Executive Compensation:

Common Pitfalls When Structuring Executive Agreements

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Poyner Spruill LLP

Remarkably Bright Solutions

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Agenda

- Provisions in Employment Agreements
- Issues with Particular Benefits
- Managing Deferred Compensation Risks

PROVISIONS IN EXECUTIVE AGREEMENTS

Provisions in Executive Agreements

- Offer Letters
- Restrictive Covenants
- Severance
  - Cause
  - Good Reason
- Change in Control
- Releases
- Benefits
- Independent Contractor?

Offer Letters

- Use of Offer Letters
  - Preceding negotiation of employment agreement
  - Summarizing terms for executives not subject to agreement
- Be Careful About Commitments
  - Clearly reserve right to change
  - Defer to plan documents/policies
  - Ensure agreement always supersedes
- Promises to Pay $$ May be Subject to 409A
  - More on that later!

Types of Restrictive Covenants

- Non-compete
  - Employment with customers
  - Employment with specific competitors
- Non-solicitation
  - Customers
  - Employees
  - Business Partners
- Confidential Information
- Non-disparagement

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Non-Compete Covenants

- Legal Requirements for Enforceable Non-Compete Covenant in NC
  - In writing and signed by employee (N.C. Gen. Stat. § 75-4)
  - Based on valuable consideration
  - Reasonable as to time and “territory”
  - Designed to protect legitimate business interest
  - Not against public policy
- Vary State-to-State
  - Ensure applicable requirements are met

Restrictive Covenants

- Does new executive have a restrictive covenant?
  - If yes, are we confident our employment is not prohibited?
  - What is the consequence if it is prohibited?
  - If new employment conflicts, can employee negotiate for release or modification that permits new employment?
- If possible
  - Include representation from executive that he/she will not breach restrictive covenant
  - Require executive to indemnify for expenses or damages against if ex-employer sues

Restrictive Covenants

- Avoiding Use or Transfer of Ex-employer's Trade Secrets and Other Confidential Information
  - Document that company reminded executive:
    - He/she cannot retain or use any restricted materials from former employment
    - He/she cannot use or disclose any of ex-employer's trade secrets or confidential information
  - Other executive/employees should not to induce or pressure employee to use or disclose ex-employer's trade secrets or confidential information

Benefits

- Beware of unintended deferred compensation
  - “Your bonus will be paid as soon as practicable following issuance of the Company’s audited financial statements for the performance year.”
  - “You will be entitled to severance pay equal to 52 weeks of your Base Salary, to be paid in accordance with the Company’s normal payroll processes.”

Benefits

- Why beware of unintended deferred compensation?
  - Code section 409A applies to deferred compensation
    - Strict requirements on time of deferral
    - Strict requirements on time and form of payment
    - Compliance in form and operation is key
  - Significant penalties if any requirement is not met

Benefits

- Beware of conflicts with benefit plans
  - “You will receive a matching contribution equal to 100% of your deferrals, up to 5% of your compensation.”
  - “You will participate in the Company, Inc. Short-term Incentive Plan.”
  - “The Company will grant you options for 10,000 shares of our common stock at an exercise price of $52.50 per share.”

Severance

- Common pitfalls:
  - Misalignment with corporate goals
  - Deferred compensation problems
  - Ambiguous terms

Severance

- Why offer severance?
  - Protect executive from loss of income and benefits
  - Encourage executive to focus, not worry about the future
  - Because other companies provide severance
- In what situations will severance be provided?
- What types of benefits?
- How much?
- Will executive be required to do (or not do) anything in order to get it?

Severance

- Deferred compensation rules apply, BUT
  - May be exempt as short-term deferral
    - Must be paid within 2 ½ months after year it vests
    - If terminate in December, will payment always happen by March 15?
  - May be exempt as involuntary separation pay if:
    - Payable <u>only</u> because of an involuntary separation
    - Does not exceed 2x the <u>lesser</u> of:
      - executive's annual compensation
      - the $280,000 Section 401(a)(17) limit
    - Paid no later than the end of the second year following the year of termination

Severance

- Is it clear when it will be paid and when it will not?
  - "Cause" - when will involuntary termination not trigger severance?
  - "Good Reason" - when will leaving be like involuntary termination?

