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EMPLOYMENT AND SEVERANCE AGREEMENTS:

Executives Coming & Going

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Overview of Today's Webinar

- **Anatomy of an Employment Agreement**
 - Determining goals and assessing needs
 - Drafting considerations
 - Provisions every employment agreement should contain
- **Traps for the unwary**
 - Section 409A
 - Healthcare continuation
- **Recent developments, design trends, and best practices**

Anatomy of an Employment Agreement

- Threshold questions
- Basic employment provisions
- Compensation arrangements
- Restrictive covenants
- Severance/termination of employment
- Dispute-resolution provisions
- Miscellaneous provisions

Threshold Questions

- Are you better off with or without an agreement?
 - Specifies terms of employment, compensation, and benefits during and after employment; restrictive covenants
 - Consider whether an employment agreement is preferable, or whether goals can be accomplished with an offer letter and/or severance agreements/plan
- Typical situations in which to use employment agreements include:
 - Acquiring a business
 - Hiring a key employee
 - Ensuring consistent severance terms
 - Ensuring consideration for noncompetition and nonsolicitation covenants

Public Company Considerations

- **Consider whether the employment agreement will need to be publicly filed**
- **Consider institutional shareholder opinions on problematic pay practices**

Term of Employment

- All employment is contractual
 - Employment with no definite term
 - Employment with a specified term
 - Employment for an initial term with an automatic renewal
- Consider who has the power to renew and how nonrenewal affects restrictive covenants
- Address whether severance is payable if an agreement is not renewed

Position Details

- Position and title
- To whom does the employee report?
- Location of performance
- Will the employee serve on any boards of directors?

Public Company Considerations

- Consider whether the employee will be a “named executive officer” for public reporting requirements

Duties; Responsibilities and Representations

- Broad vs. specific
- Employers prefer a broader scope
 - Discretion to suit the needs of the business
- Employees prefer a more specific scope
 - Deviation can result in claims for breach of contract or the right to terminate under a “good reason” provision
- Representations
 - Sought by the employer:
 - No restrictions under prior agreements
 - Nondisclosure of the former employer’s confidential information

Location of Employment

- Designated location vs. unspecified location
- Travel expectations
- Relocation benefits/repayment obligation
- Special considerations in light of COVID-19 pandemic
 - Consider broader remote-work implications
 - Consider applicable state tax issues

Compensation and Benefits

- Salary
- Commissions
- Annual bonus
- Sign-on bonus
- Equity Awards (sign-on/annual)
- Deferred compensation
- Vacation
- Sick/disability leave
- Group health and retirement benefits
- Expense reimbursement
- Perquisites
- Executive's legal fees

Do You Need Restrictive Covenants?

- What are you seeking to protect?
- What types of protection do you need?
 - Confidentiality and nondisclosure
 - Competition
 - Solicitation of employees, clients, and vendors
 - Intellectual property protection
 - Return of property
- What does state law permit?

Noncompetition Agreements

- Some states (e.g., California) generally prohibit noncompetition agreements
- In other states, covenants not to compete generally are enforceable where they are:
 - Ancillary to employment
 - Reasonably limited in duration
 - Reasonably limited in geographic scope
 - Designed to protect legitimate business interests
 - Supported by consideration

Blue Pencil/Modification of Overbroad Provisions

- Do the restrictions impose an undue hardship on the employee?
- Some states allow courts to modify covenants containing overbroad time and/or scope limitations (“blue pencil”)
- Agreements should provide for modification to avoid enforceability issues

Drafting Musts

- Consideration for restrictive covenants
- Identification of protected information and clients, and access thereto
- Reasonable need for protection
- Applicable time restriction
- Applicable geographic restriction
- Severability
- Inures to benefit of successors

Drafting Musts (cont.)

- Governing law
- Superseding of other agreements
- Assignability of agreement
- Remedies/enforcement
 - Injunctive relief
 - Arbitration
 - Attorney fees
- Clawback policy, share ownership policy, other company policies

Termination of Employment

Causes of Termination

- Involuntary termination without cause
 - Requires release as condition for severance
- Termination by employee for good reason
 - Requires release as condition for severance
 - Notice and cure provisions
- Voluntary resignation without good reason

Termination of Employment (cont.)

- Disability
- Death



Consider whether there are any special benefits that should be payable on death or disability.

