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Employment Agreements (Including Severance, Parachute, Clawback, Noncompete and §409A Issues)

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EMPLOYMENT AGREEMENTS, GENERALLY

Employment agreements, which are very common for executives and senior management, raise a number of issues relating to terms of employment, severance on termination, change in control, excess parachute tax under Internal Revenue Code (I.R.C.) §280G,[2] noncompete provisions, clawback provisions, SEC disclosure requirements, and restrictions on nonqualified deferred compensation under §409A.

The terms of employment agreements and severance arrangements are of particular relevance in corporate transactions. Executives may be terminated as a result of a transaction, and the general severance provisions in the employment agreements may be triggered.[3]

Severance provisions are often triggered on termination of employment only if there is also a change in control of the employer, or the amount of severance may be more generous if the termination occurs after a change in control. Some agreements may allow an employee to quit for any reason and still receive severance, if the quitting is in connection with a change in control. Employment and change in control agreements often provide that options will vest on a change in control typically even without a termination of employment.[4]

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[2] Unless otherwise stated, all § references herein are to the I.R.C., or the regulations thereunder.

[3] In transactions, new employment or retention agreements will often be negotiated to replace existing arrangements with the executives the buyer wants to retain, as discussed below.

[4] Some change in control agreements provide for a "change in control bonus" on a change in control even absent any termination of employment.

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PROTECTIONS AFFORDED EMPLOYEES WITH OR WITHOUT EMPLOYMENT CONTRACTS

Under the ''employment-at-will'' doctrine, absent an employment contract (or severance contract or policy), an employee in the U.S. will generally be considered an ''employee at will'' and can be terminated without cause and without notice, and no severance would be required. A handful of states have imposed an implied covenant of good faith and fair dealing. In addition, most state courts have found a tort of wrongful or abusive termination in violation of public policy.[5] Employee handbooks or policies in many states may impose a severance obligation. There are also various state and federal nondiscrimination rules to which employers must adhere. In the absence of these special rules, however, an employee will only be protected on termination of employment if an employment or severance agreement provides relief.[6]

PROVISIONS OF EMPLOYMENT AGREEMENTS

A proper understanding of the various terms of an employment agreement is necessary in drafting, negotiating and understanding the agreement.[7]

Term. Employment agreements will generally have fixed terms, e.g., for 2- or 3-year periods. Agreements often provide that they will automatically renew at the end of the term, e.g., for 1-year terms, unless proper notice is given by either party. These are often referred to as evergreen provisions.[8] On occasion, agreements provide for rolling evergreens (true-evergreens) that have rolling terms that automatically renew daily for a full year or multiple years.[9] If the employment agreement expires, certain provisions, such as the confidentiality provisions, may continue.[10] The employment term will also generally terminate on the employee's death or disability. The employer should be given the right to terminate the agreement if the employee is unable to perform his or her duties for a period of time (e.g., 60 days).[11]

Title/Duties. The position of the executive will typically be stated in the employment agreement, although employers may want to be less specific as to duties so as to allow employer flexibility to modify the employee's duties as needed, or the employer may specifically provide for the right to reassign the employee to another position in the company. This section of the agreement may also state to whom the executive will report. The agreement may also provide that the executive will be nominated to the board of directors.[12] In many companies, the CEO is also appointed as chairman of the board of directors. However, an increasing number of companies have separated the roles of CEO and chairman of the board in order to provide more accountability in operations of the company, and to maintain better control on CEO compensation.[13] The executive may be required to devote all or substantially all his or her business time to the work of the company.[14] The primary place of employment is often specified in the agreement.

Compensation and Sign-On Bonuses. Executive employment agreements typically specify the starting

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[5] *See, e.g.,* Ballum, *Employment-at-Will: The Impending Death of a Doctrine*, 37 Am. Bus. L. J. 653 (Summer 2000); Bloomberg BNA Individual Employment Rights Manual, ¶505:51.

[6] Employment terms of senior executives of public companies are required to be disclosed in the annual proxy, and receive particular scrutiny from shareholders, as discussed further below.

[7] Employment agreements are sometimes structured as offer letters, which are binding once countersigned by the employee.

[8] If the agreement is intended to be for the fixed term only and not to renew, this should be specified in the contract, since silent employment contracts are often interpreted by courts to extend for one-year terms. *See, e.g.,* 2 Williston on Contracts §6.42; *Cinefot Int'l Corp. v. Hudson Photographic Indus.*, 13 N.Y.2d 249, 246 N.Y.S.2d 395, 196 N.E.2d 54 (1963); *Otten v. S.F. Hotel Owners Ass'n*, 74 Cal. App. 2d 341, 168 P.2d 739 (1st Dist. 1946); *Kropfelder v. Snap-On Tools Corp.*, 859 F. Supp. 952 (D. Md. 1994). *But see Goldman v. White Plains Ctr. for Nursing Care, LLC*, 11 N.Y.3d 173, 896 N.E.2d 662 (2008) (when employee continued to work past expiration of 2-year employment term, agreement did not automatically renew; agreement contained specific provisions requiring parties to negotiate renewal, providing that employer had no further obligation past term, and provided that the contract reflected entire agreement and could only be modified in writing; court distinguished this from *Cinefot* where 1-year renewals were implied in oral agreements that did not expressly require negotiations for renewal).

[9] If the term of a named executive officer's employment agreement does not automatically renew, the renewal would likely need to be disclosed on Form 8-K. Note that, with increased focus on executive compensation, some employers are cutting back on automatic renewals.

[10] If the executive remains employed after the expiration of the agreement, his or her employment will generally be at-will.

[11] The employer must nevertheless keep in mind the Americans with Disabilities Act, which requires reasonable accommodation for disabilities, and the Family and Medical Leave Act, which provides for 12 weeks unpaid leave and for reinstatement on return to work (although there is a limited exception for highly compensated employees).

[12] Executive employment agreements sometimes specify that a termination of employment is automatically considered a resignation from the Board.

[13] Close to half of large public companies have separated the roles of CEO and chairman, according to recent surveys. *See, e.g.,* Meridian Compensation Partners, 2015 Corporate Governance Incentive Design Survey (44% of 250 large public company have separated role of CEO and chairman).

[14] There may be limitations on other activities. Outside activities that interfere with the employee's performance of his or her duties will often be prohibited. Frequently, an agreement will permit the executive to serve as an outside director to other companies and to be involved in civic and charitable organizations.

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salary. Agreements often provide that salary will be payable in accordance with company payroll practices.[15] The agreement may provide that the salary will be reviewed annually. On occasion, there may be inflation protection for the executive's salary with an automatic cost-of-living adjustment. Sign-on bonuses are sometimes provided to newly-hired senior executives.[16]

Annual Bonuses. Often bonuses are provided at the discretion of the employer. Some agreements for executives may set forth the minimum bonus amount and/or may specify the performance criteria of the bonuses. A purely discretionary bonus gives the employer added flexibility. Performance bonuses are also common.[17] For the CEO and top three executives (excluding the CFO) of a public company, §162(m) may prevent setting forth a minimum bonus amount in the agreement.[18] Bonuses should be payable within the first 2½ months after the year vested in order to avoid nonqualified deferred compensation restrictions under §409A.[19]

Equity Grants. Employment agreements may also provide a description of the equity compensation to be granted (often with specifics of the grant, the vesting schedule, etc.). For public companies, shareholders and the Institutional Shareholder Services (ISS), as advisor to institutional shareholders, may want a CEO to have a significant portion of his or her compensation to be a performance-based awards. Equity compensation may or may not be subject to performance goals. There may be a provision for full or partial vesting of the equity upon a termination without cause or quitting for good reason. Restricted stock units may trigger §409A issues, but fair market value options and restricted stock are not subject to §409A.

Benefits and Perks. An employment agreement will often specify the benefits and perquisites that the executive is entitled to. These could include entitlement to benefits in the company's retirement plans and welfare plans, company car, use of corporate aircraft, country club fees, relocation expenses, etc. Often the agreement will state that the executive will receive the same benefits as other company employees at comparable levels. Note that there is a more recent trend to decrease perks and increase salary for senior executives of public companies because of disclosure requirements of perks in the annual proxy and because of public scrutiny generally. Employment agreements often specify the amount of vacation the employee is entitled to.

Severance. Employees cannot compel employers to continue to employ them, and generally the only protection for the employee is for the employment agreement to provide for specific severance if the employee is terminated. Severance is often tied to noncompete restrictions (discussed below) or as consideration for executing a release of claims.

Executive employment agreements typically provide that on termination of the employee ''without cause'' the employee will be entitled to severance for a certain period of time or of a certain amount. ''Cause'' will often be defined to include: (1) conviction or plea of ''nolo contendere'' (some agreements include indictment) for a felony (often limited to one involving fraud or moral turpitude); (2) failure to perform duties; (3) gross misconduct or gross negligence that causes material harm to the company; and/or (4) breach of material provisions of the contract.[20]

Many employment agreements also allow the employee to quit for ''good reason'' and treat the quitting as a constructive termination by the employer, enti-

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[15] The employment agreement may provide for deductions from salary and benefits for federal, state and local taxes and for employee contributions to benefit plans and other amounts allowed or required by law.

Often the agreements will provide that base salary will not be reduced (unless all salaries are reduced).

[16] Sign-on bonuses may be replacing amounts forfeited by leaving the prior job. Sometimes the agreement will provide that sign-on bonuses often must be returned on termination for cause or quitting without good reason within a specified period from the hire date. Relocation benefits may be provided on hire, and some of these amounts may be tax free. Relocation benefits may cause issues under §409A if the employee can change the tax year of payment, and a short-term deferral may be required to avoid this issue.

[17] For public companies, it may be desirous to provide a performance bonus that meets the requirements of performance-based compensation under §162(m). For §162(m) purposes, public company bonus plans for executives will typically specify the target bonus with goals established annually by the compensation committee. On occasion, guaranteed bonuses may be provided. For newly hired executives, the annual bonus may be prorated.

[18] For qualified performance-based compensation to be exempt from the §162(m) limit on compensation over $1 million a year, there must be a shareholder-approved plan administered by a committee of outside directors with pre-established objective performance goals. §162(m)(4)(C); Reg. §1.162-27(e). A minimum bonus amount would generally not meet these requirements.