Severance

Offer letter from Apple, Inc. to Angela Ahrendts (2013):

> "In the event that . . . your employment is terminated by Apple **other than for Cause**, or you resign your employment with Apple **for Good Reason**, Apple will pay you as severance . . . the amount of your base salary . . . for the remainder of [the] three-year period."

Severance

Employment agreement between CBS and Leslie Moonves (2017):

"**Cause**" shall mean termination of your employment due to any of the following:

(vi) your willful and material violation of any policy of the Company that is generally applicable to all employees or all officers of the Company **(including, but not limited to, policies concerning . . . sexual harassment**), provided that such violation has a material adverse effect on the Company

(vii) **your willful failure to cooperate fully with a bona fide Company internal investigation** or an investigation of the Company by regulatory or law enforcement authorities . . . or your willful destruction of or knowing and intentional failure to preserve documents or other material known by you to be relevant to any Investigation

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TELEVISION

Former CBS CEO Les Moonves Denied $120 Million Severance Package

LISTEN · 3:54

December 18, 2018 · 5:03 AM ET
Heard on Morning Edition

ERIC DEGGANS

The CBS board of directors has fired former CEO Les Moonves for cause, meaning he won't get his severance. The board says Moonves tried to undermine a probe into sexual misconduct charges against him.

Severance

- Good Reason – a “material negative change to the service provider in the service relationship”
  - If not:
    - The severance is payable for reasons other than involuntary termination
    - The severance may need to be treated as deferred compensation
  - Good:
    - Significant salary reduction
    - CEO assigned janitorial duties
  - Probably bad:
    - Health insurance premiums went up
    - People sometimes park in my parking spot

Severance

- Deemed "good reason" if:
  - Separation must occur within two years following the event
  - Must be due to:
    - material diminution in base compensation
    - material diminution in authority, duties, or responsibilities
    - material diminution in reporting relationship
    - material diminution in budget over which executive has authority
    - material change in the geographic location at which executive works
    - material breach by company of the employment agreement
  - Amount, time, and form of payment must be generally same as payment upon involuntary termination
  - Executive must be required to provide notice to employer of the good reason within 90 days, and company must have at least 30 days to cure

Severance

Offer letter from Apple, Inc. to Angela Ahrendts (2013):

"**Good Reason**" means you resign from your employment with Apple following:

(1) a material reduction or increase in your duties or responsibilities

(2) your reporting structure is changed such that you no longer report to the CEO

(3) a material change in your primary work location after you have relocated to the San Francisco Bay Area

(4) any other breach by Company of any of its material commitments in connection with your employment. . . .

You must provide written notice to the CEO within 45 days after the occurrence . . . . Apple has 30 days to cure.

You may only terminate employment for Good Reason within 90 days after the expiration of the cure period.

Change in Control and Related Bonuses

- Change in control bonuses
  - Usually intended as additional severance protection
  - Often provide more robust or accelerated severance
  - Single trigger vs. double trigger
    - Single trigger CIC bonuses are generally disfavored, especially by proxy advisors

Change in Control and Related Bonuses

- Deal bonuses
  - Intended to incentivize completion of a change in control or other transaction
  - Often paid if executive remains employed through closing
  - Beware of Section 280G
- Retention bonuses
  - Intended to encourage executive to remain with the company or an acquirer
  - Typically paid if executive remains employed for a certain period following a change in control

Releases

- Require a Release
  - To receive severance
  - To receive change in control payment
- Consider
  - Ensuring Age Discrimination in Employment Act requirements are satisfied
  - Timing of severance payment v. timing of release (be aware of peculiar 409A legal requirements here)
  - Including a form of release

Independent Contractor Executive?