Consider role that estate or representative may play in terms of death

- Termination at end of term

- Termination for **cause**
- Voluntary resignation without good reason



“Cause” definition elements:

- **Misconduct/criminal act**
- **Negligence/failure to perform duties**
- **Breach of restrictive covenants**

Additional considerations

- **Performance of duties**
- **Materiality qualifiers**
- **Effect on the business qualifiers**
- **Violation of company policy**

Continued Fallout from #MeToo

- We have continued to see employers respond to the #MeToo movement in terms of company practices and policies and in drafting employment agreements
- More common to see the definition of “cause” include prongs for:
 - Violation of company policy
 - Actions that bring, or could reasonably be expected to bring, material disrepute on the company or negative publicity or into public disgrace, embarrassment, or disrepute

Termination of Employment (cont.)

Severance Pay

- Typically, base salary over a defined period
- Consider multiple of base salary, base *plus* bonus, base *plus* benefits compensation
- Consider whether a pro rata bonus for year of termination is appropriate, if so, based on actual or target performance

Benefits

- COBRA/continued health benefits
- Life insurance/LTD
- Outplacement

Equity

- Consider how equity compensation should be treated (e.g., full or partial acceleration on a good leaver termination)

Unused Leave

- COBRA/continued health benefits

Termination of Employment (cont.)

- Change in control
 - Enhanced severance
 - Double trigger equity vesting
 - 280G best net/cap/gross-up
- Procedures for terminating an agreement
 - Notice
 - Pay in lieu of notice

Additional Considerations for Termination of Employment

- Process for determining whether “cause” exists
 - Requirement of two-thirds board approval
- Reference letters
- Return of company property

Traps for the Unwary

- Section 409A
- Continued Healthcare Benefits

Section 409A – Overview

- Section 409A of the Internal Revenue Code imposes significant requirements on the time and form of payment under nonqualified deferred compensation arrangements
- Section 409A defines “nonqualified deferred compensation” broadly as any plan, agreement, or arrangement under which an employee, director, or consultant has a legally binding right to compensation that is or may be payable in a later taxable year
- Severance arrangements generally must be treated as nonqualified deferred compensation for purposes of Section 409A

Section 409A Penalties

- Consequences of noncompliance:
 - Taxable income recognized at time of vesting
 - Additional 20% federal income tax
 - Potential additional state income tax (e.g., additional 5% state income tax for California taxpayers)
 - Penalty rate of interest

Section 409A

- Structuring severance benefits to be exempt from Section 409A
- Postemployment benefits and reimbursements
- Separation from service requirements to commence severance
- Six-month delay considerations for severance benefits payable to specified employees
- Toggling issues
- Payments contingent on a release
- Substitution considerations

Severance Pay Agreements

There are two approaches to addressing Section 409A...

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Comply with an exemption from Section 409A

- Short-term deferral exception
- Involuntary separation pay exception
- Limited amounts (up to Section 402(g) limit, e.g., \$19,500 for 2021)
- Reimbursements within a limited period of time after separation from service

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Comply with Section 409A

- Separation from service required
- Six-month delay for “specified employees” of public companies

Short-Term Deferral Exception

- Lump-sum payment made within a short period after vesting
 - Payments made within 2½ months after the end of the year in which the severance pay vests (no substantial risk of forfeiture)
 - For example, the March 15 after the year of involuntary termination of employment

Involuntary Separation Pay Exception

- Separation Pay Exception
 - Severance payments:
 - Payable solely on account of an involuntary termination of employment
 - To the extent the payments do not exceed two times the lesser of (i) the IRS compensation limit (\$290,000 for 2021) or (ii) the employee's annualized compensation for the year preceding termination
 - Paid no later than the end of the second year following the separation from service

Involuntary Termination

- In the severance pay context, both the short-term deferral exception and involuntary separation pay exception require involuntary termination of employment
- Whether termination is involuntary is based on facts and circumstances
 - If the public documents describe termination as “mutual” or “voluntary,” the parties should clearly document support for involuntary termination
- An agreement generally will not meet the short-term deferral exception or involuntary separation pay exception if severance pay can be paid for other reasons, such as a “walk away right,” even if the termination is actually an involuntary termination

Involuntary Termination – Good Reason

- “Good reason” termination may constitute involuntary termination
- Safe-harbor “good reason” definition:
 - Material diminution of base compensation
 - Material diminution of authority, duties, or responsibilities (or responsibilities of supervisor)
 - Material diminution of budget authority
 - Material change in geographic location
 - Material breach of terms of agreement

Involuntary Termination – Good Reason (cont.)