[19] *See* Reg. §1.409A-1(b)(4)(i).

[20] Note that even if the termination by the employer is for cause or the employee is quitting without good reason, the agreement will often provide that the employee will receive: (1) accrued base salary; (2) unused vacation pay (some states, e.g. California, require employer payment for unused vacation); (3) unreimbursed business expenses; and (4) benefits to which they have already vested in.

If the termination is without cause or by quitting for good reason, the employee would generally be provided with the above items, as well as a reasonable pro-rata bonus (even though not employed at the end of the year or date of bonus payment), in addition to any severance that is provided.

The agreement will sometimes give the executive an opportunity to cure after notice is given.

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tling the employee to the same severance he or she would receive if terminated by the company without cause. ''Good reason'' is often defined as: (1) material diminution in duties or responsibilities; (2) significant reduction in pay or benefits; (3) breach of the agreement; or (4) required relocation. Some agreements also add failure of a successor company to assume the agreement as a ''good reason.''[21] See discussion below regarding §409A issues with severance payable on a quit for good reason. Often quitting for good reason requires notice to the employer and a right to cure.

Many employment agreements contain ''double triggers,'' whereby the severance will be payable (or will be payable in a greater amount) only if the termination occurs in connection with a change in control. These are discussed further below with regard to change in control agreements.

Amount of Severance; Payable in Lump Sum or Over Severance Period. The amount of severance provided on termination without cause or quitting for good reason can be anywhere between from several months of pay to three years of pay, or sometimes pay for the remainder of the term of the employment agreement.[22] The severance may include base pay only or may also include a corresponding amount of the highest or average annual bonus for the past three years or the target annual bonus. As discussed below, with a push for better corporate governance in compensation, companies have been moving away from the three times multiples for severance. In addition, due to recent increased focus on corporate governance in compensation, shareholder proposals, and tighter criteria by ISS, there has been a downward shift in the amount of severance, with three times multiples for senior executives being the exception rather than the rule.

Severance is sometimes payable over the period of severance, so that if the severance is one year's pay it would be payable over one year as if still employed.[23] Often, however, severance is payable in a lump sum on termination. Because of the §409A restrictions on nonqualified deferred compensation, it may be necessary to provide for the severance to be payable in lump sum in order to avoid §409A deferral of income requirements by meeting the short-term deferral exception to §409A, as discussed below.

Vesting of Options. Employment agreements may provide that options or other equity awards will vest on termination without cause, quitting for good reason or change in control. Such vesting provisions are prevalent in change in control agreements, as discussed below.

Duty to Mitigate. Although generally there is a duty to mitigate damages on a breach of contract, where severance is specified in the contract, the severance will be treated as liquidated damages and there is no duty to mitigate liquidated damages.[24] Therefore, if the intention of the parties is that the severance should be mitigated by new employment, the employment agreement should specifically state this. Furthermore, in order to avoid any doubt, even if no mitigation of damages is contemplated, it may be wise to specifically state that there is no duty to mitigate.

Continued Health Benefits. The executive will often receive employer-paid health insurance (or employer-paid COBRA) for the severance period, or until the executive is reemployed with comparable coverage. Note that under §105(h), health plan benefits will be taxable to highly compensated employees if they discriminate in benefits or eligibility in favor of the highly compensated employees. Prior to the effective date of rules under the Patient Protection and Affordable Care Act of 2010 (Affordable Care Act), §105(h) only applies to self-insured plans. Under the Affordable Care Act, insured plans will also be subject to §105(h) nondiscrimination rules except for grandfathered plans where the insured plans were in existence on March 23, 2010 (even if the highly compensated individual joined the plan after March 23, 2010). The penalty for discriminatory insured plans will be an employer paid excise tax. Notice 2011-1 delayed enforcement of §105(h) with regard to insured plans until the first plan year beginning after final regulation regarding §105(h) as expanded by the Affordable Care Act are issued. Note that as an alternative to continuing health benefits, the employer could pay or reimburse for premiums on an after-tax basis, or the company could increase cash severance to allow for the purchase of individual coverage to avoid application of §105(h).

Retirement Plan Benefits. Change in control agreements will sometimes provide the executive with

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[21] A change in control by itself is typically not enough to be a good reason trigger.

[22] Sometimes severance will be set at the greater of the remainder of the term or one year.

[23] An advantage to paying over the period of severance is that there is more control over the noncompete restrictions.

[24] *See, e.g., Boyle v. Petrie Stores Corp.*, 518 N.Y.S.2d 854 (1985) (where CEO terminated without cause and contract provides that receive lump sum severance, there is no duty to mitigate because it is liquidated damages); *Victory Sign Indus., Ltd. v. Potter*, 208 Ga. App. 570 (1993) (discharged employee had no obligation to mitigate specified severance damages by accepting employer's offer to reinstate employee). This is true even if severance is payable over a period of time and not just if paid in a lump sum. *Musman v. Modern Deb, Inc.*, 377 N.Y.S.2d 17 (App. Div., 1st Dept. 1975) (where contract provides that on termination without cause employee receives compensation and bonus until end of term, this liquidates damages clause and removes case from ordinary rule requiring employee to mitigate damages).

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benefit accrual credit under any nonqualified pension plans in conjunction with the severance. Sometimes the credit under the nonqualified plan will also make up any service credit lost under the qualified plan for the period of severance. Typically there will be no service credit under the qualified plan, because the employee did not work for that period of time.[25] In the case of a §401(k) plan, the §415 regulations issued in 2007 allow regular pay, overtime, vacation, and deferred compensation paid within 2½ months or the plan year to be treated as valid compensation and to be included in the §401(k) deferrals; however, severance pay or parachute payments are not compensation even if payable within 2½ months or the end of the plan year.[26]

Waiver of Claims. The employee may be required to sign a waiver of claims in order to receive severance. The agreement should specify that the severance is conditioned on executing a waiver.[27] Employees are sometimes resistant to agreeing to such a provision. Such a waiver condition should be valid even for Age Discrimination in Employment Act (ADEA) waivers.[28] If an ADEA waiver is sought, the severance provision should state that severance will not be payable until the end of the ADEA 7-day revocation period.

Noncompetition and Nonsolicitation Provisions. Noncompetition and nonsolicitation provisions are discussed below.

Confidentiality and Intellectual Property. Employment agreements often provide that the employee or former employee may not disclose any trade secrets, customer lists, or other confidential information.[29] Such disclosure may be prohibited in any event under the law of unfair competition. However, the agreement will often provide specific rules for confidentiality restrictions. Nondisparagement provisions protecting the company, and sometimes protecting the employee as well, are often also included. There may also be a provision that intellectual property belongs to the company, including rights to inventions made during the period of employment. These covenants often continue for an unlimited duration. The agreements often provide for injunctive relief, and not merely monetary damages.

Arbitration. Employment agreements often provide that disputes must be settled in binding arbitration. Arbitration clauses are generally beneficial to employers in that they can avoid jury trials (which are often sympathetic to individual plaintiffs). Also, arbitration proceedings are much quicker and cheaper than litigation, and they do not involve discovery, are confidential and may often yield a more equitable outcome.[30]

Choice of Law. Choice of law provisions will typically provide which state law governs the agreement. Choice of law provisions will generally be upheld if there is some connection between the chosen jurisdic-

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[25] On occasion, particularly where the executive is receiving the severance over a period of time, the employer may treat the executive as continuing as an employee with full credit under all the benefit plans, although the legality of such an arrangement is unclear where the executive is not performing any services that are generally performed by an employee.

[26] Reg. §1.415(c)-2(e)(3) (proposed in 2005 and finalized in 2007), provides that post-termination compensation that is paid within the later of 2½ months after severance or the end of the plan year in which the termination occurs, and that would have been paid had the participant remained employed (such as regular pay, overtime, commissions, vacation, bonuses, and deferred compensation) is treated as compensation for purposes of §415(c)(3). However, severance pay or parachute payments are not §415 compensation even if payable within 2½ months or the end of the plan year. *Id.* Reg. §1.401(k)-1(e)(8) provides that a §401(k) deferral can include severance paid after employment within 2½ months after severance or by the end of the plan year, if it meets the above rules.

[27] Some practitioners have questioned the validity of provisions in employment agreements conditioning all severance on the exercise of waivers, because such waivers can be seen as prospective waivers (waivers executed before damages arise), which may be invalid. Instead, they advocate providing for some amount of severance regardless of the execution of the waiver, and an additional amount of severance if the waiver is executed.

[28] Under ADEA, as amended by the Older Workers Benefit Protection Act of 1990, a waiver for age discrimination for employees age 40 or older must meet the following conditions: (1) it must be in writing and be understandable; (2) it must specifically refer to ADEA rights or claims; (3) it may not waive rights or claims that may arise in the future; (4) it must be in exchange for valuable consideration; (5) it must advise the individual in writing to consult an attorney before signing the waiver; (6) it must provide the individual at least 21 days to consider the agreement; and (7) the individual must be given at least 7 days to revoke the agreement after signing it. If an employer requests an ADEA waiver in connection with an exit incentive program or other employment termination program, it must give the individual a period of at least 45 days within which to consider the agreement. 29 U.S.C. §626(f)(1); 29 C.F.R. §1625.22.

Regarding provisions that require the individual to tender back the consideration before challenging the validity of the ADEA waivers, see *Oubre v. Entergy Operations, Inc.*, 522 U.S. 422 (1998) (employee is not required to return consideration received in exchange for ADEA waiver before challenging validity of waiver in court), and 29 C.F.R. §1625.33 (as amended in 2000 in response to *Oubre*).

State age discrimination laws may have varying requirements. For example, Minnesota Human Rights Act requires a 15-day revocation period.

[29] Many confidentiality provision exclude information which is or becomes part of the public domain (through no act or omission of the receiving party).

[30] Regarding the enforceability of arbitration clauses, see *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991) (Supreme Court confirmed validity of arbitration as means of resolving employment-related disputes such as ADEA, ruling that statutory discrimination claims may be subject to compulsory arbitration by agreement).

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tion and the employment situation. Attorneys may want to put in choice of law provisions in favor of their own state. Certain states, such as California and Texas, are seen as employee-friendly, and an employer may want to choose a different state if there is some nexus to that other state.

