

Compensation and Benefits Issues

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Reminder

- Please note, nothing in this presentation constitutes legal advice. The information is offered only for informational and educational purposes, and it should not be relied upon as, or substituted for, legal advice.

Basic Components

- Base salary
- Bonuses and incentive payments
- Equity incentive awards
- Benefits and perquisites
- Executive deferred compensation plans
- Severance payments and employment termination triggers

Base Salary

- Major issues:
 - Fixed or with raises (automatic or discretionary)
 - Possibility of decreases
- Sample language:

"During the term of this Agreement, the Company shall pay the Executive \$XXX,XXX per annum (the "Base Salary") payable in equal installments at such payment intervals and under such procedures as are in accord with the usual payroll practice of the Company (but no less often than monthly) with respect to its salaried employees.

The Board shall annually review the Executive's Base Salary and shall determine, in its sole discretion, whether to increase the Executive's Base Salary and, if so, by what amount and upon what terms and conditions."

Bonuses---Signing

- Signing bonus---a "golden hello"
 - Purposes: added inducement and/or make whole
 - Clawback provision (or delayed payment provided this does not violate Code Section 409A) is essential
 - Optics: consider alternative arrangement

Bonuses---Annual

- Major issues
 - Time of payment: quarterly, year end, specified date
 - Employment requirements: when earned or when paid
 - Partial year: prorated or guaranteed bonus?
 - Performance criteria
- Sample language:

"The Executive shall be eligible to be considered to receive an annual bonus. The Board shall have sole discretion in determining whether the Executive receives a bonus, the amount (if any) of the bonus, the timing of payment(s) and the performance criteria (if any) which must be satisfied for the bonus to be paid. The failure of the Board to award the Executive a bonus shall not give rise to any claim against the Company.

[For the period from the date of hire to XXXXXX, the Executive shall be entitled to a bonus payment in accordance the terms set forth in Appendix A attached hereto.]"

Bonuses---Long-Term Incentive

- Major issues
 - Multi-year arrangement
 - Performance criteria
 - Plan documents
 - Depending on size and structure of company, plan is managed by Board, Executive Committee, Human Resources
- Sample language:

"The Executive shall be eligible to participate in the Company's Long-Term Incentive Plan (the "LTIP") in accordance with its terms, provided that the Executive is continuously employed by the Company from the date that her/his eligibility for a bonus is determined through the date that such bonus is paid in accordance with the terms of the LTIP."

Equity Incentive Awards---General

- Purposes:
 - "Golden handcuffs"
 - Incentivize employees
- Complex issues involved: legal, tax, accounting, securities
- Preliminary due diligence needed
- Documentation: award agreement(s) attached to Employment Agreement

Equity Incentive Awards---Key Decisions

- Initial grant vs. subsequent grants
 - Initial grant usually fixed as part of the deal
 - Subsequent grants tend to provide for discretion on part of Company
- "Inside" vs. "outside" a plan
 - What equity plans (if any) does Company have in place?
 - What types of awards and what terms are available under any plans already in place?
 - Reasons for a grant outside of any plan ("stand-alone grant")
 - Legal requirements and tax implications for stand-alone grant
 - Options

Equity Incentive Awards---Key Decisions

- Types of award
 - Options
 - Incentive: tax-advantaged but subject to strict requirements; frequently used for high-ranking executives at major companies
 - Non-qualified: do not need meet the tax code requirements of incentive stock options, but do not have the tax advantages
 - Major incentivizing tool
 - Stock appreciation awards
 - Often tandem awards
 - Basic principle

Equity Incentive Awards---Key Decisions

- Type(s) of award (continued)
 - Phantom stock
 - "As if" stock
 - Restricted stock
 - Repurchase rights
 - Restricted stock units ("RSUs")
 - How they work
 - Current popularity

Equity Incentive Awards---Key Decisions

- Terms
 - Amount of grant
 - Vesting
 - Exercise Periods
 - Price (if any)
 - Fair market value: how will this be determined?
 - Legal, tax, plan document and other constraints

