied as to any element of the negotiation.

Identification of your priorities and chances informs how you structure the negotiation, i.e. how hard you push on each element of what you ask for. Further details on common elements of potential value in complex compensation schemes are discussed below.

Items often at issue – Sub-parts of the major steps above.

1. Cash payment of severance pay

Is there a written severance program applicable to the whole company? If so, is it an ERISA-governed severance plan? Answering the ERISA question can be complex – there is a lot of litigation concerning whether severance plans are ERISA plans. But here are the quick questions to ask that will answer for most situations:

a. Does it claim to be governed by ERISA?

This is not determinative, but it is informative.

b. Does it pay ongoing regular pay or a single payment?

Ongoing pay makes it more likely to be an ERISA plan.

c. Is there an administrative process for making claims, with an appeal process?

If so, it's more likely to be an ERISA plan.

d. Are discretionary decisions made by an administrator or committee, or is there a mechanical formula?

A discretionary scheme is more likely to be an ERISA plan.

If there is a written plan, does it require a release of claims? Most do. If so, you need to factor in the requirement of a release in the plan if you are negotiating severance based on the existence of a cause of action against the employer. A plan can provide a floor of severance, which is nice, but it can also make it much harder to persuade an employer to increase its offer, since it knows it can buy the release for the amount that the plan offers. Some employers even have severance plans with two tiers of benefits – a small amount available without a release, and more generous benefits available if the employee signs a release.

Identifying the strengths and weaknesses of available cash severance payments must be balanced against the client's interest in other facets of potential separation compensation.

2. Stock options and Restricted Stock Units (RSUs)

Stock options are the most common type of equity compensation, in my experience, and are particularly popular – and risky! – in the technology industry and in startups. Here are the main steps for dealing with an equity compensation situation in a severance negotiation.

a. Get copies of the written grants to the individual employee.

Most of the details governing an employee's options will be set forth in a written grant. If an employee has been with an employer for a couple of years or longer, they may have received multiple grants, so try to get the client to track them all down.

b. Get a copy of the written plan that governs the overall program.

Stock option and RSU compensation programs are generally governed by written plans. Keep in mind that because these are generally not retirement programs, they are not governed by ERISA. Instead, they are governed by state law and also often heavily impacted by the Internal Revenue Code and sometimes securities regulation. The details of those regulatory schemes are far beyond the scope of this guide.

The plan is often provided as an exhibit to the employee's written grant. If it isn't, the employee needs to get it from HR. You need this so you can check definitions and understand what is and is not permissible under the program, as well as to understand whether the stock options are tax-qualified ("Incentive Stock Options" or "ISOs") or not "(Non-Qualified Stock Options") or "NSOs").

c. Help the client figure out if she wants to exercise her options.

When stock options are part of your compensation, it is common to forget that you're not getting the shares outright. You're getting the right to purchase them at a set price, when certain conditions are fulfilled. The client still must exercise the options in order to get the shares. Often a client is anxious to capture the value they perceived they were getting with their stock option grants, but I caution lawyers not to jump into trying to maximize a client's stock options without careful analysis.

First, there are vesting schedules. A client can only exercise options that have vested. Every plan is different, but an example of a common structure is that an employee receives a grant of options, with an initial fraction of those options vesting after a year of employment, and the remaining options vesting in periodic chunks (monthly, quarterly, or annually) until the full grant is vested. Employees often receive a grant at the start of employment and further grants during employment, sometimes in connection with raises, promotions, or other renegotiations of compensation. The most important thing about vesting is that a client cannot exercise any options that have not yet vested at the time of termination.

Second, there are deadlines to exercise. Due to the financing required, clients sometimes want more time to decide if they will exercise their vested options. Unfortunately, ISOs have a deadline to exercise of three months after termination, which is not changeable because it comes from the Internal Revenue Code. Even NSOs have deadlines written into the plan. However, extension of a deadline may be more possible with NSOs because they are not limited by Internal Revenue Code provisions.

Third, it costs money to exercise options! How much cash does the client have available to exercise? This can interact with the cash severance component of the negotiation. If an employee is unexpectedly without a job, that can be a challenging time to find the cash to make a stock investment. This decision is not primarily a legal one and involves careful circling back to the primary interests of the client. Ethically and risk-wise, a lawyer should also avoid giving financial advice. You can help them identify the issues to make a good decision, and they may need to consult a financial advisor.

Fourth, the client must account for taxes. A big part of what makes options attractive is the possibility of purchasing shares for below market price. However, when a person purchases stock below market rate, there is a tax impact. This can be a shock to many holders of options and can really take the shine off a grant of options. If the options are NSOs, the employee must pay taxes that year on the "unrealized gain," i.e. the difference between purchase price and market value, even though that gain may never be realized. ISOs sometimes avoid that problem unless the employee is subject to AMT, and the rules are complex. If the investment loses money, the loss can be written off for tax purposes at that future time. Do not attempt to figure this out in detail yourself without a tax expert. I am not a tax expert, so I discuss these issues in a big-picture way to help a client make decisions about which aspects of their compensation are most important to them in the negotiation, and I refer them to their tax advisors for the detailed math regarding their options.

The major questions to ask and investigate are:

a. Does she want to invest in her (soon-to-be-former) employer?

Does she see this as a business that will succeed or one that is likely to fail? This question can be quite different when the company is a large, established business compared to when the company is a startup that is not yet stable. In light of that unknowable question, how much risk is she interested in taking? This question can also be impacted by the fact that once she is terminated, exercising her stock options no longer involves "betting on herself."

b. If she is interested in investing, to what extent does she want to invest?

Again, if she wants to invest all her vested options, does she have the available cash to do so? Or does the plan allow for a "cashless exercise," in which some options are surrendered to pay for others? You can look this up in the plan and you can also bring it up as a possibility in the negotiations. Don't forget about the tax issues mentioned above, which complicate this question.

c. If she is interested in making a substantial investment, and would like to exercise more options than are vested, can you push for accelerated vesting?

This can be attractive to the employer because there is no cash outlay, the employer in fact gets cash back in the form of increased investment, and it is a compliment for a departing employee to want to invest. If this is interesting for your client, this can be a way to maintain a positive relationship between employer and outgoing employee.

The "start-up lottery" increases the need to consider these questions very carefully in the context of an early-stage, highly risky, privately held company. In that context, there is a substantial likelihood that the company goes out of business. There is also the possibility of a truly massive gain. And there is rarely a ready market for shares. In that context, a client needs to consider very carefully their own risk profile and needs. In many cases I see this play out as a recognition that the equity portion of their compensation was, to their great disappointment less valuable to them than they originally believed, because they are not in a position to capture the potential value.

3. <u>Deferred compensation programs</u>

Deferred compensation programs are usually very strictly governed and rarely provide a lever for negotiation due to IRS restrictions (see the other materials for this session concerning Internal Revenue Code Section 409A). Amounts are usually set in stone because they represent deferrals of a portion of the client's compensation, previously set by the client.

However, it is always important to help the client sort through the priorities. For example, if the client has deferred compensation coming her way, that may impact her need for cash severance in comparison to other severance benefits. In addition, some deferred compensation programs have employer contributions, and if the client is close to a point of vesting in some amount of the employer's contributions, accelerating vesting can be a point of negotiation.

4. **Retirement programs, including SERPs**

Many companies have extra retirement plans for executives that are non-tax-qualified, known as Supplemental Executive Retirement Plans ("SERPs") or "top hat plans."