Assignability. Most employment agreements will provide that the agreements can be assigned by the employer to a successor company, or that the agreements are automatically assumed by a successor. Often the nonassumption of the agreement by the successor will be treated as a breach of the agreement, or otherwise trigger the ability to quit for good reason and receive severance.

§409A Provisions. See the discussion below regarding §409A rules that may be applicable to severance provisions and certain other provisions in employment agreements.

Other Provisions. Other provisions often included in employment agreements include: notice provisions, amendment by consent of both parties, severability of agreement if certain provisions are held to be invalid, executive's legal fees in negotiating the agreement[31] and indemnification of the executive to the extent permitted by law.

CHANGE IN CONTROL PROVISIONS AND CHANGE IN CONTROL AGREEMENTS

Change in control provisions are often contained in employment agreements or in separate change in control agreements (also referred to as ''golden parachute'' agreements). Such benefits are generally only provided to the most senior management.[32]

Single-Trigger or Double-Trigger Change in Control Provisions. Change in control provisions can take one of two forms. They can be ''single-trigger'' benefits where, upon a change in control, certain amounts will be paid to the executives even absent a termination. (With recent say-on-pay voting and institutional shareholder scrutiny, single triggers are less common.) This is not severance, but rather a change in control bonus. Single trigger benefits are becoming rare in public companies because of shareholder concerns and because a change in control benefit is typically viewed as limited to mitigate a loss of employment, but not merely as a deal bonus.

The more common change in control provision is a ''double-trigger'' benefit under which the executive will receive severance benefits if there is: (1) a change in control; and (2) within a certain period of time after the change in control (e.g., 12 or 24 months) (or in certain cases within a certain period of time prior to a change in control) there is a termination by the company without cause or the executive quits for good reason. Often, executive employment agreements provide for a certain amount of severance on a termination without cause or quitting for good reason, and an enhanced severance benefit if such termination takes place after a change in control.

Modified Single-Trigger (Right to Walk). Sometimes a change in control provision will state that for a certain period after a change in control (e.g., within a 12- or 24-month period) the executive can quit for any reason. He or she can ''walk'' and receive the severance. This is often referred to as a modified single trigger.[33] (With recent say-on-pay voting and institutional shareholder scrutiny, single triggers are less common.) Even where there is a ''good reason'' requirement, it may be defined so broadly that the executive in effect has the ability to ''walk'' on a change in control.[34] This has also become less popular because of shareholder concerns that this in effect is a single trigger. Also, such a good reason would not be a safe-harbor §409A good reason, as discussed below.

Window Period to Quit. Some executive employment agreements — in addition to providing for severance on a ''double trigger'' with a termination without cause or quit for good reason after a change in control — also allow the executive to walk for any reason within a 30-day window period at the end of

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[31] Some practitioners take the view that reimbursement of legal fees for an existing employee may be excludable from income as a working condition fringe benefit. In terms of §409A, reimbursement of legal expenses would be treated like reimbursement of expenses generally that must be payable by the end of the year following the year incurred.

[32] A 2016 survey of 200 large and mid-cap public companies show that about 62% of companies provide for executive severance on termination of senior executives (and 80% do so if there is also a change in control). Frederic W. Cook & Co., ''Executive Severance and Changes-in-Change Practices'' (Mar. 2016). The survey also found that: (1) good reason terminations trigger severance for 70% of CEOs and 60% of CFOs; (2) the most prevalent protection period for severance for termination following a change in control is 24 months, while some provide a 12-month protection period; (3) of those who provide severance, the multiples of severance in non-change-in-control termination were 2 to 2.99 times salary (or salary and bonus) for 52% of CEOs and 1 to 1.99 times for 66% of CFOs, and following a change in control, 50% of CEOs were entitled to treble multiples (18% for CFOs); (4) §280G excise tax gross-ups were provided in only 15% of mid-cap companies and only 6% of large-cap companies (25% had a parachute cutback); and (5) 93% of the companies provided equity vesting in a change-in-control with 70% of those requiring double trigger (change in control and termination) to be vested.

[33] In such cases, it may be very important for a buyer to buy out these contracts or negotiate new ones. Otherwise, the executive may have too much incentive to quit and receive severance.

[34] For example, if the definition of good reason includes any change in responsibilities or duties, the change in control itself will most likely trigger the good reason, and thus allow the executive to walk.

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some transition period (e.g., after one year). This has the effect of serving as a short-term retention incentive for the executive for the transition period after the change in control. There may be shareholder concerns with such a benefit.

Definition of Change in Control. The definition of change in control in employment and change in control agreements will often mirror the definition in the company's stock option or other plans. A typical change in control definition would be: (1) acquisition by a person or group unrelated to the company of 20% (or 30%) or more of the stock or voting power of the company; (2) the incumbent board ceasing to be a majority, (unless the new board is elected by the old board and not in a proxy contest); (3) a sale (or approval by shareholders of a sale) of substantially all of the assets of the company to an unrelated entity or a liquidation of the company; or (4) a merger (or approval by shareholders of a merger) with an unrelated entity where the existing shareholders no longer hold a majority of shares of the new entity.[35] Some agreements provide that shareholder approval of the transaction (and not merely the consummation of the transaction) would be a change in control, so even if the deal would fall apart, the executives would receive the benefits.[36]

Amount of Severance. The severance benefit for change in control agreements are often equal to between one year and three years of pay, and may also include a corresponding amount of bonus, as discussed above. The severance is often based on the average of the compensation for the prior two or three years (which avoids a payment based on a year with very large compensation). In most cases, the severance will be payable in a lump sum, which lessens §409A issues, as discussed above and below. As stated above, with economic downturns and an overall push for more scrutiny of corporate governance in compensation, companies have been moving away from the treble multiples for severance.

Parachute Caps and Excise Tax Gross-Ups. As discussed below in relation to §280G, large severance amounts may trigger excise taxes and nondeductibility if there is an excess parachute payment under §280G. Change in control agreements often have a parachute cap that would cut back on stock option vesting or other severance payments to the extent they would trigger nondeductible excess parachutes. Another approach sometimes used is a ''modified'' parachute cap, whereby the parachute payments will be cut back only if the cutback results in a greater after-tax benefit to the executive after taking into account both the excise tax that would otherwise have been payable on the excess parachute, and the larger income tax that would otherwise have been due had the payment not been reduced. Historically, senior executives of large corporations were not given parachute cutbacks, but rather gross-up provisions that would reimburse the executives from any excise tax on the excess parachute and any income tax and excise tax on the gross-up amount. In recent years, however, there has been a strong movement away from §280G gross-ups because of increased scrutiny due to the SEC requirement to disclose the value of the gross-up in the proxy, and say-on-pay voting and institutional shareholder concerns (ISS will not approve of an arrangement with a parachute gross-up).

Vesting of Equity Awards. Change in control agreements typically provide that stock options and other nonvested equity awards will become fully vested on a change in control, typically even without a termination of employment.[37]

Business Judgment Rule and Validity of Change in Control Agreements. On occasion, courts have struck down unreasonable change in control agreements.[38] In most cases, however, change in control ar-

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[35] Some change-in-control definitions provide that a change in control does not include a board-approved transaction, although these have become less common because hostile takeovers often eventually receive board approval. Spinoffs would typically not be considered a change in control event unless there is also a sale of substantially all of the assets of the company.

[36] This occurred in WorldCom's attempted takeover of Sprint in 2000, which never closed.

[37] In a private company, on termination, there may be a requirement that the employee return any company shares, typically based on some valuation.

[38] *See, e.g., Black & Decker Corp. v. Am. Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988) (in response to tender offer, company offered alternative recapitalization plan, thus putting company up for sale and requiring under ''Revlon'' standard that board act as auctioneer with respect to competing bidders; implementation of severance plan triggered on change in control, but not by recapitalization plan held invalid because it treated competing bids unfairly); *Tate & Lyle PLC v. Staley Cont'l, Inc.*, 1988 BL 393, 9 EBC 2031 (Del. Ch. 1988) (rabbi trust funded on change in control as anti-takeover device was not protected by business judgment rule); *Gaillard v. Natomas Co.*, 208 Cal. App.3d 1250, 256 Cal. Rptr. 702 (App. 1st Dist. 1989) (genuine issues of material fact regarding approval of parachutes for officers in midst of tender offer; agreements did not serve traditional golden parachute function of fostering executive objectivity toward mergers and attracting top executives to companies that are potential takeover candidates, because parachutes did not ensure continuity of management, and actually encouraged officers to quit); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009) (motion to dismiss denied in claim involving compensation paid to Citigroup's CEO, Charles Prince, who was given $68 million as severance on leaving company after collapse of housing market; court noted that there is outer limit to the board's discretion to set executive compensation, at which point executive compensation may be so disproportionately large as to be unreasonable and constitute corporate waste).

