

Morgan Lewis

webinar

Executive Compensation Basics | A Webinar Series

Anatomy of an Employment Agreement

Webinar 1 of 4

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Overview of Today's Webinar

- Structuring employment agreements
 - Determining goals and assessing needs
 - Drafting considerations
 - Provisions every employment agreement should contain
- Traps for the unwary
 - Section 409A
 - Section 162(m)
 - Healthcare continuation
- Recent developments, design trends, and best practices



Structuring Employment Agreements

Do You Need an Employment Agreement?

- What are your goals?
 - as an employer
 - as an employee
- Are you better off with or without an agreement?
- Trend is fewer employment agreements and more offer letters or executive severance agreements
- Consider ISS problematic pay practices

Do You Need an Employment Agreement? (cont'd)

- Typical situations in which to use employment agreements include:
 - Acquiring a business
 - Hiring a key employee
 - Ensuring consistent severance terms
 - Ensuring consideration for non-competition and non-solicitation covenants

Employment Agreement Provisions

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

Term of Employment

- All employment is contractual
 - Employment at will – no definite term
 - Employment with specified term
- Evergreen agreement vs. fixed term with renewal
 - Consider who has the power to renew and how non-renewal affects restrictive covenants
- Address whether severance is payable if agreement is not renewed

Position Details

- Position and title
- Who does the employee report to?
- Duties and responsibilities
- Location of performance
- Other boards of directors and business interests

Duties and Responsibilities

- Broad vs. specific
- Employers prefer broader scope
 - Discretion to suit the needs of the business
- Employees prefer more specific scope
 - Deviation can result in claims for breach of contract or the right to terminate under a good reason provision

Place of Performance

- Designated location vs. unspecified location
- Travel expectations
- Relocation benefits/repayment obligation

Representations

- Sought by employer:
 - No restrictions under prior agreements
 - Intellectual property

Compensation and Benefits

- Salary
- Commissions
- Annual bonus
- Sign-on bonus
- Incentive plans
- Stock options/restricted stock units
- Pension/401(k)
- Deferred compensation
- Vacation
- Sick/disability leave
- Group insurance benefits
- Expense reimbursement
- Perquisites

Effect of Employee Handbook References

- References to employee handbooks or other employee benefits and policies may create unintended contractual obligations
- If cited to within the agreement, identify the provisions that do and do not apply
 - Leave provisions
 - Discipline and termination provisions

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

Undue Hardship/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

Other Drafting Musts

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

Termination of Employment

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

Termination of Employment (cont'd)

- Termination for cause
 - Performance
 - Misconduct/criminal act
 - Negligence/failure to perform duties
 - Breach of restrictive covenants
- Disability
- Death
- Termination at end of term

Termination of Employment (cont'd)

- Change in control
 - Enhanced severance
 - Double trigger equity vesting
 - 280G best net/cap/gross up

Termination of Employment (cont'd)

- Procedures for terminating an agreement
 - Notice
 - Pay in lieu of notice
- Process for determining whether “Cause” exists
 - Requirement of two-thirds board approval

Termination of Employment (cont'd)

- Severance pay
 - Multiple of base salary or base and bonus
- Equity compensation vesting
- Prorata bonus for year of termination based on actual performance or target
- Benefits
 - COBRA/continued health benefits
 - Life insurance/LTD
 - Outplacement
- Unused leave
- Reference letters
- Return of property



Traps for the Unwary

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

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

Severance Pay Arrangements

- Two approaches to addressing Section 409A:
 - **Comply with Section 409A**
 - *Separation from service required*
 - *Six-month delay for “specified employees” of public companies*
 - **Comply with an exemption from Section 409A**
 - *Short-term deferral exception*
 - *Involuntary separation pay exception*
 - *Limited amounts (up to the Section 402(g) limit, e.g., \$17,500 for 2014)*
 - *Expense reimbursement within a limited period of time after separation from service*

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 \$170,000 for 2014 (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

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 (\$260,000 for 2014) 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

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'd)

- Other good reason safe harbor requirements:
 - 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
 - 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

Involuntary Termination

- An agreement generally will not meet the involuntary separation pay exception or short-term deferral 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
- Plans that provide payment upon an involuntary termination are aggregated for purposes of the Section 409A rules
 - This means that all severance arrangements for an employee must be analyzed together for purposes of Section 409A

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

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’d)

- Design the arrangement so it is not subject to Section 409A
- Know the exceptions to the anti-toggling rule
 - Termination within 2 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
 - JCEB: OK to accelerate payment on a subset of a permitted payment event
- 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

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

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.

Section 162(m) Qualified Performance-Based Compensation

- Section 162(m) limits the compensation deduction for “covered employees” at public companies to \$1,000,000 per year
- Pursuant to IRS Notice 2007-49, “covered employees” are the principal executive officer and up to three officers reported in the proxy by reason of being among the three most highly compensated officers of the company

Qualified Performance-Based Compensation Exception

- The Section 162(m) annual \$1,000,000 deduction limit does not apply to “qualified performance-based compensation,” which (among other requirements) is paid under a shareholder-approved plan and is conditioned on the attainment of pre-specified, objective performance goals
- The discretion to pay if the goals are not attained is not generally permitted

Qualified Performance-Based Compensation Exception (cont'd)

- The Treasury Regulations provide that compensation does not qualify as 162(m) performance-based compensation if the facts and circumstances indicate the employee would receive the compensation without regard to attainment of the goals
- Explicit exceptions are provided for death, disability, and change in control

Revenue Ruling 2008-13

- In Revenue Ruling 2008-13, the IRS takes the position that if compensation will be paid upon good reason or involuntary termination, or due to early retirement, without regard to the attainment of the performance goals, the arrangement does not meet the qualified performance-based compensation exception of Section 162(m)

162(m) Review

- Severance arrangements for executives of public companies should be reviewed to determine whether the final year's bonus or the severance amount is based on the target bonus for the year of termination

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 has 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

- 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, and Best Practices

Recent Developments, Design Trends, and Best Practices

- EEOC Strategic Enforcement Plan for FYs 2013 to 2016 states that the EEOC intends to “target policies and practices that discourage or prohibit individuals from exercising their rights under employment discrimination statutes, or which impede the EEOC's investigative or enforcement efforts.”
- Aggressive EEOC actions re: severance arrangements
 - *EEOC v. Baker & Taylor, Inc.*
 - *Consent decree entered into in July 2013 requires, among other things, inclusion of language in the general release that the employee retains the right to “recover any appropriate relief” relating to a charge or claim of discrimination filed with the EEOC or any similar state or local agency*
 - *EEOC v. CVS Pharmacy, Inc.*

Recent Developments, Design Trends, and Best Practices (cont'd)

- Increased use of clawbacks/recoupment policies
- Increased use of performance-based stock options and restricted stock/RSUs
- Increased use of “double trigger” change in control benefits in lieu of “single trigger” benefits
 - For example, options vest if involuntary termination occurs within one year after change of control
- Decreased use of full 280G “gross-ups”
 - Modified cut-back alternative
 - Best net value alternative

Recent Developments, Design Trends, and Best Practices (cont'd)

- Shareholder criticism of tax gross-up payments
- Shareholder criticism of “walk rights” after change of control
- ISS “poor pay practices”
 - Tax gross-ups
 - Walk rights
 - Excessive severance pay
 - Guaranteed bonuses
 - Excessive SERP, including service credit for years not worked

Recent Developments, Design Trends, and Best Practices (cont'd)

- Consultants are recommending severance multiples at levels lower than those several years ago
- Short term limits on employment agreements
 - “Best practice” would indicate a move away from evergreen employment agreements



Questions?

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