These programs are often generous in their monetary terms but leave a lot of discretion with the employer and little remedy for the employees. However, since there is often a lot of discretion with the employer, you can sometimes persuade them to take a generous position on whether a client has vested or not. Similarly, it is worth seeing if a slightly longer employment period could affect eligibility for a benefit. These plans are usually only available to senior executives, but they are an area where a small non-monetary agreement can provide a significant benefit to a client. Also, since these plans are generally funded separately from the employer's general assets, it may be able to convey the benefit on your client without an immediate payout of cash, which can make it an easier sell to the company in the right circumstances.

5. **Bonuses**

Identify if bonuses were an element of your client's compensation. If they were, identify if there are any potential disputes about bonuses, including their timing and amount. If there is any uncertainty around a bonus, figure out how the bonus program is structured. For example, a written policy provides different levers in a negotiation than a casual policy does. The same is true of a purely discretionary bonus as opposed to a bonus that is based on agreed-upon and verifiable metrics. Another common potential disputes concerns a bonus that is payable only if the employee is employed on the day it is paid, even if it is earned based on performance prior to that date. Laws vary on whether an employee is entitled to a pro-rata portion of a bonus that is ordinarily paid only if she is employed on a certain date. Research your local laws on this point if this is an issue for a client.

6. **Health coverage continuation**

For some clients, continuation of health coverage at an affordable rate is a critical issue. Sometimes clients want to be maintained on the health plan as though they were an active employee for an extended period. Unfortunately, most health plans do not allow a person to remain covered as an active employee beyond the end of the month in which her employment terminates. This can sometimes be ameliorated by moving a termination date by a tiny margin (e.g. last day of June 1 gets another month of coverage compared to last day of May 31).

In addition, some severance negotiations include reimbursement for COBRA premiums for a certain amount of time. Some agreements make this contingent on the client not becoming eligible for another employer's plan during the reimbursement period. This is usually fine with a departing employee, because the point of this term is access to health coverage, not forcing the employer to pay. If forcing the employer to pay is the goal, that is better achieved through a hardball cash negotiation. This is another illustration of knowing what matters to your client. COBRA reimbursement will be critical for some clients, and secondary for others.

7. **Reputational terms**

In a situation where the availability of a positive reference (or the absence of one) can have a serious impact on the client's future job search, you may want to bargain for a positive letter of reference from someone at the company. Sometimes this can take the form of a pre-agreed letter – that can often be a way around a company's strict reference policies.

Another item to keep an eye out for is the non-disparagement provision. Many severance agreements ask for a commitment from the employee not to disparage the company. I believe strongly these should be reciprocal.

An employer's agreement not to contest an Unemployment Insurance application can be valuable as well. This can be especially important in a situation where, for reputational reasons, the employer and employee are otherwise characterizing the termination as a resignation, which would ordinarily render the employee ineligible for unemployment insurance.

8. **Non-Competition Agreements**

A full discussion of non-competition law is far beyond the scope of this guide. It is mentioned here because changes to non-competition provisions can have major value for your client. In general, you need to check your local law if a client's termination presents a non-competition issue. Understand what factors your state law uses to evaluate a restrictive covenant.

For example, if the restrictive covenant is important to the employer, perhaps you can persuade them that they need to pay severance for the full restricted period, in order to help ensure it is enforceable. And, of course, watch out for an employer seeking to use the severance agreement to increase a previously agreed term of non-competition.

Negotiating Deferred Compensation Issues in Employment, Compensation, and Severance Agreements

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1. Overview

When representing an employee, the best opportunity to enhance and secure deferred compensation interests is by negotiating specific and strong provisions in agreements, particularly at the outset of the relationship.

An employee's optimum leverage to negotiate compensation terms typically is during the hiring phase, when the employer is trying to entice the employee to join the company. Once the employee has started work, the leverage is diminished. At the end of the relationship, the leverage may be nil. Nonetheless, an employee's counsel often can help an employee at each stage of the employment relationship with respect to deferred compensation interests.

2. The Hiring Phase

During the hiring phase, counsel for the employee should examine carefully the terms of any proposed offer letter and/or employment agreement with respect to the circumstances under which the employee may or will be granted deferred compensation and under which the employee will vest and be paid such deferred compensation. Typically, such documents are vague about such matters, especially offer letters; and when they are not vague, they often provide little or no protection for the employee.

The counsel also should gather information about the employer's compensation plans, such as copies of plan documents (e.g., Long Term Incentive Plan, Equity Incentive Plan, Supplemental Executive Retirement Plan) and template grant or award agreements. These are the seminal documents that will govern compensation. Also, when possible, counsel should gather information about employment agreements the company has entered into with others; for publicly traded companies, employment agreements of top executives are readily available.

Such agreements can show what kinds of arrangements others have gotten, which can be the basis for negotiating comparable terms for one's client.

Typically, plan documents grant to the board (or the compensation committee of the board) fairly broad authority to determine the terms and conditions for awards of deferred compensation. In some situations (e.g., with a senior executive) that authority can enable counsel to negotiate improved terms and conditions for grants of deferred compensation. For example, counsel may be able to negotiate a provision in the grant agreement that, in the event of a termination without cause or a resignation for good reason, the employee will get accelerated or continued vesting of some or all of invested deferred compensation.

Employers typically say that the terms and conditions of a standard grant agreement are not negotiable. And that is usually true. But sometimes it isn't true. When a standard grant agreement produces illogical or unfair results, employers sometimes - under pressure from affected employees - will revisit the standard provisions and change them. For example, in a recent contract negotiation, we realized that the terms for vesting of unvested deferred compensation upon termination due to death or disability were more pro-employee than the corresponding terms upon termination without cause. When this was called to the attention of the CEO, who was subject to such terms himself, he went to the board's compensation committee, which agreed to improve dramatically the vesting provisions upon termination without cause.

Counsel for the employee generally should try to negotiate as part of the employment agreement that, upon termination without cause (or resignation for good reason), all or most unvested deferred compensation will vest despite the termination -either accelerated vesting or continued vesting. Accelerated vesting is typically hard to obtain, except in the context of a change-in-control, when accelerated vesting is the norm. Nonetheless, continued vesting is common and valuable, i.e., the deferred compensation will continue to vest on the normal schedule despite the termination. The goal of course is to get continued vesting of 100% of unvested compensation, but sometimes the best that can be obtained is continued vesting of part of the unvested compensation, such as any tranches that would vest in the 12 months after the termination date.

Another point for negotiation relates to the circumstances under which deferred compensation will be granted or will vest. For example, under incentive compensation plans, a bonus (which may include deferred compensation) is earned only upon achieving certain performance goals for the company, the business unit, and/or the employee. In such circumstances, counsel should strive to make sure that the performance goals are reasonable and achievable; unachievable goals are illusory. Thus, the specific goals might be spelled out in the employment agreement. Or the method for determining the goals might be specified (e.g., the goals will be mutually agreed upon between the employee and the employer, rather than established by the employer in its discretion).

Some employees receive "make whole" awards of deferred compensation as part of their employment package to compensate for some or all of the deferred compensation the employee will forfeit upon leaving the prior employer. Such make whole awards typically are subject to vesting requirements similar to the vesting requirements applicable to the forfeited deferred compensation. These awards present the strongest case for the employee to negotiate accelerated or continued vesting upon termination without cause (or resignation for good reason), given that the employee should not be put at risk of losing compensation that presumably was not subject to substantial risk of forfeiture at the prior employer. Of course, the employee may choose to accept such risk in the context of other considerations, such as the overall attractiveness of the job and the total compensation. It sometimes comes down to who wants whom the most - the employer or the employee - as well as what the employee's alternatives are (at the current employer or with other prospective employers).