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rangements have been upheld under the business judgment rule.[39]

[39] *See, e.g., Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S. D. Ohio 1987), *aff'd without op.*, 815 F.2d 76 (6th Cir. 1987) (upheld parachute arrangements adopted by company after being subject to tender offer; applied "Unocal" analysis that to apply business judgment rule in takeover, directors must establish reasonable grounds for believing there was danger to corporate policy and effectiveness, and that bounds of defensive measures are reasonable; held that parachute agreements are in shareholders' best interest because they are only triggered if management employees are fired or discharged after change in control and the §280G cap in the contract ensured that the severance would be reasonable; but CEO's single trigger parachute was unreasonable); *Tate & Lyle PLC v. Staley Cont'l, Inc.*, 1988 BL 393, 9 EBC 2031 (Del. Ch. 1988) (approved parachute arrangements adopted prior to takeover threat, including double trigger parachutes, SERP and bonus plans with change in control acceleration, and trust that will be funded on change in control; plans are protected by business judgment rule because good faith responses to possible takeover attempt, but retirement plan for outside directors and funding trust were held invalid); *Nomad Acquisition Corp. v. Damon Corp.*, 1988 BL 282, 1 EXC 389 (Del. Ch. Sept. 16, 1988) (court upheld parachutes as part of poison pill in takeover; approved by outside directors acting in good faith; required to remain six months after change in control to earn parachute, which implies they were not management entrenchment devices); *Int'l Ins. Co. v. Johns*, 874 F.2d 1447 (11th Cir. 1989) (5-year consulting noncompete agreement with former chairman in connection with merger and performance units that were payable on change in control, approved by disinterested Board members, were not corporate waste, because they ensured executive with firm-specific knowledge would remain in difficult period; fact that arrangement did not have §280G cap is not dispositive); *Hills Stores Co. v. Bozic*, 769 A.2d 88 (Del. Ch. 2000) (agreements with severance for demotion or discharge within one year of change in control, or upon any change in control not approved by majority of board in response to takeover threat were reasonable under the *Unocal* analysis because Board properly determined in good faith that corporation faced threat warranting defensive response and severance agreements were not disproportionate to threat); *Campbell v. Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792 (6th Cir. 2001) (employer's board did not exhibit gross negligence in approving "golden parachute" severance payments); *Brehm v. Eisner*, 746 A.2d 244 (Del. Supr. 2000) (regarding Disney board's approved large severance package for former president (Michael Ovitz), the court held that: directors relied in good faith on financial expert who advised board on employment agreement; directors' lack of substantive due care is foreign to business judgment rule; waste by directors was not shown; and president did not engage in gross negligence or malfeasance; board was afforded protection of business judgment rule as long as it exercised due care in its decisions), later proceeding in *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. Supr. 2006) (upheld Chancery Court 2005 ruling and ruled for defendants in shareholder suit described above against officers and directors of Disney regarding hiring of Ovitz as president and decision to allow him to terminate on no-fault basis one year later with severance package worth about $130 million; CEO, committee and board did not violate fiduciary duties and acted in good faith when they fired Ovitz; business judgment rule gives directors presumption that decision acted on informed basis was valid; directors though providing minimal oversight still acted in good faith without gross negligence; payment of severance did not constitute corporate waste).

Reasons for Change in Control Agreements. As discussed above, most cases have upheld change in control agreements under the business judgment rule. There are, in fact, a number of reasons why it would be beneficial, even for the company, to enter into change in control agreements with the executives. Change in control benefits may give the executives job stability and financial reassurance, so that they can concentrate on the needs of the company and the transaction, and not merely on their own future. In addition, the promise of severance could keep executives from jumping ship in advance of a transaction. Noncompete restrictions secured in exchange for the severance are often very valuable to the employer. Care must be taken, however, that change in control severance does not cause the executive to quit right after the transaction to receive the severance, and does not encourage executives to seek takeovers. In addition, rich change in control agreements may in certain cases be intended primarily as a takeover deterrent, and may arguably not be in the best interest of the company and its shareholders.

NONCOMPETE RESTRICTIONS

Noncompete Provisions. Employment agreements typically contain provisions for noncompetition and nonsolicitation of customers for the period of the agreement and for a period of time after termination, e.g., for one or two years after termination, or sometimes for the period of severance. A non-solicitation restriction (regarding clients, customers, suppliers or employees) is often the same duration as the noncompete provisions, and other times is extended longer than the noncompete provisions.

Enforceability of Noncompete Provisions. State laws vary regarding enforceability of noncompete provisions. Generally, noncompete provisions will be enforced in most states if the restrictions are reasonable in geographical scope and reasonable in duration, and they are necessary to protect legitimate business interests.[40]

For example, in New York, which is fairly liberal in allowing noncompete restrictions, the noncompete will be enforceable if: (1) the time period of restriction is reasonable; (2) the geographical scope is reasonable; (3) the burden on the employee is not unreasonable; (4) public policy is not harmed; and (5) the restrictions are necessary for the employer's protection.[41] In New Jersey noncompete restrictions will be enforced only if reasonable under the circum-

[40] The duration of the noncompete is often one to two years beyond termination. Reasonableness of the geographical scope may depend upon the type of business.

[41] *Mallory Factor Inc. v. Schwartz*, 146 A.D.2d 465, 536

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stances.[42] Texas and Florida statutes restrict noncompete requirements unless they are reasonable restrictions necessary to protect legitimate business interests.[43]

California by statute generally voids noncompete provisions, providing that ''except as provided in this Chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void.''[44] The Ninth Circuit allowed ''narrow restraint'' enforcement of noncompete provisions that are very limited, but the California Supreme Court rejected this exception.[45] Sometimes noncompete restrictions in California are enforced based on an out-of-state choice of law provision.[46]

Blue-Penciling of Noncompete Restrictions. Where noncompete provisions are overbroad and therefore unenforceable on their terms, many states will ''blue pencil'' the restrictive covenants to a limited scope for which they would be enforceable.[47] For example, in New York restrictive covenants will be blue penciled.[48] Often, employment agreements will add language to specifically provide for blue penciling.

Consideration for Noncompete Agreements. Often employees are asked to sign noncompetition, nonsolicitation and/or confidentiality agreements even without any severance or other added consideration for the employee. Where the only consideration for the noncompete or similar restriction on the employee is employment or continued employment, some states may not enforce the agreement, finding lack of adequate consideration. Most states, however, will find adequate consideration for noncompete agreements merely with beginning employment or continuing employment even if only for employment at will.[49]

N.Y.S.2d 752 (App. Div., 1st Dept. 1989) (public relations firm brought action against former employee for breach of restrictive covenant; to be found reasonable and, therefore, enforceable, restrictive covenants must meet following criteria: (1) time and geographical scope of the restriction must be reasonable; (2) burden on employee must not be unreasonable; (3)general public must not be harmed; and (4) restriction must be necessary for employer's protection; court held that former employee was also liable for breaching restrictive covenant); *Int'l Paper Co. v. Suwyn*, 951 F. Supp. 445 (S.D.N.Y. 1997) (non-competition agreement is enforceable only if it is reasonable in duration and geographical area, not burdensome to employee, not harmful to general public, and necessary for employer's protection; adequate consideration supported noncompetition agreement providing that executive could not work for competitor for period of 18 months following termination of his employment); *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999) (restrictive covenant enforceable only if reasonable in time and area, necessary to protect employer's legitimate interests, not harmful to the general public and not unreasonably burdensome to the employee; employer's legitimate interest is limited to protection of trade secrets, confidential customer lists and protection from competition by former employees whose services are unique or extraordinary); *Estee Lauder Cos. v. Batra*, 430 F. Supp.2d 158 (S.D.N.Y. 2006) (skin and hair care company sued former employee who went to work for competitor; restriction on employment with competitor was reasonable as to geographic reach even though it was worldwide; 12-month noncompete would be reduced to five months, and preliminary injunction was issued).

[42] *Comty. Hosp. Grp., Inc. v. More*, 183 N.J. 36 (2005) (utilizing *Solari/Whitmyer* test providing that reasonableness of noncompete depends on whether: (1) restrictive covenant was necessary to protect employer's legitimate interests in enforcement; (2) it would cause undue hardship to employee; and (3) it would be injurious to the public; three additional factors include its duration, geographic limits, and scope of activities prohibited). *See also Chemetall US Inc. v. LaFlamme*, No. 16-780 (JLL), 2016 BL 91281 (D.N.J. Mar. 24, 2016) (quoting tests in *Comty. Hosp. Grp.* and granting preliminary injunction for Chemetall US to enforce noncompete against former executive).

[43] Texas Business & Commerce Code §15.50-§15.52; Florida Statutes Annotated §542.335.

[44] California Business & Professions Code §16600. There is an exception in the California statute to allow noncompete agreements given in the connection with the sale of a business. *Id.* at §16601.

[45] The Ninth Circuit provided a narrow restraint exception in, e.g., *Campbell v. Trustees of Leland Stanford Jr. Univ.*, 817 F.2d 499 (9th Cir. 1987) (exception to Cal. Bus. Prof. Code §16600 where one is barred from pursing only small or limited part of business, trade or profession); *General Commercial Packaging v. TPS Package Eng'g, Inc.*, 126 F. 3d 1131 (9th Cir. 1997) (contract valid if noncompete is only for small or limited part of business, trade or profession, i.e., narrow restraint). The California Supreme court rejected this narrow restraint exception in *Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937, 81 Cal. Rptr. 3d 282 (Cal. S. Ct. 2008) (post-employment restrictions that limit in any way employee's ability to compete, e.g., 18-month prohibition on performing services for any client of former employer that employee was involved with in past 18 months, are void under §16600; only exceptions are those under California statute).

[46] *IBM v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (California courts may respect different state choice of law even if working in California).

[47] *See, e.g.,* R. Dare, *Judges Should Have Power to 'Blue-Pencil' Noncompetes*, 18 Va. Law Weekly 427 (Sept. 29, 2003); Malsberger, *Covenants Not to Compete, A State-by-State Survey*, (BNA). A majority of states will blue pencil restrictive covenants, while several states refuse to do so. The following are among the states that will generally blue-pencil restrictive covenants: New York, New Jersey, Florida, Massachusetts, North Carolina, Connecticut, Maryland and Pennsylvania. The following states will not blue pencil restrictive covenants, but will invalidate the entire noncompete provision: Arkansas, California, Georgia, Nebraska, Virginia and Wisconsin.

[48] *See, e.g., Deborah Hope Doelker, Inc. v. Kestly*, 449 N.Y.S.2d 52 (1st Dep't 1982); *Muller v. NY Heart Ctr. Cardiovascular Specialists PC*, 656 N.Y.S.2d 464, 465 (N.Y. App. Div. 1997); *BDO Seidman v. Hirshberg*, 93 N.Y. 2d 382 (1999).

[49] *See, e.g., Mallory Factor v. Schwartz*, 536 N.Y.S.2d 752 (1st Dep't 1989) (beginning employment is valid consideration for noncompete); *Zellner v. Conrad*, 589 N.Y.S.2d 903 (N.Y. App. Div. 1992) (continued employment is valid consideration for noncompete).

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CLAWBACK PROVISIONS

Contractual Clawback Provisions. Employment contracts and equity compensation award sometimes contain ''clawback'' provisions. Such provisions may, for example, provide that the senior executives (or the CEO and CFO) will forfeit severance, bonuses, performance-based awards, equity-based awards or cash or stock received from such awards, if the employee engages in financial statement errors, discloses confidential company information, or engages in fraud or other misconduct, with material harm to the company. Sometimes the clawback is subject to discretion of the board. Case-law has upheld contractual clawback provisions.[50]

State wage and hours laws must be considered in offsetting bonuses or other incentive compensation, which may under certain state laws be considered wages that may not be forfeited.