Equity Incentive Awards---Sample Language

- Initial grant---Option

"Pursuant to the terms of the Company's Equity Incentive Plan (the "Plan"), the Executive shall, upon the Commencement Date, be granted an option (the "Option") to purchase 25,000 shares of the Company's common stock (the "Common Stock"). To the maximum extent permitted under the Internal Revenue Code of 1986, as amended (the "Code"), the Option shall be granted as an incentive stock option under Section 422 of the Code; however, any portion of the Option that does not qualify for incentive stock option treatment under Code Section 422 shall be treated as a non-qualified stock option. The Option shall vest in four (4) equal annual installments beginning with the one-year anniversary of the Commencement Date. The exercise price of the Option shall be the fair market value of the Common Stock on the Commencement Date, as determined by the Board in a manner compliant with Section 409A of the Code. In all respects, the Option shall be governed by the terms of the Plan and a stock option agreement to be entered into between the Company and the Executive pursuant to the terms of the Plan. [The stock option agreement shall be in substantially the form attached hereto as Exhibit A.]"

Equity Incentive Awards---Sample Language

- Continuing equity awards---company friendly

"The Executive may, at the sole discretion of the Company, be eligible to participate in such equity incentive plans that the Company may establish and maintain from time to time, subject to the terms and conditions of the applicable plan and any applicable award agreements."

Equity Incentive Awards---Sample Language

- Continuing equity awards---more executive favorable

"The Executive shall participate in the Company's equity incentive plan, including without limitation all stock option and other equity incentive plans that the Company may from time to time adopt and sponsor, on a basis no less favorable than that of any other similarly situated executive officer of the Company."

Benefits and Perquisites

- Benefit plans available generally in the company
 - Provide for participation on same basis as other similarly situated employees
 - Avoid "most favored nation" provisions
 - Plan document and legal requirements for many benefit plans
 - Due diligence essential, especially for executive's counsel

Benefits and Perquisites

- Perquisites
 - Should be specified in agreement
 - "Stand-alone" vs. tied to an underlying plan
 - Taxation issues: when in doubt, assume that a perquisite is taxable
 - Optics: shareholders, investors, other employees

Benefits and Perquisites

- Sample language

"Executive shall be entitled to participate in all employee benefit programs, including all qualified retirement plans and health and welfare plans, that the Company provides to its employees on a basis that is no less favorable than the basis on which such employee benefit programs are provided to other similarly situated executives. Such participation is subject to and dependent on the terms of such employee benefit programs and all applicable legal requirements (including, without limitation, the requirements of the Internal Revenue Code). The Company reserves the right, in its sole discretion, to cancel or amend any employee benefit program, subject to the terms of applicable law and the terms of the relevant program."

Nonqualified Deferred Compensation

- "Top hat" plans: requirements
- Types of plans
 - Salary deferral: individual account plans
 - Supplemental Executive Retirement Plans ("SERPs")
 - Defined benefit
 - Company funding
 - Excess benefit plans
 - Connection to broad-based plans

Severance and Employment Termination Triggers

- Severance considerations
 - Cash severance
 - Amount
 - Form
 - Lump sum
 - Installments
 - Hybrid: e.g., paid in installments except on change in control, death, disability
 - Salary continuation period
 - Employee status retained for a specified time with salary payments
 - May be followed by lump sum payment

Severance and Employment Termination Triggers

- Severance considerations (continued)
 - Cash severance: annual bonus
 - Target vs. actual earned bonus
 - Form of payment
 - General employee benefits (health and welfare)
 - Address in agreement
 - Health benefits raise complex issues
 - Issues may arise if coverage extended beyond COBRA or if premiums paid by company, possible penalties
 - Simplest approach: lump sum cash payment (will be taxable)

Severance and Employment Termination Triggers

- Employment termination triggers for severance benefits
 - Specific triggers
 - Termination without cause: failure to perform duties, negligence and other factors
 - Resignation for good reason: Internal revenue code section 409A ("Section 409A")
 - Disability: Section 409A
 - Death
 - Change in control: numerous issues, including Section 409A

Withholding

- Agreement should provide for withholding from all salary and benefits for applicable federal, state and local taxes (and any required contributions to benefit plans)
- Use stand-alone provision
- Sample language:
 - The Company shall withhold from all salary and benefit payments payable to the Executive all applicable federal, state, local and other applicable taxes as required or permitted under law, rule or regulation."