3. The Employment Phase

Most employees do not have the opportunity to negotiate compensation terms beyond the initial stage of their employment, if at all. Thus, most grants of deferred compensation during employment are determined by the employer with little or no input from the affected employees. Nonetheless, employees can help themselves by such things are trying to assure that performance standards and goals are reasonable and achievable, striving to meet such standards and goals, and keeping informed about developments affecting compensation of the employee and others. For example, learning what others have been granted may reveal patterns of discriminatory or unfair treatment, which may lead an employee to seek correction.

4. The Separation Phase

Upon termination, employee's counsel obviously wants to maximize the economics of the client's separation package.

The starting point for counsel is gathering as much information as possible that might relate to the economics, including any unvested deferred compensation. Counsel should ask the client to provide, for example, the following: offer letter, employment agreements, compensation or grant agreements for each and every grant of deferred compensation, underlying plan documents, and a chart showing complete information for each grant of deferred compensation (e.g., grant dates, number of units, nature of units, vesting dates, amounts vested, amounts unvested). If for no other reason, the client should have all that information in any event upon departure. Moreover, careful evaluation of such documents can set the stage for negotiations around unvested deferred compensation.

At the threshold, if the company takes the position that the client will forfeit deferred compensation due to termination for cause, counsel may be able to persuade the employer that cause does not exist. If that doesn't work (and usually it won't), counsel should ascertain whether grounds exist under any employment, compensation, or grant agreement or plan to challenge the determination of cause.

In the more typical situation, the termination will be without cause, but the client has no apparent right under the governing documents to continued vesting. For example, a grant agreement may provide for continued vesting only if the termination was due to a reorganization or downsizing - not for other terminations without cause; in that event, counsel may try to fit the client's termination into the mold created in the grant agreement. Likewise, the grant agreement may provide that continued vesting may occur under certain circumstances, such as retirement or early retirement, which might apply to the client. Some grant agreements provide that an employee who is a "good leaver" (i.e., with a certain number of years of service who does not go to work for a competitor) may continue to vest as long as the employee retains the good leaver status.

Sometimes a terminated employee may be within striking distance of a vesting date. In that event, the employer might be persuaded to extend the effective termination date to a date beyond the vesting date, i.e., to "bridge" to the vesting date. Of course, the longer the bridge, the harder it is to convince the employer to do it. The negotiation strategies to convince the employer to bridge are beyond the scope of this outline, but relevant factors include: how long the employee worked with the employer, the contributions of the employee to the company, the degree of unfairness of depriving the employee of the unvested compensation, the degree of guilt or sympathy felt toward the employee, and any legal leverage the employee has or is perceived to have.

The employer may take the position that it cannot provide for more vesting of deferred compensation because doing so would violate the terms of the grant agreement or the plan. That may or may not be the case; the relevant documents should be examined carefully to test the proposition.

An employer may say that it cannot provide for more vesting because it would set an adverse precedent. That may or may not be the case. Of course, the client can and will promise confidentiality of the deal terms, but that may not satisfy the employer.

An alternative in the latter two scenarios is to seek compensation in lieu of the forfeited deferred compensation. For example, the cash value of some of the forfeited deferred compensation may be added to another category, such as the amount of severance pay, the amount of any unpaid bonus or incentive compensation, or adding payment for COBRA premiums, outplacement service, attorneys' fees, etc.

Counsel should be sure to alert the client to any deadlines, such as the accelerated expiration of vested stock options upon termination (typically three months after termination).

5. Summary

Counsel for employees can substantially increase the amount and security of a client's compensation package or severance package by careful attention to the terms of employment, compensation, and grant agreements and of plan documents, and by employing creative negotiating tactics and strategies at each stage of the employment relationship.

409A Tax Issues in Employment Agreements and Severance Pay

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409A Tax Issues in Employment Agreements and Severance Pay[1]

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I. Consequences of a Section 409A Violation for the Service Provider

A. **Income Tax** on service provider's vested (*i.e.*, not subject to substantial risk of forfeiture) nonqualified deferred compensation under the plan/contract (subject to

[1] This paper is based on material by author presented at the NYU Annual Conference on Labor in 2013.

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aggregation of plans, *See* Treas. Reg. §1.409A-1(c)(2)) is assessed in year(s) of Section 409A violation (not year of payment);

1. A Section 409A documentary failure will be a Section 409A violation for each year until the year in which the plan/contract is corrected or the nonqualified deferred compensation is recognized as income and taxed accordingly.

B. **20% Additional Tax** on service provider's vested nonqualified deferred compensation is assessed in year(s) of Section 409A violation;

C. **Penalty Interest** on the service provider's unpaid Section 409A taxes charged at a rate equal to sum of the I.R.C. § 6621 underpayment rate plus one percent (1%); and

D. **Potential State Penalties** or interest on service provider's state taxes (*e.g.*, Cal. 20 % additional tax and penalty interest)

II. Section 409A's Scope

A. Section 409A's requirements apply whenever a "service provider" has a "legally binding right" to "nonqualified deferred compensation" from a "service recipient" and no Section 409A exemption applies

1. Service provider means an employee, director, consultant, or, in some cases, an independent contractor (incorporated or not) (Treas. Reg. §1.409A-1(f)) (*I.e.*, the "Employee")[3].

2. Legally binding right means a contractual right (or in rare cases, statutory right) enforceable under the relevant law that is either non-conditional or that is conditional on fact(s) not entirely within the service recipient's control (*See* 72 Fed. Reg. 19,234, 19,236).

3. Nonqualified deferred compensation ("NQDC") means compensation that:

   a. *might* be (although not necessarily is) paid in a tax year after the Employee's right to the compensation vests (Treas. Reg. §1.409A-1(b)(1)); and

   b. is not exempt from Section 409A due to the exemptions for deferred compensation paid under a qualified retirement plan, certain broad-based foreign retirement plans, ISO or I.R.C. § 423 plans.

4. Service recipient means a person or company that the Employee performs work for as well as other companies under common control (Treas. Reg. §1.409A-1(g)), (*I.e.*, the "Employer")[4].

[3] For the remainder of this outline, "Employee" will be used to mean any Section 409A service provider.

[4] For the remainder of this outline, "Employer" will be used to mean any Section 409A service recipient.

a. Entities included in the definition of Employer due to common control are generally only relevant in the severance context when considering separation from service issues.

B. **Typical Section 409A-Governed Agreements**:

1. Employment agreements;
2. Bonus arrangements; and
3. Severance plans (salary continuation, benefits continuation, etc.).

C. **Section 409A Exemptions** that excuse an arrangement from Section 409A's requirements:

1. Separation Pay exemption (Treas. Reg. §1.409A-1(b)(9)), which applies if:

   a. the Employee receives full payment within two (2) years of separation from service; and

   b. payment is ≤ two (2) times the lesser of:

      i. the Employee's compensation for tax year before separation; and

      ii. the I.R.C. § 401(a)(17)(B) compensation limit for the year of separation ($255,000 in 2013)

   and

   c. Either Employee experiences an "involuntary separation from service";

      i. Involuntary separation from service means a "separation from service" either initiated by Employer (termination) or initiated by the Employee (resignation) for "good reason" (Treas. Reg. §1.409A-1(n)(2)).

         aa. Good Reason resignation means a separation from service due to a "material negative change" that the Employer has an opportunity to cure and fails to cure. The regulations provide a safe harbor definition of good reason (Treas. Reg. §1.409A-1(n)(2)(ii)).

      ii. An involuntary separation of service might occur even if the Employee continues to work for the Employer but at a significantly lower rate (Treas. Reg. §1.409A-1(h)).

   d. Employee (voluntarily or involuntarily) participates in a "Window Program"

      i. Window Program means a program lasting no more than twelve (12) months that is established by the Employer in connection with impending separations from service for those who separate under certain circumstances (Treas. Reg. §1.409A-1(b)(9)(vi)).

e. The Collectively Bargained Separation Pay Plan exemption allows for a broader definition of involuntary separation from service than the standard Separation Pay exemption and for payments exceeding the 2x pay cap and 2 year term (Treas. Reg. §1.409A-1(b)(9)(ii)).