Sarbanes-Oxley Act Clawback Restrictions. The Sarbanes Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires clawback of payments due to certain erroneous financial information.[51] The Sarbanes-Oxley Act of 2002 (SOA), §304 requires disgorgement (clawback) of all bonuses or other incentive or equity-based compensation, or profits from the sale of employer securities, received by the CEO or CFO of a public company during the 12-month period following the public release of financial statements, if there is a restatement of the financial statements because, as a result of misconduct, there has been material noncompliance with financial reporting requirements under federal securities laws.[52]

Dodd-Frank Act Clawbacks. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), §954 added Securities Exchange Act §10D, which instructs the SEC to direct the listing exchanges to require of listed companies: (1) disclosure of the company's policy regarding incentive compensation based on reported financial information; and (2) recoupment (clawback) from any current or former executive officer of any incentive compensation paid during the past three years based on erroneous data if the company is required to restate the financials. The recoupment is for the excess of the amount of incentive compensation paid based on the erroneous financial information over what would have been payable under the corrected financial information.[53] Some award agreements or employment agreements include a provision that the compensation will be subject to any clawback policy in effect from time to time, or any clawback rules that may become necessary to comply with the Dodd-Frank Act.

The SEC in July 2015 proposed rules to implement the clawback provisions in §954 of the Dodd-Frank Act.[54]

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[50] *See, e.g., IBM v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (employee exercised stock options that had noncompete forfeiture clause in option agreements and went to work for competitor; court applied New York law and held that restrictive covenant can be tied to forfeiture of stock options); *Lucente v. IBM*, 310 F.3d 243 (2d Cir. 2002) (forfeiture provision in option and restricted stock agreements for noncompete restrictions could be enforced despite unreasonableness of noncompete restrictions, because employee had choice whether to enter into agreement).

[51] The proxy disclosure rules require discussion in the Compensation Discussion & Analysis regarding policies for recovery of award or payment if performance measures on which they are based are restated.

[52] 15 U.S.C. §7243. SOA does not provide an enforcement mechanism for failure to disgorge the compensation following a restatement except for enforcement by the SEC, which has happened only occasionally, for example in *In Re Yazdani*, Exchange Act Release No. 73201 (Sept. 24, 2014).

Item 402 of Regulation S-K required that the Compensation Discussion and Analysis section of the proxy describe any policy regarding adjustment or recovery of awards if relevant performance methods on which they are based are restated or adjusted.

[53] 15 U.S.C. §78j-4. *See* proposed Dodd-Frank clawback SEC regulations, below. However, these regulations are not yet final.

[54] 80 Fed. Reg. 41,144 (July 14, 2015). These proposed rules would provide:

> (i) Proposed Rule 10D-1 under the Securities Exchange Act of 1934 (17 C.F.R. §240.10D-1), which would require national securities exchanges to adopt new listing standards that would prohibit the listing of securities of an issuer that has not adopted a written compensation recovery policy providing that the issuer will recover erroneously awarded incentive-based compensation that is received by a current or former executive officer during the three fiscal years immediately prior to the date the issuer is required to prepare restated financial statements (accounting restatements) due to the issuer's material noncompliance with any financial reporting requirements under the securities laws;
>
> (ii) New Item 402(w) of Regulation S-K (17 C.F.R. §229.402) requiring a listed issuer to provide comprehensive disclosure regarding the accounting restatements completed during its last fiscal year that required a recovery of erroneously awarded incentive-based compensation under the issuer's recovery policy, as well as each prior accounting restatement as to which a balance of erroneously awarded incentive-based compensation was outstanding during the last completed fiscal year as a result of the application of its recovery policy; and
>
> (iii) New instructions to Item 402(c) and Item 402(n) of Regulation S-K that would require summary compensation tables to reflect the reduction of any named executive officer's compensation for any year covered by the summary compensation tables as a result of the recovery of erroneously awarded incentive-based compensation under its recovery policy. Once the SEC publishes final rules, the national security exchanges

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The Dodd-Frank Act clawback is in many ways broader than the Sarbanes-Oxley Act clawback. For example, under the Dodd-Frank Act clawbacks apply to erroneous information whether or not there was misconduct, it goes back three years instead of 12 months and it applies to all executive officers not just the CEO and CFO.

Section 409A. See below regarding §409A restrictions on clawbacks of deferred compensation.

SECTION 280G EXCESS PARACHUTES AND GROSS-UPS

§280G, Generally. Severance provided under employment or change in control agreements will often trigger nondeductible excess parachute payments under §280G. An understanding of the §280G excess parachute rules is important in drafting employment and change in control agreements and in deciding how to deal with these agreements in transactions.

Excess Parachute Payment as Parachute Payment Over Base Amount. Section 280G provides that ''excess parachute payments'' are not deductible by the employer. Section 4999 imposes a nondeductible 20% excise tax on the recipient of any excess parachute payment. An ''excess parachute payment'' is the excess of any ''parachute payment'' over the ''base amount.''[55] A parachute payment is compensation to a ''disqualified individual'' (an employee or independent contractor who is also an officer, shareholder or highly compensated individual) if: (1) the payment is contingent on a change in ownership or effective control of a corporation, or a change in ownership of a substantial portion of assets of a corporation; and (2) the aggregate present value of the payments contingent on such change equal or exceed three times the base amount.[56] The ''base amount'' is the individual's average annual taxable compensation (W-2 compensation) payable in the most recent five taxable years ending before the year in which the change in control occurs.[57] If the 3-times-base-amount threshold is triggered, the entire excess over the base amount (and not just over 3-times-base-amount) is an excess parachute payment. If the 3-times-base amount is not met, there will be no parachute payment and therefore no excess parachute payment.[58]

Section 280G Cutbacks or Gross-Ups. Because an excess parachute will trigger excise taxes and nondeductibility, change in control agreements often have a ''parachute cutback,'' which cuts back on stock option vesting or other severance payments to the extent they would trigger nondeductible excess parachutes. Another alternative is a ''modified parachute cutback'' whereby if the executive would be better off with the cutback to below three times the base amount (thereby avoiding the excise tax on everything over one times the base amount) the parachute is cut back, but if the executive would be worse off with the cutback, the amount will not be cut back.

With recent scrutiny on executive compensation and corporate governance and say-on-pay voting, many companies have cut back severance to be well below three times salary, and assuming other awards do not cause change in control payments to exceed three times the base amount, there will be no excess parachute and therefore no gross-up will be needed.

Agreements for senior executives of large corporations in the past often had parachute gross-up provisions (and not cutbacks) that would reimburse the executives for any excise tax on the excess parachute and any income tax and excise tax on the gross-up amount (and any interest and penalties) such that the executive will not incur any loss as a result of the payments being an excess parachute. Such gross-ups can cost 50% or more of the amounts of excess parachute payments. Currently, general practice has moved away from §280G gross-ups of executives because of increased scrutiny due to the SEC requirement to disclose the value of the gross-up in the proxy, say-on-pay voting and institutional shareholder concerns (ISS will generally not approve of an arrangement with a gross-up). Modified parachute cutbacks, discussed above, are much more palatable to shareholders.

Contingent on Change in Control. To be a parachute payment, the payment must be contingent on the change in control. The payment is contingent on change in control if the payment would not have been made if no such change in control occurred, even if the payment is also conditioned on another event.[59] A payment can be contingent on a change in control even though it is also contingent on the occurrence of a second event.[60] Thus, a double-trigger severance arrangement could be contingent on a change in control, even though payment is only made if there is also a termination. Also, severance or termination within one year of a change in control may be presumed to

must publish implementing rules to be effective within one year of the SEC rules, and issuers will have 60 days to adopt recovery policies.

[55] §280G(b)(1).

[56] §280G(b)(2)(A).

[57] §280G(b), §280G(d).

[58] §280G(b)(2)(A)(ii).

[59] Reg. §1.280G-1, Q&A-22(a). If it is contingent upon an event closely related to the change in control, it is also treated as contingent on change in control, and an event will be considered materially related to the change in control if it occurs within one year of the change in control. Reg. §1.280G-1, Q&A-22(b).

[60] Reg. §1.280G-1, Q&A-22(b). This is true whether or not the second event is closely associated with a change in control. *Id.*

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be a parachute even if the severance in the agreement does not require a change in control.[61] If the change in control accelerates the time of payment, it is treated as contingent on a change in control.[62]

Change in Control. The parachute payment must be contingent on: (1) a change in ownership of the corporation; (2) a change in effective control of the corporation; or (3) a change in ownership of a substantial portion of the assets of the corporation (collectively a ''change in control'').[63]

A change in control of an S-Corporation, a partnership, or an LLC taxed as a partnership would be exempt from §280G, as §280G only applies to C corporations.

A change in ownership occurs when one person, or two or more persons acting as a group, acquire ownership which would cause that person to own a majority of the total fair market value or total voting power of stock.[64] A change in effective control is presumed to occur when either: (1) any one person, or two or more persons acting as a group, acquire within 12 months ownership of stock of the corporation possessing 20% or more of the total voting power of stock of the corporation; or (2) a majority of members of the corporate board is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the current board.[65] A change in ownership of a substantial portion of the corporation's assets occurs when a person acquires within 12 months one-third or more of the company's assets.[66]

A change in effective control trigger would apply in a transfer of stock of a parent corporation, but not in a transfer of stock of a subsidiary corporation (except with respect to a change in ownership of a substantial portion of the parents assets, as detailed below), because §280G(d)(5) and the regulations in Q&A-46, provide that, generally, for purposes of §280G, all members of the same affiliated group as defined in §1504 are treated as a single corporation. However, the sale of stock of a subsidiary in the consolidated group would be a change in control if it constituted a change in ownership of a substantial portion (i.e., one-third or more) of the parent's assets under Q&A-29.[67]

Reasonable Compensation for Services Rendered After Change in Control and Retention Agreements. A parachute payment does not include the portion that the taxpayer establishes by clear and convincing evidence is reasonable compensation for services to be rendered after the change in control.[68] In terms of what is considered clear and convincing evidence, reasonable compensation for services rendered after change in control would include, for example, showing that: (1) the payments are made only after performance of service; and (2) if the individual's duties are substantially the same after the change in control, the annual compensation is not significantly greater than annual compensation prior to change in control.[69] Retention agreements that meet the above rules would not be considered parachute payments. Consulting agreements and noncompete agreements for periods after the change in control could also be considered reasonable compensation for services rendered after the change in control if the above requirements are met.[70] Courts are skeptical,

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[61] *See, e.g., Am. Med. Int'l, Inc. v. Valliant*, 1994 WL 443675 (N.D. Cal. 1994) (severance payment that was to be paid if employee involuntarily terminates or resigns for good reason, and was paid when change in control occurred and employee resigned, was parachute payment).