Legal Requirements

- General
 - Compensation and benefits very rule driven
 - Federal, state, local
 - Tax, corporate, securities, ERISA, listing requirements

Legal Requirements

- Executive employment agreements: two key laws
 - Internal revenue code section 409A ("Section 409A")
 - Internal revenue code section 280G ("Section 280G")---the golden parachute rules

Legal Requirements---Section 409A

- General
 - Governs nonqualified deferred compensation plans
 - Defined broadly: Any plan, agreement, program or arrangement that provides a "service provider" with a legally binding right to compensation earned in one year but payable in a subsequent year
 - Key exemptions: qualified plans, short-term deferrals, others
 - All plans, agreements, programs or arrangements that provide for a deferral of compensation must either:
 - Be exempt from Section 409A, or
 - Comply with its requirements both in writing and operationally

Legal Requirements---Section 409A

- Basic requirements
 - Written plan document
 - Amounts deferred must be paid only upon the occurrence of certain specified events
 - Initial elections of, and subsequent changes to, form and/or time of payment must be made according to strict rules
 - Acceleration of the timing of a payment or a schedule of payments is prohibited (with certain very limited exceptions)

Legal Requirements---Section 409A

- Bonuses
 - Short-term deferral rule: Exempt from Section 409A if paid on or before the later of the 15th day of the third month following the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the employer's fiscal year in which the amount is no longer subject to a substantial risk of forfeiture
 - Sample language---simple approach:
 "The Executive's annual bonus shall be paid no later than March 15 of the year following the calendar year to which it relates."

Legal Requirements---Section 409A

- Equity awards
 - Generally, not subject to Section 409A
 - Major exception: options with an exercise price of less than 100% of fair market value at date of grant
 - Possible Section 409A issues that might arise are best handled in the underlying equity compensation agreement
 - Note: Accelerating the vesting of an equity award does not raise Section 409A issues

Legal Requirements---Section 409A

- Severance
 - Two main exclusions from Section 409A
 - Short-term deferral rule
 - Separation pay exception (2 x 2 rule)
 - Need for involuntary termination
 - Definition of good reason---Treas. Reg. Sec. 1.409A-1(n)(2)(i)
 - Language in agreement: May be narrower (more restrictive) but may not be broader (less restrictive) than regulation
 - Frequent source of contention between parties

Legal Requirements---Section 409A

- Reimbursement arrangements
 - Nontaxable reimbursement arrangements---Section 409A does not apply
 - Taxable reimbursement arrangements---Section 409A does apply

Legal Requirements---Section 409A

- Other issues that may arise
 - Six-month delay rule (public companies only)
 - Treatment of installment payments
 - Timing of releases (dealt with in the last segment of this presentation---"Coordination Issues")

Legal Requirements---Section 280G

- Basic provisions
 - Affected entities: public and non-public corporations
 - Affected individuals: referred to as "disqualified individuals"
 - Base amount
 - Parachute payment
 - Tax results
 - Company loses deduction for everything over base amount
 - Disqualified individual has 20% excise tax imposed on everything over the base amount

Legal Requirements---Section 280G

- Some common methods for addressing Section 280G
 - Cut-back
 - Best after-tax result
 - Gross-up: modified or full
 - Determine reasonable compensation for pre- and/or post-change in control services
 - Shareholder vote: privately held companies only

Legal Requirements---Section 280G

- Sample language---straight cut-back:

"In the event that the severance and other benefits payable to the Executive under the terms of this Agreement are deemed to constitute parachute payments within the meaning of Section 280G of the Internal Revenue Code (the "Code") and subject to the excise tax imposed under Section 4999 of the Code (the "Excise Tax"), then the Executive's applicable benefits under this Agreement shall be reduced to the extent necessary so that no portion of such benefits shall be subject to the Excise Tax.

All determinations required to be made under this provision of the Agreement, including whether the benefits constitute parachute payments and, if so, in what order they shall be reduced, shall be made by a professional services firm designated by the Board that is experienced in performing such calculations. All fees and expenses of the professional services firm shall be the responsibility solely of the Company."