2. Short-term Deferral exemption (Treas. Reg. §1.409A-1(b)(4)), which applies if:
   a. contract/plan provides for payment to be made within two and one-half (2 ½) months after the later of:
      i. the end of the Employee's tax year in which payment is no longer subject to a "Substantial Risk of Forfeiture" (*e.g.*, March 15th if Employee is natural person); and
         aa. Substantial Risk of Forfeiture means payment is still contingent upon either the performance of substantial future services or the occurrence of an event that is both related to compensation goals (*e.g.*, reaching earnings benchmark) and has a substantial risk of not occurring (Treas. Reg. §1.409A-1(d)).

         An obligation to observe a restrictive covenant (Treas. Reg. §1.409A-1(d)(1)) or to sign a release of claims (72 Fed. Reg. 19,234, 19,251) does not constitute a substantial risks of forfeiture

      or

      ii. end of the Employer's tax year in which payment is no longer subject to a "Substantial risk of forfeiture" (*e.g.*, June 15th if Employer has a March 31 end of tax year)

   and

   b. payment is actually received/constructively received by Employee within time period provided for in the contract/plan;
      i. Annuities are treated as one payment (Treas. Reg. §1.409A-2(b)(2)(ii)(A)) and thus no portion of the annuity will satisfy the short-term deferral if the annuity's term extends beyond the 2 ½ month window
      ii. A series of installment payments will be treated as an annuity (and thus ineligible for short-term deferral) unless the contract/plan specifically provides that the installments should be treated as a series of separate payments (Treas. Reg. §1.409A-2(b)(2)(iii)).

3. Equity Compensation exemptions for restricted stock, statutory stock options, and FMV Employer stock option and SAR grants

4. Grandfathered compensation that was granted and vested prior to January 1, 2005 (Treas. Reg. §1.409A-6(a)(1)(i));

5. Miscellaneous exemptions include, but are not limited to:
    a. I.R.C. § 401(a) qualified retirement plans and I.R.C. § 403 annuity plans (Treas. Reg. §1.409A-1(a)(2));
    b. Bona fide employment claim settlements (Treas. Reg. §1.409A-1(b)(11));
    c. Certain separation payments, benefits and reimbursements (Treas. Reg. §1.409A-1(b)(9)(v)) are exempt if:
        i. Employee incurs expense before end of second (2nd) year following separation; and
        ii. Employee receives payment by end of third (3rd) year following separation; and
        iii. payment relates to specially exempted categories such as:
            aa. either reimbursement of a deductible business expense; or
            bb. in-kind benefits (*e.g.*, financial planning, company car, company housing)
    d. Health plans and other reimbursements of medical expenses that are excludable from income under I.R.C. §§ 105-106 (Treas. Reg. §1.409A-1(a)(5));
        i. Health expense reimbursements are not excludable from income if the relevant health plan discriminates in favor of "Highly Compensated Individuals" under I.R.C. §105(h), such as by offering better post-employment coverage for Highly Compensated Individuals.
            aa. Highly Compensated Individual includes the top twenty-five percent (25%) of employees as ranked by compensation (I.R.C. §105(h)(5)).
            bb. Traditionally, I.R.C. §105(h) discrimination was only a concern for self-insured plans, but the Affordable Care Act applies the same concepts to fully insured plans under 42 U.S.C. § 300gg-16.
    e. Health plans covering only I.R.C. §213 deductible medical benefits during the COBRA continuation period, even if plan is discriminatory or otherwise taxable (Treas. Reg. §1.409A-1(b)(9)(v)(B)).
    f. Health plan premiums paid in full (employer plus employee cost) by the Employee to secure the I.R.C. §104(a)(3) tax exemption.

III. Section 409A's Requirements

A. **Documentary Compliance**: A Section 409A-compliant contract/plan (composed of one (1) or more written parts) must include terms providing that:

1. Payment Trigger is limited to one (1) or more of the following seven (7) permissible payment events:
    a. Permissible payment events are:

i. A Fixed Date (Treas. Reg. §1.409A-3(a)(4));
ii. Lapse of Substantial Risk of Forfeiture (Treas. Reg. §1.409A-3(i)(1)(i));
   aa. If an Employer waives vesting criteria (*i.e.*, waives the substantial risk of forfeiture), then payment timing must be determined as if such waiver never occurred or else there will be an improper acceleration of payment.
   bb. This payment event is technically a subset of the fixed date permissible payment event. Thus commentators typically list six (6) permissible payment events.
iii. "Change in control" of the Employer or majority owner of Employer (Treas. Reg. §1.409A-3(i)(5));
iv. "Separation from service" of the Employee (Treas. Reg. §1.409A-1(h));
   aa. Separation from service for an employee means expectation of ≥ eighty percent (80%) reduction in future services compared to of average service in preceding thirty-six (36) months;
   bb. Separation from service for a contractor means complete termination of services;
   cc. "Key employee" (Treas. Reg. §1.409A-1(i)(1)) separation of service payments are subject to mandatory six (6)-month delay if Employer is a public company.
v. Death of the Employee;
vi. "Disability" of the Employee (Treas. Reg. §1.409A-3(i)(4)); or
vii. "Unforeseeable emergency" (Treas. Reg. §1.409A-3(i)(3));

b. A contract/plan can provide that payment will occur on earliest or latest of permissible payment events selected (*e.g.*, earlier of January 1, 2020, death, and separation from service);

2. Payment Timing is set to occur or commence on a compliant date or schedule (Treas. Reg. §1.409A-3(b))
   a. Compliant payment timing/forms include:
      i. lump sum payment on the actual date of the permissible payment event or another date that is nondiscretionary and objectively determinable as of the payment event;
      ii. payment in multiple installment payments on a schedule in which each installment date is nondiscretionary and objectively determinable as of the payment event; or

iii. lump sum payment or in installments that occur anytime during a nondiscretionary and objectively determinable payment period that is limited:
    aa. to one (1) tax year of the Employee; or
    bb. to ninety (90) days and that does not allow the Employee to control the tax year of payment;

b. A contract/plan can only include only one (1) schedule of payments for Fixed Date payments (Treas. Reg. §1.409A-3(c));

c. The contract/plan can include no more than two (2) schedules of payment for Change in Control, Death, and Disability payment events, each schedule to be linked to one of the following:
    i. a Death/Disability/Change in Control prior to a specified date (*e.g.*, five equal annual payments if change in control before 2020); and
    ii. a Death/Disability/Change in Control subsequent to that specified date (*e.g.*, lump sum if change in control during or after 2020) (Treas. Reg. §1.409A-3(c)).

d. The contract/plan can include no more than three (3) schedules of payment for Separation from Service payment events, each schedule to be linked to one of the following:
    i. separation from service within two (2) years of a change in control (Treas. Reg. §1.409A-3(c)(1));
    ii. separation from service before or after a specified date/period of service (Treas. Reg. §1.409A-3(c)(2));
    iii. separation from service unrelated to a change in control, specified date, or period of service (Treas. Reg. §1.409A-3(c)(3))

3. Payment Amount is limited to a specific sum or to an amount to be determined under an objective, nondiscretionary formula (*See* 72 Fed. Reg. 19,234, 19,250).
    a. If the amount of deferred compensation is entirely within the Employer's discretion (no controlling formula), then the Employee has no "legally binding right" to the compensation and Section 409A will not be applicable.