[62] Reg. §1.280G-1, Q&A-22(c). For example, legislative history provides that if upon change in control there would be an acceleration of vesting, an acceleration of the time for exercise of stock options or a payment in cancellation of stock options, such amount would be treated as contingent on change in control. H.R. Conf. Report. No. 961, 98 Cong., 2d Sess. 851, *Ex.* 4 (1984). *See also* Reg. §1.280G-1, Q&A-22(c), and examples in Q&A-22(e).

[63] §280G(b)(2)(A)(i).

[64] Reg. §1.280G-1, Q&A-27.

[65] Reg. §1.280G-1, Q&A-28(a).

[66] Reg. §1.280G-1, Q&A-29(a). This is based on ''gross fair market value,'' which is the value of the assets determined without regard to any liabilities associated with such assets. *Id.* This rule can apply to, e.g., purchase of stock of a subsidiary or a merger. *Id.*

[67] Reg. §1.280G-1, Q&A-29(a) (''This A-29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A-29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q&A-46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not the surviving entity''). *See also* Reg. §1.280G-1, Q&A-29(e), *Ex.* 4 (parent sells all the stock of its wholly-owned subsidiary; the fair market value of the affiliated group is $210 million and the fair market value of the subsidiary is $80 million; because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group).

[68] §280G(b)(4)(A); Reg. §1.280G-1, Q&A-9. Whether compensation is reasonable is based on all facts and circumstances, including: (1) the nature of the services; (2) the individual historical compensation; and (3) compensation of comparable services by other individuals. Reg. §1.280G-1, Q&A-40.

[69] Reg. §1.280G-1, Q&A-42. If the individual's duties are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid to persons performing comparable service. *Id.*

[70] Reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as a covenant not to compete). Reg. §1.280G-1, Q&A-40(b). An agreement to refrain from performing services (like a covenant not to compete) is an agreement for the performance of personal

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however, of sham arrangements entered into to replace parachute payments.[71]

Small Business Corporation Exception and Private Company 75% Shareholder Approval Exception. There is an exception to the excess parachute rules for payments made by a corporation that immediately before the change in control is a small business corporation that would be eligible for S-corp status.[72]

In addition, there is an exception to the excess parachute rules for payments made by a privately-held corporation that does not have any readily tradeable stock on an established securities market, which also receives more than 75% shareholder approval and makes adequate disclosure to its shareholders regarding the payments.[73] The payment must be approved by more than 75% of voting power of all the stock entitled to vote immediately before the change in control.[74] Such shareholder approval must determine the right of the disqualified individual to receive such payment, or in the case of payments made before the vote, the right to retain such payment.[75] Thus, if the executive is not willing to risk that the vote on the parachute payment (which has to be separate from the merger vote) may not go his or her way, and does not waive the pre-existing rights to the parachute, the shareholder vote will not work. The payments must be approved in a separate vote, and the change in control cannot be conditioned on the shareholder approval of the parachute payment.[76] The shareholder approval is not valid unless, before the vote, there is adequate disclosure to all persons entitled to vote of all material facts concerning all material parachute payments.[77]

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services under Q&A-42 to the extent it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is reasonable likelihood that the agreement will be enforced against the individual. Reg. §1.280G-1, Q&A-42(b). Some accountants use 1 to 1.5 times base salary and bonus as a reasonable amount for valuing noncompete agreements for purposes of the §280G reasonable compensation rule.

[71] *See, e.g., Balch v. Commissioner*, 100 T.C. 331 (1993), *aff'd sub. nom. Cline v. Commissioner*, 34 F.3d 480 (7th Cir. 1994) (holding that severance agreement that was amended to comply with golden parachute restrictions, where difference was made up through minor consulting agreement with successor would be sham and entire amount will be seen as severance payment, and therefore it was a parachute payment that exceeded the §280G limits).

[72] §280G(b)(5)(A)(i). A small business corporation is a corporation that would be eligible for an S corporation election under §1361 (regardless of whether or not an S corporation election is actually made), i.e., it is a domestic corporation, it has no more than 100 shareholders, all shareholders are individuals (or estates or certain trusts), and it has no more than one class of stock. §280G(B)(5)(A)(i); Reg. §1.280G-1, Q&A-6(a)(1). Members of an affiliated group are *not* treated as one corporation for this purpose. Reg. §1.280G-1, Q&A-6(b).

[73] §280G(b)(5)(A), §280G(b)(5)(B). In determining who comprises the more than 75% group, stock actually or constructively owned by the disqualified individuals receiving the payments (i.e., not disinterested) is not counted, unless all of the shareholders are not disinterested. Reg. §1.280G-1, Q&A-7(b)(4).

[74] Reg. §1.280G-1, Q&A-7(a)(1). Except as otherwise provided in regulations, the normal voting rules of the corporation are applicable. Reg. §1.280G-1, Q&A-7(b)(1). The vote to approve the payments can be made based on the shareholders as of any day within the 6-month period immediately prior to and ending on the change in control, provided the disclosure rules are met. Reg. §1.280G-1, Q&A-7(b)(2).

[75] Reg. §1.280G-1, Q&A-7(b)(1). It is evident from the regulations that shareholder approval must cause the employee to forfeit the grant if not approved. *See also* Ginsburg & Levin, Mergers, Acquisitions and Buyouts, ¶1506.6.1.

[76] Reg. §1.280G-1, Q&A-7(b)(1). Thus the obtaining of the vote should not be a condition to closing in the merger agreement.

The vote can be on less than the full amount of the payments to be made. *Id.* Thus, if the executive is not willing to waive the full amount, he or she could waive just the amount equal to or in excess of three times the base amount (or some larger amount as a cushion if the parachute calculations are not exact) and the shareholders would merely approve that excess. Shareholder approval can be a single vote on all payments to one disqualified individual, or more than one disqualified individual. *Id.* There can be a single vote on all payments to multiple disqualified individuals. *Id.*

[77] Reg. §1.280G-1, Q&A-7(a)(2). It would appear that disclosure to all persons entitled to vote would have to be made even to those not actually voting (such as where majority written consent is obtained), although the issue is not entirely clear.

See Ginsburg & Levin, Mergers, Acquisition, and Buyouts, ¶1506.6.1. In practice, it may be hard to take advantage of the shareholder approval exception, because a shareholder vote at the time of the employment contract may not qualify because of the changes in identity of the shareholders between the time of the employment contract and the subsequent ownership change, and because subsequent changes in other parachute benefits to executives make the prior disclosure inadequate. Holding a shareholder vote at the time of the change in control may be impractical if the executive is unwilling to expose his right to receive or retain the payment to the shareholder vote.

The material facts must include the event triggering the payments, the total amount of payments that would be parachutes absent the 75% rule, and a brief description of each payment (e.g., acceleration of vesting of options, bonus or salary). Reg. §1.280G-1, Q&A-7(c).

In a bankruptcy, the shareholder approval could be met by the bankruptcy court's approval of the plan of reorganization. Rev. Rul. 2004-87, 2004-32 I.R.B. 154 (company listed on NYSE files for bankruptcy reorganization and delists from NYSE; acquirer buys more than one-third of assets out of bankruptcy with sale triggering parachute payments to executives, and bankruptcy court approves sale; ruling held that although sale out of bankruptcy is change in control, it is nonpublic company at that time and 75% of shareholder approval and disclosure requirement is met by disclosure and approval by bankruptcy court); PLR 200212013 (shareholder approval requirements would be satisfied by bankruptcy court's approval of plan of reorganization, as creditors' committee and bankruptcy judge represented shareholders and

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SECTION 409A CONSEQUENCES FOR SEVERANCE ARRANGEMENTS

Section 409A and Short-Term Deferral Exception. Under §409A, enacted by the American Jobs Creation Act of 2004 (AJCA), nonqualified deferred compensation plans will be subject to immediate taxation and a 20% additional tax unless they comply with various requirements of §409A(a) relating to advance elections, limitations on distributions, and barring of accelerations.[78] IRS guidance provides that there is no deferral of compensation for amounts that (absent an election to further defer) are paid within 2½ months after the close of the taxable year (of either the employer or the employee) in which there is a legally binding right (and the amount is vested).[79] Severance plans are not excluded from the definition of a deferred compensation plan.[80]

Severance Plans at the Discretion of the Employer Are Excluded Because There Is No Legally Binding Right. Severance plans that can be reduced or terminated by the employer are discretionary and the employee does not have a legally binding right. Therefore, there is no deferral of compensation under §409A.[81] However, once an individual separation agreement is signed providing for the severance over a period of time, this may require a 6-month wait for specified employees. Individual employment agreements or union plans that cannot be unilaterally amended could be subject to §409A.

Exception If Payout Only on Involuntary Termination (e.g., Termination Without Cause) or Within 2½ Months After the Year of Such Termination. Where severance arrangements only pay out on an involuntary termination, e.g., on termination without cause, this would cause the payment to be a nonvested right (i.e., subject to a substantial risk of forfeiture) until termination, and from the point of termination when there is a legally binding vested right it would be a short-term deferral exempt from §409A if the severance is paid within 2½ months after the year vested.[82] Therefore, it is important to draft change in control and employment agreements so that severance will be fully paid within 2½ months after the end of the taxable year (of the employer or the employee), or alternatively that it meet the two year two times-pay exception below.