- Can My Executive Be Paid on a 1099?
  - Is he/she an independent contractor?
    - Ordinarily a permanent executive would not be
  - Review IRS factors
    - Their website is pretty helpful… really!
  - Get advice from counsel
    - Penalties apply if you're wrong

ISSUES WITH SPECIAL BENEFITS FOR EXECUTIVES

Issues with Special Benefits for Executives

- Post-termination Benefits
- Fringe Benefits
- 280G Implications
- Employee Loans
- Equity Compensation
- 162(m)/Excise Tax
- Proxy Advisors

Post-Termination Benefits

- Executives often want post-term benefits
  - Health plan continuation/retiree coverage
  - COBRA subsidy
  - Life/disability insurance continuation
  - Outplacement services
  - Retirement supplements
- Often for severance period

Post-Termination Benefits

- Before Agreeing
  - Does relevant plan permit the benefit?
  - Can the benefit be legally provided?
  - Is practicable/affordable to provide?
  - What are the tax implications?
- Consider Current and Future Possibilities
  - What if company changes carriers?
  - Changes in the law (particularly health plan nondiscrimination)

Fringe Benefits

- Common Perquisites
  - Additional paid time off (or unlimited)
  - Relocation
  - Company car
  - Travel benefits: airplane and/or spousal travel
  - Country club/social club dues
  - Financial/tax planning services
  - Higher life/disability benefits
  - Medical examinations

Fringe Benefits

- Avoiding Pitfalls in Perks
  - Understand the taxation
    - May be a mixed bag
    - Tax reform made significant changes
  - Ensure payroll knows and system is ready
    - Taxation and other treatment (such as retirement plans)
  - Is there a gross-up in the contract?
  - Preserve right to change, if possible
    - “Perquisites provided to similarly situated executives”
    - Include only the perks the executive will not do without

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Section 280G

- If payments to certain executives are:
  - Contingent upon a change in control and
  - Are at least 3x the amount of the executive's prior five year average compensation (the "base amount")
- Then payments over <u>1x</u> the base amount are:
  - Not deductible by the company
  - Subject to a 20% excise tax payable by the executive

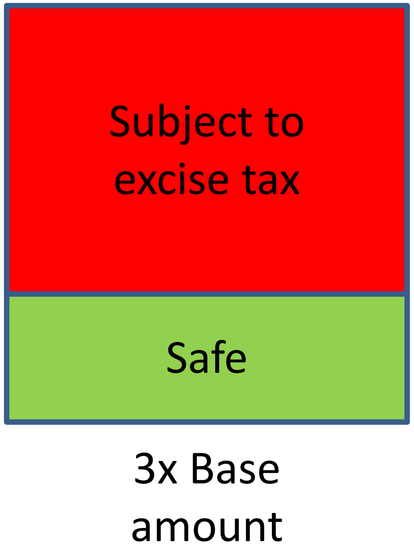
Section 280G

Section 280G

- Applies to payments to "disqualified individuals"
  - Shareholders - individuals who own stock with a fair market value that exceeds 1% of the fair market value of the outstanding shares of all classes of the stock
  - Officers - identified based on the facts and circumstances (such as the nature and extent of the individual's duties). Limited to 50 employees (or, if less, the greater of three employees, or 10% of employees)
  - Highly compensated employees - a member of the group consisting of the lesser of the highest paid 1% of the employees, or the highest paid 250 employees

Section 280G

- "Base amount" is generally a disqualified individual's average Box 1 W-2 or 1099 compensation from the company for the past 5 years (or shorter period of service)



Section 280G

- What will trigger 280G?
  - Severance
  - Change in control bonuses, retention bonuses, etc.
  - Accelerated vesting of equity awards
  - Grants promised by acquiring company
  - Any payment unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred

Section 280G

- Approach to 280G will depend on your business goals:
  - <u>Do Nothing in Advance</u> - deal with it if it happens
  - <u>Cutback</u> - executive agrees in advance to forfeit any compensation over 2.99x base amount
  - <u>Best net</u> - determine if the executive would be better off with a cutback or the excise tax
  - <u>Tax gross-up</u> - company will cover the executive’s excise tax

Section 280G

Best net example #1:

- Base amount is $100,000
- Contingent payments of $310,000
- Excise tax: $42,000, i.e., ($310,000 - $100,000) * 20%
- Resulting payment: $268,000

Better off cutting back to $299,000 and avoiding the excise tax!

Best net example #2:

- Base amount is $100,000
- Contingent payments of $600,000
- Excise tax: $100,000, i.e., ($600,000 - $100,000) * 20%
- Resulting payment: $500,000

Better off paying the excise tax!