- Other good-reason safe-harbor requirements:
 - The employee must give notice and the employer must have the right to cure during a cure period
 - The separation must occur within a specified period following a good-reason event
 - The amount, time, and form of payment upon a good-reason separation must be identical to the amount, time, and form of payment upon an involuntary termination

Reimbursements

- Certain reimbursement arrangements are excluded from Section 409A deferred compensation
 - Medical reimbursements may continue for COBRA continuation-of-coverage period
- If reimbursements are not excluded from Section 409A, they may be structured to satisfy the fixed schedule of payments requirement

Separation from Service

- The Section 409A regulations define when there has been a separation from service
 - A separation from service occurs when the level of services is reduced to a level expected to be no more than 20% of the level of services provided during the preceding 36-month period
 - The agreement can provide for a percentage greater than 20% but less than 50%
 - There is no exception for “payroll continuation”
 - Employees and independent contractors are subject to the same rules

Six-Month Delay Rule for “Specified Employees”

- Section 409A requires that severance benefits be delayed for six months in the case of a “specified employee” of a public company
- A “specified employee” is:
 - An officer having annual compensation greater than \$185,000 for 2021 (up to 50 employees)
 - An employee who is a 5% owner
 - An employee who is a 1% owner and has annual compensation greater than \$150,000

Avoiding Impermissible “Toggling”

- Under Section 409A, subject to certain exceptions, payments must have one possible payment schedule for any single payment event
 - For example, a payment that is made on various types of separations from service must generally be paid on the same schedule following each type of separation
- Deferred compensation, including RSUs and severance arrangements that are subject to Section 409A, must comply with this anti-toggling rule

Avoiding Impermissible “Toggling” (cont.)

- Design the arrangement so it is not subject to Section 409A
- Know the exceptions to the anti-toggling rule
 - Termination within two years following a Section 409A change in control
 - Termination following a specified age, service, or age and service
 - Prior to or following a single fixed date
- Provide for one schedule of payments for a single payment event
- Different payment events (i.e., death, disability, change in control) may provide for different payment schedules

Payments Contingent on a Release

- If payments are subject to Section 409A, the payment date must be specified and the employee must not be able to designate, directly or indirectly, the calendar year of payment
- IRS Notice 2010-6 takes the position that the following language violates Section 409A:
 - Payment shall be made within 60 days following separation from service, subject to the employee's signing a release, and not earlier than expiration of the revocation period for the release.
- IRS-recommended language:
 - Payment will be made on the 60th day following separation from service, subject to the employee's executing and not revoking a release.

Flexibility in Structuring Severance Pay

- If no existing severance agreement is in effect, at the time of termination the parties can structure severance pay to be paid on specified payment dates without a six-month delay
- The severance payments cannot be a replacement for forfeited deferred compensation

Continued Healthcare Benefits

- Continued participation by a former executive in the active employees' health plan at active rates creates discrimination issues for a self-insured health plan under Section 105(h)
- Nondiscrimination rules applicable to insured health plans have been postponed, but are expected to be implemented in the future
- It is often difficult/costly to provide continued life and disability coverage after termination of employment

Continued Healthcare Benefits (cont.)

- The preferred approach is to have the executive pay for the medical coverage and have the employer make a payment at termination to provide funds for the premium cost
- There may be Section 409A issues if the employer elects to “cash out” promised benefits at the termination of employment

Recent Developments, Design Trends, & Best Practices

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Recent Developments, Design Trends, & Best Practices

- COBRA subsidy for certain terminations on or after April 1, 2021, and before the subsidy ends on September 30, 2021
- Seeing an expansion of the “cause” definition to include violations of company policies
- In light of COVID-19, clarifying that a working location may include a requirement to work remotely and aligning the “good reason” definition

Questions?

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Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

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To help keep you on top of developments as they unfold, we also have launched a resource page on our website at www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.



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Biography



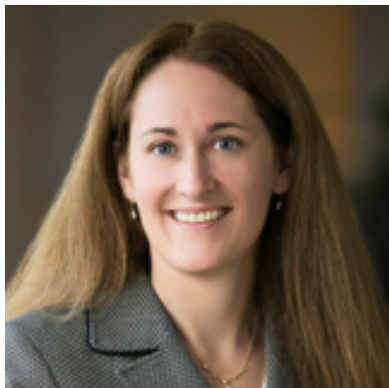
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Erin is part of a team that helps clients find solutions to their employee benefits–related problems. She counsels clients on employee benefits matters, including design, implementation, and administration of cash or deferred compensation arrangements, nonqualified deferred compensation plans, and executive and equity compensation arrangements. Erin negotiates employment agreements and severance arrangements for senior executives and advises clients on all employee benefits and compensation-related aspects of mergers, acquisitions, sales and spin-offs.