Test for When Quit for Good Reason Is Considered Involuntary Separation. Where severance is also payable if the employee quits for good reason, the severance will be treated as payable only on an involuntary termination where the good reason condition is such that the separation from service is effectively an involuntary separation from service (a constructive discharge).[83] If the good reason trigger is viewed as a voluntary termination, this would be considered a vested right even prior to termination, and therefore the severance would not meet the 2½ month short-term deferral exception or the two year two times pay exception for severance discussed below, and the severance would be subject to the requirements of §409A, which would require a 6-month delay for specified employees of public companies, as discussed above. Likewise, if there is a right to walk for any reason, this may cause there to be a voluntary termination and therefore not meet the short-term deferral or two year two times pay exception, which would mean that the severance is a §409A deferral, and a 6-month delay for public companies will be required.[84]

If, however, the right to walk for any reason is triggered only after a change in control, it would not be vested until the change in control, and if the right to walk only applies during a window period that ends within a short-term deferral period after the change in control, it may meet the short-term deferral exception to §409A.[85] With regard to this short-term deferral exception, note that the IRS takes the view that if vested

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shareholders were not otherwise eligible to approve payments under plan of reorganization).

[78] Otherwise, all compensation deferred under the plan for the taxable year and all preceding years will be includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income.

[79] Reg. §1.409A-1(b)(4)(i).

[80] Section 409A(d)(1)(B) excludes certain welfare plans, but does not exclude severance plans.

Separation pay refers to compensation conditioned upon a separation from service (including death or disability) and not to compensation the employee could receive without separating from service (such as an amount also payable upon a change in control, an unforeseeable emergency, or on a date certain). Reg. §1.409A-1(b)(9). For example, the right to a gross-up payment for taxes payable due to the application of §280G will constitute separation pay only if a separation from service is required to obtain the payment. Preamble to Final Regulations.

[81] Reg. §1.409A-1(b)(1).

[82] Reg. §1.409A-1(b)(4).

An involuntary separation from service is a separation due to independent exercise of unilateral authority of the employer to terminate the employee (other than by the employee's request). Reg. §1.409A-1(n)(1).

Proposed regulations, which may be relied upon immediately, provide that the 2½ month period may be delayed to avoid violating federal securities laws or other applicable laws, without causing the arrangement to not be a short-term deferral. 81 Fed. Reg. 40,569 (June 22, 2016).

[83] Reg. §1.409A-1(n)(2)(i).

[84] Note that a right to walk for any reason is less common with say-on-pay voting and increases in institutional shareholder scrutiny.

[85] Note, however, that the right to walk is beyond the short-term deferral period, for example if the right to walk is in the 13th

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severance is payable within a short-term deferral window, but there is a potential for severance to be paid in certain cases outside the window, the potential from the outset of the payment being made outside the short-term deferral period would cause the payment in all cases to not be a short-term deferral.

Note also that even if the payable upon a quit following a non-§409A compliant good reason would be subject to §409A, it may not violate §409A because the payment is still on termination which is a permissible payment event, provided all payments on account of termination have the same time and form of payment so as not to be an impermissible toggle, and a 6-month delay for specified employees of public companies would also be required.

For good reason to be treated as an involuntary separation, the avoidance of §409A must not be a purpose of the good reason trigger. In addition, such good reason condition must be triggered by action taken by the employer resulting in a material negative change in the employment relationship, such as a material negative change in the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received. Additional factors that may be relevant are: the extent to which the payments upon quit for good reason are the same as payments upon a termination by the employer, and whether the employee is required to give the employer notice of the existence of the good reason condition and a reasonable opportunity to remedy the condition.[86]

Safe Harbor Good Reason. The regulations provide a safe harbor under which a provision for a payment upon a voluntary separation for good reason will be treated for purposes of §409A as an actual involuntary separation.[87] These conditions include that: (1) the amount be payable only if the employee separates from service within two years following the good reason trigger; (2) the payment upon a quit for good reason be identical to the payment upon an involuntary separation (by a termination without cause); and (3) the employee must be required to provide notice of the existence of the good reason condition within 90 days, and the employer must be provided at least 30 days during which it may remedy the good reason condition.[88] A good reason condition may consist of one or more of the following conditions: (1) a material diminution in the employee's base compensation;[89] (2) a material diminution in the employee's authority, duties, or responsibilities; (3) a material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee reports, including a requirement that an employee report to a corporate officer of the employer instead of reporting directly to the board of directors; (4) a material diminution in the budget over which the employee retains authority; (5) a material change in the geographic location at which the employee must perform the services; or (6) any other action or inaction that constitutes a material breach of the terms of an applicable employment agreement.[90]

Note that the failure to have the successor assume the agreement is not a valid §409A good reason. However, it should be permissible to provide in a covenant elsewhere in the employment agreement that employer will obtain consent of the successor to assume the agreement, and then it may be a material breach of the agreement if the successor employer fails to assume the contract.

If severance can be delayed until completion of the noncompete, it will likely not meet the short term deferral exception and would be subject to §409A.[91] However, it could still comply with the requirements of §409A if it is structured on a fixed date or dates that will occur after the noncompete period.

Notice 2007-78 provides that until further guidance is issued, an extension of an employment agreement

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month after the change in control, it would be subject to §409A and a good §409A termination would be required with all payments on account of termination having the same time and form of payment, and a 6-month delay for specified employees of public companies would also be required.

The two year two times pay exception would not be available, however, because that only applies if the payment is on account of an involuntary termination, and here where there is not a valid good reason, the termination is viewed as a voluntary termination.

[86] *Id.*

The regulations provide that an involuntary separation from service may include the employer's failure to renew a contract at the time it expires, provided that the employee is willing and able to execute a new contract providing terms and conditions substantially similar to those in the expiring contract and to continue providing such services. Reg. §1.409A-1(n)(2)(i).

[87] Many practitioners believe that even if there is not a true safe harbor, a balanced good reason definition that complies with the general rule, has a cure provision and no walk-away rights is usually sufficient. *See, e.g.,* 40 BNA Pen. & Ben. Rptr. 618 (Mar. 12, 2014).

[88] Reg. §1.409A-1(n)(2)(ii).

[89] ''Base compensation'' is generally understood as base salary, but some officials have stated that ''base compensation'' would include salary and bonus. A loss of 10% or more would likely be material.

[90] Reg. §1.409A-1(n)(2)(ii). It is recommended to generally adhere to the safe harbor as a precaution for the executive. Some variations though that are not significantly different (e.g., material diminution in base and bonus) would probably not raise IRS objections.

[91] Payment for a noncompetition agreement could be subject to §409A, because a noncompete generally does not create a substantial risk of forfeiture, and a legally binding right obtained in one year to a payment in a subsequent year in connection with the noncompete agreement generally would constitute deferred compensation. 72 Fed. Reg. at 19,236 (preamble).

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or entering into a new employment agreement will not be considered a substitution for rights to deferred compensation, as long as the previous right to the deferred compensation was payable only on an involuntary termination.

Severance Conditioned On Executing Release of Claims. Payment of severance is often conditioned on the employee's signing a release of claims (e.g., an ADEA release) in the form attached to the agreement.[92] This can create an issue under §409A, as the employee could sign the release at any time and could thus cause the severance arrangement to fail to be a short-term deferral or not have a fixed payment date.[93] The IRS has endorsed two approaches to have severance conditioned on the release and still be considered a short-term deferral and/or have a fixed payment date. One method approved by Notice 2010-6, §VI.B, is for the agreement to provide that regardless of when the release is executed, the severance payment will only be made exactly 60 (or 90) days after the termination, provided an irrevocable release is in place by then. A second more flexible method, which has also been approved by the IRS in Notice 2010-80, §III.B, is to allow the release to be signed and payment to be made (after the release 7-day revocation period) within a 60- (or 90-) day period, provided that if such period straddles two taxable years, the payment will automatically be made in the second taxable year.[94]

Note that much of the above requirements only apply if the severance arrangement is subject to §409A, but if the severance can be paid within the short-term deferral period (e.g., has valid §409A good reason definition) or within the two years two times pay exception for involuntary terminations, this would avoid application of §409A and therefore it would not be subject to the toggle rule relating to §409A payment events or the straddling of two years. The release would have a fixed deadline that must be executed and become irrevocable within e.g., 60 days, and the severance would have to be paid in all events no later than 2½ months (to ensure that it is a short-term deferral), or within two years if relying on that exception.

Treatment of Involuntary Severance Plan as a Separate Plan. For purposes of the plan aggregation rules, the regulations provide for the separate treatment of plans providing for separation pay due solely to an involuntary separation from service or participation in a window program. This exception is not intended to apply where the amounts may also become payable for some other reason, even where such payments actually are made due to an involuntary separation from service. Accordingly, any amount that would be paid as a result of a voluntary separation from service (other than good reason if treated as involuntary) will not be included in this category.[95]

Exception for Involuntary Severance or Early Retirement Programs If Separation Pay Does Not Exceed Two Times Lesser of Pay or §401(a)(17) Amount and Paid by Second Year Following Separation. Severance plans that pay upon an involuntary separation from service or pursuant to an early retirement window program are exempt from §409A if the separation pay does not exceed the lesser of two times the employee's base pay or two times the §401(a)(17) limit ($265,000 in 2016), and the severance is paid by the end of the second calendar year following the year of separation.[96] The employee's base pay is the annualized compensation based on the annual rate of pay

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[92] Releases are often attached to employment or change in control agreements so that the company cannot hold up the severance for an overly restrictive release. Other times the agreement may provide that severance is subject to a customary release.

[93] The release for continued health coverage would generally not be an issue under §409A, as long as it does not extend beyond the COBRA period.

[94] The solution regarding the timing of a severance condition on executing a release that practitioners have advocated, and which was ultimately approved by the IRS in Notice 2010-80, §III.B., is to provide a fixed deadline in which to execute the release, e.g., the release must be executed and not revoked by the 60th (or 90th) day following termination. This way, the ADEA 21-day period to consider the release, or the 45-day period in connection with an exit incentive program, and the seven days to revoke can be satisfied before the expiration of that period. In addition, in order to avoid an employee being able to control the year of payment, which is impermissible under Reg. §1.409A-3(b), a provision should be added that if the 60- (or 90-) day period begins in one taxable year of the employee and ends in the next taxable year ,the payment will automatically be pushed to the next taxable year.