4. Subsequent Deferral Elections by the Employee are either prohibited or are limited to elections that satisfy the following requirements:
    a. Amendment occurs ≥ twelve (12) months before payment is originally scheduled under initial elections;
    b. Amended payment date/event cannot take effect for twelve (12) months from date of subsequent deferral election; and
    c. Either the amended payment date/event causes ≥ five (5) year delay in payment from original payment schedule; or

d. The amended payment date/event is linked to the Employee's death, disability, or unforeseeable emergency (Treas. Reg. §1.409A-2(b)(1)).
e. Because annuities are considered one payment, the subsequent deferral election must occur 12 months before an annuity first commences

5. Acceleration of Deferred Payments is prohibited (Treas. Reg. §1.409A-3(j)(1)), subject to exceptions described below.

6. Furthermore, the Election of Payment Amount, Timing, and Form must be set out in the written contract/plan in a timely fashion;
   a. General rule:
      i. Employee must make Election in calendar year prior to year in which corresponding services are performed (Treas. Reg. §1.409A-2(a)(3));
      ii. If Employee is offered no election deferral opportunity, then the Employer must determine the date and form of payment by the later of:
         aa. the date the Employee first has a legally binding right to the deferred compensation (*e.g.*, contract execution date or discretionary bonus determination date); and
         bb. the date the Employee election rules require an election to be made (Treas. Reg. §1.409A-2(a)(2)).
   b. New entrant rule: Election must occur within thirty (30) days of date that Employee first becomes eligible to accrue deferred compensation under the contract/plan
   c. "Performance-based" compensation (payment based on attainment of predetermined performance criteria, see Treas. Reg. §1.409A-1(e)) rule: Election must occur prior to earlier of:
      i. six (6) months before end of performance period; and
      ii. date that the amount payable becomes ascertainable
   d. Negotiated Separation pay (Treas. Reg. §1.409A-2(a)(11)) rule: Election must occur on or before date on which the Employee first obtains a legal right to the payment. The exception does not apply for payments that Employee had some right to prior to separation, even a contingent, unvested right (*e.g.*, rule does not apply to amount from separation pay plan, even if plan only guaranteed payment for involuntary separation and separation turns out to be voluntary).

B. **Operational Compliance**: All Section 409A-mandated terms of the contract/plan must be strictly adhered to, subject to the following limited exceptions:

   1. Leeway regarding payment timing:

a. Payment can be delayed after date designated in contract/plan as long as payment(s) occurs:
    i. either within the same Employee tax year as the designated payment event; or
    ii. on or before the fifteenth (15^{th}) day of the third (3^{rd}) calendar month following designated payment event (provided that Employee cannot control year of payment) (Treas. Reg. §1.409A-3(d)).
b. Payment can precede date designated in contract/plan by as many as thirty (30) days (provided that Employee cannot control year of payment) (Treas. Reg. §1.409A-3(d)).
c. Late payment will not violate Section 409A if payment is delayed due to a bona fide dispute and Employee takes timely enforcement action (Treas. Reg. §1.409A-3(g)).

2. <u>Election Revocation Opportunities</u>:
    a. An initial election can be revoked if the Employee becomes disabled (Treas. Reg. §1.409A-3(j)(4)(xii)) or suffers an unforeseeable emergency (Treas. Reg. §1.409A-3(j)(4)(viii)).

3. <u>Amending the payment timing/form</u> provided for in the contract/plan terms based on:
    a. Acceleration of Payment: Contract/plan can be amended anytime to allow for earlier (not later) payment date triggered by Employee's death, disability, or unforeseeable emergency (Treas. Reg. §1.409A-3(j)(2)).
    b. Terminating amendment: Plan can be amended to accelerate payment to pay out upon termination of plan in certain situations (*e.g.*, termination caused by change of control, bankruptcy)

IV. <u>Section 409A Considerations for Severance Pay and/or Benefits in Employment Agreements</u>

A. First, **Identify the "Nonqualified Deferred Compensation"** in the employment agreement that may be paid out after separation from employment. Likely examples include:

1. Severance pay/Salary continuation;
2. Pro-rated annual bonus for year of separation of service (if eligible) or payment of long-term incentive award;
3. SERP;
4. Continuation of health plan coverage; and
5. Other reimbursement or in-kind benefits (*e.g.*, outplacement benefits, moving expenses, etc.)

B. Second, **Secure Section 409A Exemptions**, where possible.

1. For NQDC payments, the likely exemptions include:
   a. the Short-term Deferral Exemption (*See* II.C.2). To secure a short-term deferral exemption, the contract/plan must:
      i. Condition entire payment of severance-related NQDC on the lapse of a Substantial Risk of Forfeiture.
         aa. Standard practice is to condition payment on the Employee's Involuntary Separation from Employment, as that term is defined under Section 409A.
         bb. In no circumstances should the payment vest on an entirely voluntary separation from employer because then there is never a Substantial Risk of Forfeiture and the limited payment window for the Short-term Deferral exemption will begin running down once the employment agreement is signed.
      ii. Condition entire payment (but not date of payment) on the timely execution of a comprehensive release of claims and/or restrictive covenant such that the release and/or covenant is irrevocable by or before the payment date;
         aa. *Note* that the Older Workers Benefit Protection Act (which amended the Age Discrimination in Employment Act) requires an employer to allow the employee twenty-one (21) days to review the release and seven (7) days to revoke a signed release. A forty-five (45) day review period must be offered if the termination is part of a group termination.
      iii. Provide for severance-related NQDC to be paid in full by March 15th in year following separation from service (date of separation from service may not be last day of work if advance notice given).
      iv. *Sample Form Language*:

         If, during the Employment Period, the Company shall terminate the Executive's employment other than for Cause or Disability or the Executive shall terminate employment for Good Reason, then provided that the Executive signs a Satisfactory Release within 21 days of the Date of Termination and does not revoke it within 7 days after the date he executes such Release, the Company shall pay to the Executive, within 90 days following the Date of Termination, but not later than March 15 of the calendar year following the Date of Termination, a lump-sum cash payment equal to [______________].

   and/or

b. the Separation Pay Exemption. To secure a severance pay exemption, the contract/plan must:

  i. Condition entire payment of severance-related NQDC on the occurrence of an “Involuntary Separation from Service” or participation in a “Window Program”;
  ii. Condition entire payment (but not date of payment) on the timely execution of a comprehensive release of claims such that the release is irrevocable by or before the payment date/commencement;
  iii. Specify that each installment of severance-related NQDC is a separate payment;
  iv. Limit the total payments to the lesser of two (2) times the Employee’s previous year compensation or the I.R.C. § 401(a)(17)(B) compensation limit for the termination year;
  v. Provide that installment payments will cease on the second (2^{nd}) anniversary of the Involuntary Separation from Service and any remaining balance will be paid at that time in a lump sum
  vi. *Sample Form Language*:

     Subject to the Executive’s execution and non-revocation of a binding release in accordance with Section [_] below, in the event of the Executive’s Separation from Service with Company by reason of a termination without Cause [or a termination by the Executive for Good Reason], the Company shall pay to the Executive, in regular installments in accordance with the Company’s payroll practices and less appropriate payroll deductions, the Executive’s monthly Base Salary as in effect immediately prior to the Termination Date for the lesser of (i) [_] months or (ii) the Base Salary payable for the remainder of the Term (the “Severance”).