Section 280G

Tax gross-up example:

- Contingent payments of $600,000
- Excise tax: $100,000, i.e., ($600,000 - $100,000) * 20%
- Gross up: $284,487, i.e., $100,000 / (1 – (20% + 37% + 2.35% + 5.499%))

Loans to Executives

- Not generally an option for public companies
  - Sarbanes-Oxley (Sec. 402) generally prohibits any public company from, directly or indirectly, extending, maintaining, or arranging credit in the form of a personal loan to or for the benefit of any executive officer
- Can be problematic even for private companies
  - Unless properly structured, a loan can result in taxable compensation to the executive

Equity Compensation

- Consider whether the person making the offer can promise equity (e.g., can the CEO or must the Comp. Committee?)
- Certain terms will likely need to be determined as of a later grant date (e.g., option exercise price)
- Bear in mind the terms of the plan (e.g., share reserve, available award types) and the potential that they might change
- Be sure award agreements reflect (and if possible reference) any equity promises in an employment agreement

Equity Compensation

- Understand the tax treatment of equity grants
  - Stock options as deferred compensation
  - Restricted stock units – short-term deferral or deferred compensation?
- Consider proxy advisor concerns

Section 162(m)

- Publicly-traded – compensation in excess of $1M is nondeductible
  - In the past, performance-based compensation and commissions could be fully deducted even if they exceeded $1 million.
  - Tax reform has generally eliminated these exceptions and expanded both the types of companies and the employees covered by the $1 million limit

Section 162(m)

- Limit continues to apply to companies with publicly traded stock, and now also applies to companies with publicly traded debt
- Applies to “covered employees,” which now include anyone who, in any taxable year beginning after December 31, 2016, was:
  - The company’s principal executive officer (i.e., CEO),
  - The company’s principal financial officer (i.e., CFO), or
  - One of the company’s three highest compensated officers
- Anyone who becomes a covered employee will remain a covered employee forever

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Section 162(m) – Grandfathering Rule

- Revised limit does not apply to compensation that:
  - Is provided pursuant to a written binding contract in effect on November 2, 2017, and
  - Has not been modified in any material respect on or after that date
- Grandfathered only to the extent the corporation is obligated to pay the executive under the contract
- Contract that is <u>renewed</u> after November 2, 2017 is a new contract and not grandfathered

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Excise Tax for Not-for-Profits

- 21 % excise tax on certain comp in excess of $1M
- Applies to the following types of entities:
  - Exempt from taxation under Section 501(a) (including 501(c)(3) organizations)
  - Income excluded from taxation under Section 115(1) (generally, state government-related organizations, including some government hospitals)
  - Certain farmers' cooperatives and political organizations.

Excise Tax for Not-for-Profits

- Applies to “covered employees”:
  - Organization’s five highest-paid employees for any tax year beginning after 2016
  - Once a covered employee, always a covered employee
    - Even if drop out of the top five in a future year
    - Even post-termination

Excise Tax for Not-for-Profits

- Compensation for the excise tax generally includes:
  - All taxable wages other than designated Roth contributions under a company retirement plan
  - Amounts of deferred compensation that are included in the employee's income (457(f))
- Excludes compensation paid to licensed medical professional for performance of medical services
  - For physicians who serve in both clinical and administrative roles, covered health systems should track what portion of pay relates to performing medical services

Proxy Advisors

- Disfavor certain problematic pay practices, including:
  - High pay compared to peer group
  - Guaranteed multi-year compensation increases
  - Tax gross-ups
  - Guaranteed bonuses
  - Incentive payments not tied to performance
  - Front-loaded and one-time equity awards
  - Fully vested equity awards
  - Single trigger change in control payments
  - Liberal change in control definitions

Proxy Advisors

- What happens if proxy advisors don’t like our compensation practices?
  - Recommend vote against say-on-pay
  - Recommend vote against board members on the compensation committee

DEFERRED COMPENSATION FOR EXECUTIVES

Deferred Compensation

- A Benefit Has Been Promised… Now What?
  - Identification
  - Documentation
  - Operation
  - Taxation

Identification

- Identify Type of Arrangement
  – Qualified benefit
    - 401(k), 403(b), pension plan, certain other benefits
  – Non-qualified benefit
  – Not deferred compensation