Biography



Leslie DuPuy

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Leslie advises clients on diverse benefits and compensation issues relating to incentive compensation, nonqualified deferred compensation, employment arrangements, tax-qualified retirement plans, severance programs, and health and welfare plans. She advises employers on compliance with the Internal Revenue Code, ERISA, HIPAA, COBRA, and other US federal statutes affecting employee benefit plans. Leslie also counsels clients on benefits issues that arise in connection with corporate transactions, such as mergers and acquisitions.

Biography



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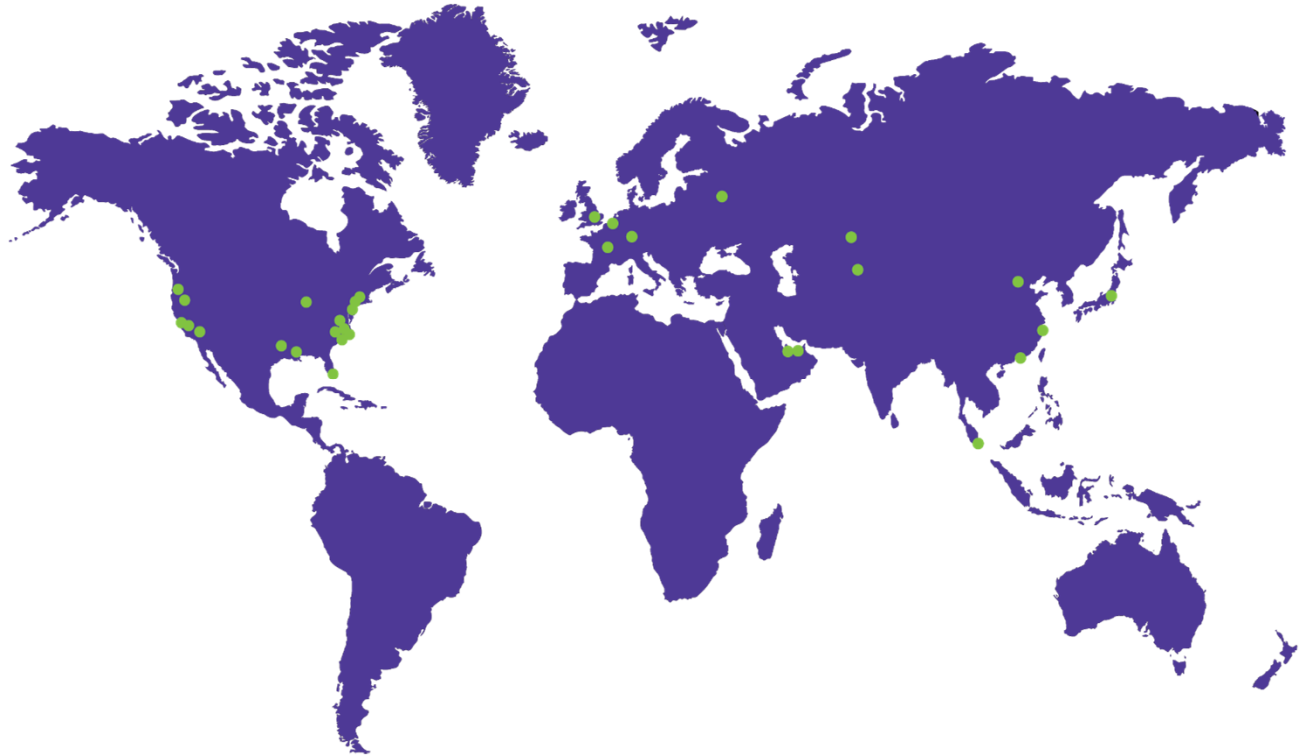
Timothy advises public and private companies on a wide variety of executive compensation and employee benefits matters, both in ensuring compliance in the ordinary course of business and when engaging in corporate transactions, including M&A, spinoffs, initial public offerings, joint ventures, and restructurings. He regularly assists private equity clients with the negotiation of equity and cash-based compensation packages for executives of portfolio companies and advises public companies on compensation-related public disclosure rules, including drafting and reviewing their public filings.

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