     Payment of such Severance shall commence as of the first regular payroll date following the Termination Date, *provided, however*, that any such installments that are payable prior to the date the binding release becomes effective shall be withheld by the Company and paid in a single lump sum payment, without interest, on or before the second regularly scheduled payroll following the effectiveness of the binding release, but not later than March 15 of the calendar year following the Termination Date. Each payment under this Agreement, including without limitation each payment other than a life annuity (within the meaning of Treasury Regulation Section 1.409A-2(b)(2)(ii)) in a series of scheduled installments (within the meaning of Treasury Regulation Section

1.409A-2(b)(2)(iii)), shall be deemed a separate payment for purposes of Section 409A.

or

c. Stacking of the Short-term Deferral and Separation-Pay exemptions. To stack the short-term deferral and severance pay exemptions, the contract/plan must:

   i. Condition entire payment of severance-related NQDC on the occurrence of an "Involuntary Separation from Service" or participation in a "Window Program";
   ii. Condition entire payment (but not date of payment) on the timely execution of a comprehensive release of claims such that the release is irrevocable by or before the payment date/commencement;
   iii. Specify that each installment of severance-related NQDC is a separate payment;
   iv. Provide for a series of bi-monthly, equal payments that are limited in total amount to two (2) times the Employee's previous year compensation and that will conclude on the second (2^{nd}) anniversary of the Employee's separation from service;
   v. Provide for a lump sum payment equal to the difference between the total NQDC owed under the contract/plan and the amount described in IV.B1.c.iv above to be paid by March 15^{th} in the year following separation from service.

2. For NQDC in-kind benefits or reimbursements, the likely exemptions include:

   a. the COBRA Continuation Coverage exemption;. To secure the COBRA continuation health plan exemption, the contract/plan must:
      i. Limit the term of participation in the group health plan to the COBRA continuation period;
      ii. Ensure that the group health plan offered, only covers I.R.C. §213 medical benefits.

   or

   b. the Non-discriminatory Health Coverage exemption;

   or

   c. the I.R.C. §104(a)(3) tax exemption;

   or

   d. the in-kind business benefit or reimbursement exemption.

C. Third, **Ensure Section 409A Documentary Compliance** for payments and benefits/reimbursements not exempted from Section 409A exemption (or to employ a "belt and suspenders" approach in case a documentary or operational failure renders the anticipated Section 409A exemption(s) unavailable). This can be achieved by addressing in the contract/plan the NQDC's:

1. Payment Trigger:
    a. Standard practice: Use Separation from Service (as defined under Section 409A) as the payment trigger.
    b. Alternative: Use Lapse of Substantial Risk of Forfeiture as payment trigger.
2. Payment Form and Schedule:
    a. Standard practices for payment include:
        i. Lump sum payment to occur within 90 days of the payment trigger;
        ii. Installment payments on employer's regular payroll cycle with the first payment scheduled for the first payroll date occurring 60 or more days after the payment trigger, subject to six-month delay if Employee is a Key Employee.
    b. *Note* that payment commencement generally will be contingent on the timely execution of a comprehensive release of claims;
3. For in-kind benefits or reimbursements only, provide for a Deemed-Compliant Payment Schedule (Treas. Reg. §1.409A-3(i)(1)(iv)(A)), which requires describing in the contract/plan:
    a. an objective, nondiscretionary definition of the eligible reimbursements or in-kind benefits (*e.g.*, same health coverage offered to specified class of active employees);
    b. an objective period during which in-kind benefits will be provided, reimbursable expenses may be incurred;
    c. a limitation to prevent benefits and reimbursements provided in one tax year from affecting benefits and reimbursements in any other tax year;
        i. *Note* that lifetime limits in group health plan will not violate this requirement
    d. a requirement that reimbursements are made by end of the tax year following the tax year in which the expense was incurred; and
    e. a prohibition on exchanging the in-kind or reimbursement benefit for another form of benefit.
4. For gross-up payments only, provide for a Deemed Compliant Payment Schedule by requiring gross-up payments to be made by the end of the Employee's tax year following the tax year in which the relevant tax was remitted by the Employee (Treas. Reg. §1.409A-3(i)(1)(v)).
5. Timely Election of Payment Timing, Form, and Schedule
    a. Generally, an employment agreement will define the payment timing, form, and schedule in its initial terms (thus ensuring timeliness) and will not provide the Employee with the right to elect a deferral of the NQDC or will provide deferral opportunities under a written plan in which Section 409A election timing rules are provided.

6. Six (6)-Month Delay for Key Employees upon separation from service if Employer is a public company or might go public during term of employment agreement
    a. *Sample Form Language*

       Notwithstanding anything in this Agreement or elsewhere to the contrary, if the Executive is a Specified Employee (as defined by Section 409A(a)(2)(B)(i) of the Code and determined by the Company's Compensation Committee or its delegate) on the Date of Termination and the Company reasonably determines that any amount or other benefit payable under this Agreement on account of the Executive's termination of employment constitutes nonqualified deferred compensation that will subject the Executive to "additional tax" under Section 409A(a)(1)(B) of the Code (together with any interest or penalties imposed with respect to, or in connection with, such tax, a "409A Tax") with respect to the payment of such amount or provision of such benefit if paid or provided at the time specified in the Agreement, then the payment or provision thereof shall be postponed to the first business day of the seventh month following the Date of Termination or, if earlier, the date of the Executive's Death (the "Delayed Payment Date").

       In the event that this Section [_] of the Agreement requires a delay of any payment, such payment shall be accumulated and paid in a single lump sum on the Delayed Payment Date together with interest for the period of delay, compounded monthly, equal to the prime or base lending rate then used by [insert bank name] and in effect as of the date the payment would otherwise have been made. In the event that this Section [_] of the Agreement requires a delay of the provision of any benefit, then continuation of such benefit until the Delayed Payment Date is condition on pre-payment by the Executive to the Company of the full taxable value of the benefit and following the Delayed Payment Date, the Company shall repay the Executive for the payments made by the Executive pursuant to the terms of this sentence.
7. Restrictions on Subsequent Deferral Elections and Accelerations
    a. Generally, the contract/plan should bar both non-Section 409A compliant subsequent deferral elections and non-Section 409A compliant accelerations of payments.

D. Fourth, review the contract/plan for **Potential Section 409A Traps**.

1. Ensure that Employee cannot control year that non-Section 409A exempt severance is paid, especially where payment is contingent on execution of a release of claims.
    a. Solution One: Provide that payment will occur on fixed date sixty (60) or ninety (90) days after separation of service

b. Solution Two: Provide that if payment period spans two years, payment will be made in latter year

2. Ensure that no compensation newly granted at the time of termination/resignation is deemed to be payment/improper acceleration of other Section 409A NQDC that was forfeited (*See* Treas. Reg. §1.409A-1(b)(9)(i)).

E. Fifth, **Document Intent** of parties to comply with Section 409A and cooperate in order to do so.

1. *Sample Form Language*:

The intent of the parties is that payments and benefits under this Agreement comply with or be exempt from Section 409A of the Internal Revenue Code of 1986, as amended, and the regulations and guidance promulgated thereunder (hereafter referred to as "Section 409A"), and this Agreement and any associated documents shall be interpreted in a manner that establishes an exemption from or compliance with the requirements of Section 409A.

If Executive notifies the Company (with specificity as to the reason therefore) that he believes that any provision of this Agreement (or of any award of compensation, including equity compensation or benefits) would cause him to incur any additional tax or interest under Section 409A and the Company concurs with such belief or the Company independently makes such determination, then the parties shall co-operate in good faith to modify such provision to avoid application of, or to comply with the requirements of Section 409A to the extent reasonably possible consistent with the original intent of this Agreement. In no event, shall the Company be required to incur any further financial obligations, including to Executive, as a result of such modification.