Non-qualified Deferred Compensation

- Deferral of compensation outside of a “qualified” plan
- Can be found various places:
  - Formal plans
  - Offer letters
  - Employment agreements
  - Severance agreements
  - Bonus plans
  - Wherever there is a promise to pay compensation in a year that is after the year it was earned

Unlike a qualified plan, a nonqualified plan can be created unintentionally

Why It Matters

- Identifying Deferred Compensation is Key
  - Legal compliance
    - Tax code
    - ERISA for most employers
  - Taxation

Legal Compliance for Deferred Comp

- Tax Code Requirements (Code Section 409A)
  - Must be in writing
    - Strict requirements for timing of documentation
  - Requirements regarding time of deferral election
  - Strict requirements regarding time and form of payment
    - Must be specified at deferral
    - Only certain specific payment events permissible
    - Limited ability to change time and form of payment
  - Must be operated in strict conformity with document
    - Small variances can result in penalties

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Legal Compliance for Deferred Comp

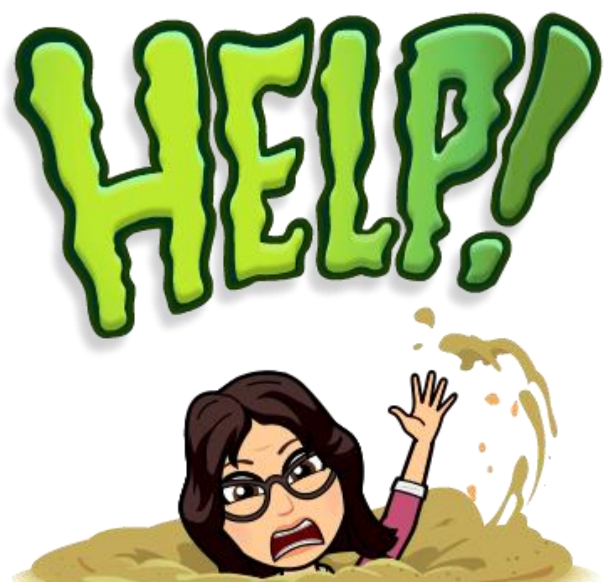
- What is not subject to 409A?
  - Qualified plans and 457(b) plans are exempt
  - “Short-term deferrals”
  - Certain other exclusions
- If you see something that pays in a later year, get a clear answer on whether it is subject to 409A

Taxation

- Taxation of benefits
  - Two types at the federal level:
    - Income Taxation
    - Social Security and Medicare Taxation
  - Timing is key
- Special rules apply to tax-exempt entities – Code Section 457

What if there is an error?

- Non-qualified Plans
  - Generally limited corrections available under IRS guidance
  - Generally not as favorable as qualified plans
- May Result in Penalties under 409A
  - Must include in income and pay taxes <u>now</u>
  - Additional 20% penalty tax
  - Additional interest-based tax
  - Company must report



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Join us as we discuss the impact of #metoo, managing risks in retirement plans, safeguarding against cybersecurity threats in 2019, and more in this full-day seminar.

6 hours of NC CLE Pending

02|06|19
WEDNESDAY
9 A.M. - 4 P.M.

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Please RSVP to
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Questions??

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Kelsey's practice is focused in the areas of Employee Benefits and Executive Compensation. She has extensive experience working with governmental, non-profit, and for-profit employers on all aspects of qualified and non-qualified plans, welfare benefit plans, fringe benefit plans, and executive compensation plans. She routinely represents clients before the Internal Revenue Service and Department of Labor in matters involving employee benefits.

Representative Experience

- Assisting employers establish and maintain defined benefit and defined contribution retirement plans in compliance with ERISA and the Internal Revenue Code.
- Designing and redesigning retirement plans to take advantage of new rules and strategies, including safe harbor 401(k) plans, automatic contribution arrangement features, and cash balance plan conversions.
- Providing guidance to plan fiduciaries regarding meeting fiduciary duties and responsibilities under retirement plans.
- Counseling companies considering a retirement plan termination regarding compliance, required filings, and taxation issues.
- Aiding employers in the design, modification, and termination of executive employment agreements and executive compensation arrangements.
- Negotiating and reviewing executive compensation arrangements, including compliance with Internal Revenue Code Section 409A.
- Advising employers on administration of benefit plans in accordance with applicable rules and regulations.
- Working with employers to identify and correct plan errors through the DOL and IRS compliance programs.
- Advising employers on welfare and fringe benefit plans, including HIPAA, COBRA, domestic partner, and non-discrimination issues.