Section 409A Separation Pay Plans

	Separation from Service Trigger	Involuntary or Window Severance Payment Exemption	Collectively Bargained Separation Plan
Relationship to §409A	Satisfies the timing requirement.	Exempt from definition of NQDC.	Exempt from definition of NQDC.
Compensation Limit	Unlimited.	Lesser of two times: • Annual Base Pay • Statutory limit for compensation under a qualified plan ($265,000 in 2016).	Unlimited.
Timing Considerations	May be immediate, unless the employee is a Specified Employee in which case, after six months. Payment date should be keyed to the date of termination, not to date of execution of any required releases.	Payment must be made no later than the last day of the second year after the year of separation. Subject to the 6-month delay for certain executives.	None.
Additional Considerations.	For most employees, a separation of service means an 80% reduction in services. Can combine with other 409A exemptions, e.g. short term deferral, severance payment; provided agreement states that each payment shall be treated as a separate installment.	Must be keyed to an event outside the control of the employee; most commonly, involuntary termination without cause. Can combine with other 409A exemptions, e.g. short term deferral, severance payment; provided agreement states that each payment shall be treated as a separate installment.	Established subject to a good faith, arm's length negotiation of an agreement that the DOL determines to be a CBA. The terms "separation of service" and "involuntary separation" may be based on reasonable, negotiated definitions; a deemed separation must occur if the employee does not provide any services to a participating employer for 12 contiguous months.

409A Issues in Employment Agreements and Severance Pay

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Presented June 24, 2016 at the NELA 2016 Conference

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Pillsbury Winthrop Shaw Pittman LLP

Overview of Today's Presentation

- Step 1: Identifying severance benefits that might be Nonqualified Deferred Compensation subject to Section 409A
- Step 2: Structuring severance benefits to be exempt Section 409A
  - Short-term deferral exemption
  - Separation from service exemption
  - In-kind benefit and reimbursement exemptions
- Step 3: Structuring non-exempt severance benefits to conform with Section 409A requirements
  - Section 409A documentary requirements
  - Deemed compliance for in-kind benefits and reimbursements
  - 6-month delay for Key Employees
- Step 4: Reviewing for common Section 409A traps
  - Timing of releases
  - Avoiding deemed NQDC substitutions
- Step 5: Documenting intent to comply with Section 409A and cooperate to achieve compliance

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Identifying NQDC severance benefits

- Section 409A applies whenever a "service provider" (*e.g.*, employee) has a "legally binding right" to "nonqualified deferred compensation" from a "service recipient" (*e.g.*, employer) and no Section 409A exemption applies
- <u>Legally binding right</u> means an enforceable right to property that may either be non-conditional or conditional on objective facts *(e.g*., right to annual bonus if employee's unit experiences a year-over-year revenue increase of at least 8%).
- <u>Nonqualified deferred compensation</u> ("NQDC") means compensation that: (i) might be (although not necessarily is) paid in a tax year after the employee's right to the compensation vests; and (ii) is not exempt from Section 409A due to the exemption for deferred compensation paid under a qualified retirement plan or other exemption.

Identifying NQDC severance benefits (cont.)

- Both individual contracts (*e.g.*, employment or severance agreement) or multi-party plans (*e.g.*, union severance plans) may raise NQDC and Section 409A issues.

- Examples of typical severance-related NQDC include:
  - Severance awards and salary continuation;
  - Pro-rated annual bonuses or payments of long-term incentives;
  - Health benefits continuation; and
  - Other reimbursement or in-kind benefits (*e.g.*, moving expenses, outplacement benefits).

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Securing a Section 409A Exemption

The Short-term Deferral Exemption

- The Short-term Deferral Exemption applies to NQDC if the contract/plan provides that:
  - payment of the NQDC is contingent on a Substantial Risk of Forfeiture; and
  - the NQDC must be paid in full by 2 ½ months after the later of:
    - the end of the employee's tax year in which Substantial Risk of Forfeiture lapsed (March 15th for natural person); or
    - the end of the employer's tax year in which Substantial Risk of Forfeiture lapsed.

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Securing a Section 409A Exemption

The Short-term Deferral Exemption (cont.)

- Substantial Risk of Forfeiture means that the employee's right to the NQDC is still contingent on either:
  - the employee's performance of substantial future services; or
  - the occurrence of an event that is both related to compensation goals (*e.g.*, earnings benchmark, service requirement) and is substantially at risk of not occurring.

- The date of the lapse of a Substantial Risk of Forfeiture is the Section 409A term of art for the vesting date.

Securing a Section 409A Exemption

The Separation Pay Exemption

- The Separation Pay Exemption applies if the contract/plan provides that:
  - payment of the NQDC is contingent on an Involuntary Separation from Service or separation pursuant to participation in a Window Program;
  - the NQDC must be paid in full within two (2) years of the separation from service; and
  - the NQDC payment is no more than 2x the lesser of:
    - the employee's compensation from the employer in the year preceding separation; and
    - the IRC qualified plan compensation limit for the year of separation ($255,000 in 2013)

Securing a Section 409A Exemption
The Separation Pay Exemption (cont.)

- Involuntary Separation from Service means either:
  - an involuntary termination by the employer; or
  - a Good Reason resignation of the employee
    - the plan/contract must define Good Reason in advance and that definition must include a notice/cure period
    - Standard practice is to incorporate the safe harbor “good reason” definition included in the Section 409A regulations

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Securing a Section 409A Exemption

The Separation Pay Exemption (cont.)

- Safe harbor definition of Good Reason requires that:
  - separation from service occur within 2 years of the occurrence of the good reason event;
  - employee provide notice within 90 days of good reason event and afford employer a 30-day cure period; and
  - the employee experience a good reason constituting:
    - material diminution of salary; or
    - material diminution of employee's or employee's supervisor's authorities, duties, or responsibilities; or
    - material change in budget; or
    - material change in location; or
    - material breach of relevant agreement.

Securing a Section 409A Exemption

The Separation Pay Exemption (cont.)

- Participation in a <u>Window Program</u> means involuntary or voluntary separation from service pursuant to severance terms offered by the employer for no more than 12 months.

- Abusive use of the window program (*e.g.*, constant offers, very targeted offers, offers unrelated to business conditions) will render the Section 409A exemption unavailable.

Securing a Section 409A Exemption

Stacking Exemptions

- Different Section 409A exemptions can be "stacked."
- For example, a long-term incentive plan might provide that an executive's accrued awards under the plan might be paid in equal, bi-monthly installments pursuant to the Severance Pay Exemption, with any amount exceeding the Severance Pay Exemption's 2x pay limit paid out under the Short-term Deferral Exemption.

Securing a Section 409A Exemption

In-kind Benefit and Reimbursement Exemptions

- Exemptions for medical benefits
  - COBRA continuation period exemption; and
  - Non-discriminatory plan exemption

- Exemption for reimbursement of deductible business expenses, outplacement expenses, and moving expenses incurred by the end of the 2^{nd} year after separation from service and paid by the end of the 3^{rd} year.

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Complying with Section 409A

Section 409A Documentary Requirements

- Provide in the plan/contract that the severance related NQDC:
  - will become payable upon a Section 409A-compliant payment “trigger”, such as Separation from Service, Fixed Date, or Lapse of Substantial Risk of Forfeiture;
  - will be paid/commence payment on an “objectively determinable” date or during the period concluding 90 days after vesting;
  - cannot be subsequently deferred after certain dates have passed; and
  - cannot be accelerated (subject to certain exceptions).

Complying with Section 409A
6-Month Delay for Key Employees

- Public companies must delay payments due to Key Employees upon separation from service for 6 months

- Key Employees means:
  - a 5% owner of the employer;
  - top 50 officers with compensation exceeding $165,000 (for 2013); or
  - a 1% owner of the employer with compensation exceeding $150,000

Evading Section 409A Traps
Timing of Release

- Coordination of a release of claims with the Section 409A payment timing rules; plan/contract must eliminate opportunities for employee to manipulate tax year of payment.

- Two approaches:
  - Payment to be made on [60th/90th] day after separation from service, provided that release is executed and irrevocable
  - Payment to be made within [60/90] days after separation from service, provided that release is executed and irrevocable, and further provided that if payment period spans 2 tax years, the payment will occur in the 2nd year

Evading Section 409A Traps
Deemed NQDC "Substitutes"

- New severance benefits negotiated at the time of severance are at risk of being deemed "substitutes" for previously-arranged NQDC that is forfeited. This raises concerns of improper subsequent deferral and/or acceleration of the NQDC payment.

- Whether compensation is merely a substitute is a fact/circumstances analysis based on:
  - circumstances around separation from service; and
  - value of benefit negotiated at termination in comparison to value of the forfeited NQDC

Cooperating to Comply

- Even the best efforts in drafting a plan or agreement may not be enough to prevent a potential Section 409A failure, and the resulting employee penalties.

- Section 409A correction opportunities exist, but most depend on the employer's ability to amend the relevant contract/plan.

Deferred Compensation Issues in Negotiating Severance Agreements

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Types of Deferred Compensation

- Defined benefit
  - Plans that pay out predetermined amounts according to a plan, typically at retirement. They are very common with government jobs but are also used in private companies.
- Defined contribution
  - These are employer contributions to retirement accounts such as 401(k), 403(b), 501(c), or 457(b) accounts.
- Profit/Revenue Sharing
  - These are agreements to give a % of profits/revenues from the company/project.
  - Commonly used in film contracts, where even a fraction of a single % of revenue can be worth millions of dollars.
- Stock Related Deferred Compensation
  - This is the section that I will focus on.
  - There are two main types of stock compensation restricted stock units, which are actual shares of stock given to the employee, and stock options, which are options to buy stock at a certain price.

Stock Options/Units

- Stock Unit
  - Stock units are just a unit of stock in the company.
- Stock Options
  - A stock option is the right, but not the obligation, to purchase (or sell) a stock at a certain price, otherwise known as the Strike Price. Call options, which gives the holder the option to buy a stock, and put options, which gives the holder the option to sell a stock.
  - Employment contracts will award call options, providing incentive for the holder to raise the company stock price.
  - In addition to the Strike price, options will have an expiration date, which is the last date that the option can be exercised.
  - As the option is a right but not an obligation, the value of an option will always be at least $0. If the current stock price is above the strike price, the option is

considered “in the money”. If the stock price is under the strike price, the option is considered “out of the money” and would not be exercised.

- Vesting Schedule
  - Stock Units and Options given in employment contracts typically have a vesting schedule, which will detail how many units or options the employee will receive at what time.

Valuation of Stock Units

- Publicly Traded Companies v. Privately Held Companies.
  - Public Companies
    - Traded on public exchanges.
    - The market price is generally a very good indicator of how much the stock is worth, still subject to much interpretation however.
  - Private Companies
    - Privately held companies are companies that are not traded on public exchanges.
  - Approaches to valuing privately held companies can include the discounted cash flow method, which is done by projecting out future cash flows of the company and then discounting them to the present. However, this method is very reliant on the accuracy of projections, rates of return, growth rates. A small error can lead to a big difference in valuation.
  - Comparable company analysis, which is to find guideline companies in the same business, and then apply valuation metrics from the group to value the subject company.
  - Valuation metrics often include ratios such as P/E, EV/EBITDA, P/A, P/B ratios.
- Startups
  - Valuation of a start up company is especially difficult, due to the little to no history of income or profits, potentially extreme volatility, difficulty in defining comparability.
  - Sometimes can look at the latest funding valuations.
  - Do not assume a percentage ownership reflects a proportionate percentage of Company value.

Valuation of Stock Options

- American vs. European Options
  - American options can be exercised at any time before the expiration date, while European options can only be exercised on the expiration date.
  - Most of the options you will deal with in employment contracts will be American options.
- Pricing Models
  - The two most popular methods are the Black Scholes Model and the Binomial Options Pricing Model.
  - Both these models are extremely complex, but they rely on similar variables. Most public companies apply Black Scholes
- Variables
  - The gain at the time of option exercise is Stock Price less Strike Price. Therefore, it logically follows that as the stock price rises and the strike price falls, the value of the option will rise.

- The risk free rate is the theoretical rate of return that a zero-risk investment would generate. It is in the equation to factor in opportunity cost.
- Time refers to the amount of time before the option expires. The longer the time period, the more valuable the option.
- Volatility is a measure of the distribution of returns for a stock.
- As volatility goes up on a stock, the value of the option will rise because the upside of the option will increase. This owes the asymmetric properties of options.

Startup Equity – Benefits

- Equity Amount
  - Employees at a startup will typically receive proportionally more equity than they would at a large established company.
- High Ceiling
  - Startups can potentially have explosive growth. A startup's stock can skyrocket, especially if the company has not had an IPO. Over a thousand Google employees who became millionaires due to stock options they received during the company's early days.

Startup Equity – Risks

- Dilution
  - Startups often raise money through seed rounds, where the company will create shares of stock to sell to investors. With each share of stock created, the existing stock will be diluted.
- High Risk
  - Despite media, a startup is highly risky. For every Uber, there will be thousands of companies that fizzle out and close down.
  - Availability bias comes into play here.
- Liquidity Issues
  - Prior to an IPO, it is very hard to sell stock in a startup company.
  - Even in IPO, shareholders subject restrictions from exercising stock options or selling company stock for a period of time.

Avoiding Me

- Define Terms
  - Income, profits, net, gross, proceeds, reasonable, adjusted, commissions, etc.
- Identify source
  - Tax returns, QuickBooks, particular reports
- Give examples
  - Provide the specific formula and give an example or two.
  - Provide specific figures to be applied
- Discount rate, percentages, trailing x months, etc.
  - LIBOR, trailing 6 months as of x date, etc.
- Specify approach to valuation
- Mechanism for cashing out

Deferred Compensation

David Weiner of VWM Analytics

Types of Deferred Compensation

- Defined Benefit Plans
- Defined Contribution Plans
- Profit/Revenue Sharing (eg: Film)
- Stock Related Deferred Compensation
    - Restricted Stock Units
    - Employee Stock Options

Stock Options/Units

- Stock Units
- Stock Options
  - Strike Price
  - Expiration Date
- Vesting Schedule
  - Ex: 50% in 2 years, 50% in 4 years

Valuation – Stock Units

- Public Companies
  - Market Price
- Private Companies
  - Discounted Cash Flow Valuation
  - Comparable Company Analysis
  - Assets, etc.

Valuation – Stock Units

- Startups
  - Discounted Cash Flow Valuation
  - Post-Money Valuation
- Control Premium/Minority Interest
  - Shareholder Control

Valuation – Stock Options

- American vs. European Options
  - Most options will be American options
- Pricing Models
  - Black Scholes Model
  - Binomial Options Pricing Model

Pricing Models

- Variables
  - Stock Price
  - Strike Price
  - Risk Free Rate
  - Time
  - Volatility

Startup Equity - Benefits

- Equity Amount
  - Each option/unit will be a larger %
- High Ceiling
  - Startups can grow exponentially

Startup Equity - Risks

- Dilution
  - Future seed rounds
- High risk
  - Going concern
- Liquidity Issues
  - Pre-IPO companies
  - Lockout Periods

Avoiding Me

- Define terms
  - Income, profits, net, gross, proceeds, reasonable, adjusted, commissions, etc.
- Identify source
  - Tax returns, QuickBooks, particular reports
- Give examples
  - Provide the specific formula and give an example or two.
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