Kelsey N. H. Mayo
Partner

Areas of Experience

Services

Employee Benefits
Economic Development

Education

Wake Forest University, JD, 2008, *cum laude*

North Carolina State University, BS, 2005, magna cum laude

Recipient of the James and Marie Mason Scholarship

Articles Editor, Wake Forest Law Review

Professional and Community Activities

Charlotte Benefits Forum Past President
American Society of Pension Professionals & Actuaries (ASPPA) IRS Subcommittee Chair, asap Committee Member, and Plan Consultant Magazine Committee Member
ASPPA College of Pension Actuaries (ACOPA) Government Affairs Committee
ASPPA Benefits Council of the Carolinas Board Member and Government Affairs Committee Chair
Professional Mentor with the NCSU Poole College of Management, 2012-2013, 2015-2016
North Carolina Bar Association
North Carolina Association of Women Attorneys
Children & Family Services Center, Board Member
Co-Editor-In-Chief of the Journal of Pension Benefits

Recent Publications

Federal Budget Deal - Look Before You Leap Into Withdrawals

The Impact of the Federal Budget Deal on Retirement Plans

2018 Limits for Benefit Plans

Prior Legal Experience

Prior to joining Poyner Spruill, Kelsey worked as a Summer Associate for Sonnenschein, Nath & Rosenthal in Charlotte. She was also a Legal Intern at Click Commerce, Inc., in Chicago, and a Summer Associate for Blanco, Tackabery, Combs, and Matamoros in Winston-Salem, NC.

Time to Prepare for the End of the Year 2

Notable Accomplishments

Certified Yellow Belt in Legal Lean Sigma by the Legal Lean Sigma Institute®

2018 National Women in Law Award by Corporate Counsel and Inside Counsel

Jurisdictions Licensed

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Jesse is a member of our Employee Benefits and Executive Compensation team and he represents clients before the Internal Revenue Service and Department of Labor in matters involving employee benefits. He has experience working with a diverse range of benefits and compensation matters including those involving qualified and non-qualified plans, welfare benefit plans, fringe benefit plans, and executive compensation plans. *Jesse is not currently licensed to practice law in North Carolina*.

Representative Experience

- Drafting qualified and nonqualified retirement plans, health and welfare plans, short- and long-term cash and equity incentive plans, and individual compensation agreements.
- Advising clients regarding employee benefits and executive compensation issues in mergers and acquisitions.
- Drafting compensation-related proxy disclosures for public company clients.
- Providing ERISA compliance support, contract review, and assistance with claims responses.
- Representing clients in connection with multiemployer pension plan withdrawal liability assessments.

*Jesse is currently licensed to practice law in New York only.

Prior Legal Experience

Prior to joining Poyner Spruill, Jesse worked as a Senior Associate at Harter Secrest & Emery LLP in Rochester, New York from 2008 to 2017. Jesse also worked as a Summer Associate for two summers at Steptoe & Johnson PLLC, and served as a Judicial Intern to the Honorable F. Bradford Stillman, United States Magistrate Judge in the United States District Court for the Eastern District of Virginia.

Areas of Experience

Services

Employee Benefits

Education

The College of William & Mary, School of Law, JD, 2008

George Mason University, BA, 2003, *cum laude*

Teaching Assistant in the Legal Skills Program

Moot Court Team, 2008 ABA Best Advocate Award (5th Place, Washington, DC Region)

Notes Editor, William & Mary Environmental Law and Policy Review

Professional and Community Activities

Past Chair, Rochester, NY Chapter, J. Reuben Clark Law Society

New York State Bar Association

Recent Publications

Best Practices for Retirement Plan Fiduciaries

Tax Reform Strengthens Limits on Excessive Compensation

Tax Reform Could Cost Tax Exempt Entities

Notable Accomplishments

Certified Yellow Belt in Legal Lean Sigma by the Legal Lean Sigma Institute®

Jurisdictions Licensed

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