The IRS has also provided for an alternative solution for severance conditioned on a release. Notice 2010-6, §VI.B., provides a solution that regardless of whether the release is executed right away, the severance can be set up that it will only be made at a fixed payment date exactly on the 60th (or 90th) day after termination, provided an irrevocable release is in place by then. Notice 2010-6, §VI.B., provides a documentary correction that if payment is conditioned on the employee executing a release, correction can be made before the permissible payment event occurs by removing the ability of the employee to delay or accelerate the timing of the payment as a result of his or her actions, and fixing the payment date at 60 or 90 days after the payment event.

[95] Reg. §1.409A-1(c)(2)(i)(D); Preamble to Final Regulations.

[96] Reg. §1.409A-1(b)(9)(iii). This exemption is similar to the safe harbor to treat severance plans as welfare plans under 29 C.F.R. §2510.3-2(b).

There was a transition rule for severance plans adopted before Dec. 31, 2005 so that they could be terminated until the end of calendar year 2005, in order to terminate participation or cancel a deferral election. It also did not have to meet the requirements of §409A for calendar year 2005, if it was a collectively bargained plan or covered no key employees. Notice 2005-1, Q&A-19(d).

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for the taxable year preceding the year in which the separation from service occurs.[97] This exception will not help for voluntary termination, e.g., if there is not a valid §409A good reason definition, but it will help for involuntary termination, so that it need not be paid within 2½ months after the taxable year of vesting if the above exception is met. If there is a quit for good reason trigger, it will still be involuntary termination if it is a valid §409A good reason, as described above.[98] If there is payment on a noncompliant good reason or on a termination for any reason (even if only after a change in control) the requirements for an involuntary severance would not be met. Note that the §402(g) limit payment exception ($18,000 in 2016) discussed below can be added to the two times §401(a)(17) amount (so that, in total with 2016 COLA numbers, up to $548,000 would be allowed). See also above for the general exception for discretionary plans that can be reduced or terminated by the employer. There is also an exception for collectively bargained severance plans.[99]

Exception from §409A for Reimbursement for Expenses, In-Kind Benefits and Other Fringe Benefits Following Termination of Employment. As stated in the Preamble to the Final Regulations, expense reimbursements will not meet the short-term deferral rule because a legally binding right arises when the right to reimbursement occurs (even prior to incurring the expense). There is a general rule that reimbursements of expenses, in-kind benefits, and medical reimbursements will be treated as if made at a specific date or fixed schedule if the reimbursement is made by the end of the calendar year following the year of expense and certain other requirements are met.[100] However, the 6-month delay for specified employees would still be applicable to such reimbursements. If the expense reimbursement payments are made on account of termination, there are broader exceptions that entirely exempt the payments from §409A. Where plans provide for reimbursements (even if not otherwise excludible from gross income) for expenses that could be deducted as business expenses or reimbursement of reasonable moving expenses or reasonable outplacement expenses, and such expenses are directly related to a termination of the employee's services and incurred by an employee following a separation from service, such reimbursements are not subject to §409A, provided that such reimbursements are available only for expenses incurred within the second taxable year of the employee following the separation from service (although reimbursement can occur until the third year).[101] Amounts that would be excludible from gross income would in any event be exempt from §409A.[102]

There is also an exception for severance providing for medical benefit reimbursements, provided they do not extend beyond the COBRA period.[103] It is arguable that the 6-month delay could run concurrent with the COBRA period, thus avoiding the need for 6-month delay even if §409A would otherwise apply.[104] Note also that the medical reimbursement exception is only needed for medical plans that are taxable under §105 because they fail the nondiscrimination rules of §105(h) where only senior executives receive the retiree health as part of severance (and discriminates in eligibility under §105(h)).[105]

Prior to the Affordable Care Act, §105(h) only applied to self-insured plans. Under the Affordable Care Act, insured plans are also subject to §105(h) nondiscrimination rules except for grandfathered insured plans that were in existence on March 23, 2010. (See discussion above regarding the Affordable Care Act provisions and the delay in effective date by Notice 2011-1.) See also the discussion above regarding payment and reimbursement on an after-tax basis (or increasing cash severance to allow for purchase of individual coverage) to avoid application of §105(h).

IRS officials have indicated that medical benefit reimbursements would include payment or reimburse-

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[97] Reg. §1.409A-1(b)(9)(iii)(A)(1).

The 2016 proposed regulations, which may be relied upon immediately, provide that, while the two times base pay is generally based on pay in the year prior to the year of separation from service, if the year of separation from service is the employee's first year of employment, annualized base pay is determined based on the year of separation from service. 81 Fed. Reg. 40,569 (June 22, 2016).

[98] IRS officials have indicated that the two years/two times pay exception only applies to amounts payable solely on involuntary termination but not if, e.g., also payable on disability.

[99] Reg. §1.409A-1(b)(9)(ii).

[100] Reg. §1.409A-3(i)(1)(iv).

[101] Reg. §1.409A-1(b)(9)(v), as amended in 72 Fed. Reg. 41,620 (July 31, 2007) to remove a misleading comma. The same exception would apply to employer payment of premiums for a self-insured plan. ABA JCEB Q&As for IRS (2008), Q&A-26.

[102] *See, e.g.,* Reg. §1.409A-1(b)(1) (third sentence): "A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includable in income [other than a cafeteria plan]." *See also* Reg. §1.409A-1(a)(5) (nontaxable medical arrangements), Reg. §1.409A-1(b)(4)(B) (short-term deferrals and receipt being when taxable), and Reg. §1.409A-1(b)(6) (no receipt if nonvested property is not taxable).

[103] Reg. §1.409A-1(b)(9)(v)(B).

[104] In addition, the medical reimbursement exception under Reg. §1.409A-3(i)(1)(iv)(B) may also apply.

IRS officials have indicated that medical benefit reimbursements would include payment or reimbursement for medical (or COBRA) premiums or by providing the actual benefits.

[105] If the medical reimbursement arrangement is nontaxable it is entirely excludible from §409A under Reg. §1.409A-1(a)(5).

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ment for medical (or COBRA) premiums or by providing the actual medical benefits.

The Final Regulations provide that in-kind benefits provided to the employee by the employer do not provide for a deferral of compensation if benefits must be provided by the end of the second year following the separation from service.[106]

See also above regarding requirements for expense reimbursements for an active employee and when they will be considered made at a fixed time or schedule.

The Final Regulations clarify that a right to a benefit that is excludible from income, for example, health coverage excludible under §105 (provided it doesn't fail §105(h)), will not be treated as a deferral of compensation for purposes of §409A.[107]

Limited Payment Small Sum Cashout Exception. There is an exception for payments under a separation plan that do not defer amounts in excess of the §402(g) limit (currently $18,000 in 2016).[108] This can be ''stacked'' with the $530,000 amount to allow deferrals of $548,000.

Stacking of Exemptions. The exemptions from §409A for separation pay plans may be used in combination (so-called ''stacking''). The two times pay or §401(a)(17) amount exception, reimbursements for reasonable moving expenses and outplacement expenses, payments that do not exceed the limit on elective deferrals under §402(g), payments during the short-term deferral period, etc., may all be excluded from coverage under §409A due to application of several of the above exceptions at the same time.[109] For example, if a termination occurs on July 1, 2008, the amounts payable in the short-term deferral period through March 15, 2009 could be treated separately from the severance payable after the short-term deferral period, so that even if the total severance exceeds the two times the §401(a)(17) limit, the separate parts would each be separately exempt.[110] There would have to be a designation of the separate payments to bifurcate the stream of payments into a short-term deferral payment and a §409A two-year two-times pay amount.[111]

Consequences of Applicability of §409A to Severance Arrangements. Where a severance arrangement is subject to §409A, e.g., an arrangement that is nondiscretionary by the employer and is considered voluntary to the employee (for example, where there is a broad good reason condition that is not treated as involuntary), there would be the following §409A consequences: (1) a 6-month delay would be required for specified employees of public companies under §409A(a)(2)(B);[112] (2) distribution would have to be at a permitted §409A payment event under §409A(a)(2)(A), such as a fixed time/fixed schedule as defined in Reg. §1.409A-3(i)(1) or upon a separation from service as defined in Reg. §1.409A-1(h); (3) changes to time and form of payment may be subject to the restrictions of §409A; (4) the release triggering severance could not straddle two years; and (5) the deferral would have to be reported.

Clawback Recovery Issues for Deferred Compensation Under §409A. If deferred compensation is required to be offset by a statutory or contractual clawback obligation (discussed above), there may be an issue under §409A, because the clawback obligation, once triggered, may be considered employee debt, and under Reg. §1.409A-3(j)(4)(xiii), offsets of

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[106] Reg. §1.409A-1(b)(9)(v)(C).

[107] The Final Regulations extend the limited period during which taxable reimbursements of medical expenses (e.g. for discriminating self-insured plans) may be provided, to cover the period during which the employee would be entitled to COBRA continuation coverage if the employee elected such coverage and paid the applicable premiums. In addition, the Final Regulations contain several provisions governing reimbursement plans (Reg. §1.409A-1(b)(9)(v)) (including plans providing in-kind benefits) that constitute nonqualified deferred compensation plans for purposes of §409A. *Id.*

[108] Reg. §1.409A-1(b)(9)(v)(D). There is a similar exemption in Reg. §1.409A-3(j)(4)(v) regarding permissibility of acceleration of small sum cashouts.

[109] Reg. §1.409A-1(b)(9)(i); 72 Fed. Reg. at 19,246 (preamble).

[110] Another example: If severance is paid over three years, the payment must be delayed six months only to the extent that the payments over that period are not eligible for another exception, like the two times pay or §401(a)(17) exception, assuming that there is a valid §409A good reason definition.

[111] Reg. §1.409A-2(b)(2) (a plan can designate installment payments to be treated as a series of separate payments). *See also* Reg. §1.409A-3(c) (single time and formal benefit must be designated for each payment event). This treatment of a series of payments as separately identified amounts, from assisting in stacking of exemptions, will also be helpful for purposes of subsequent changes in time or form of payment under §409A, and for purposes of exempting certain payments as short-term deferrals. A provision that all installment payments are treated as separate payments is typically included in deferred compensation agreements with installment payments.

[112] ''Specified employee'' is a key employee under §416(i) without regard to paragraph (5) (regarding treatment of beneficiaries) of a service recipient. §409A(a)(2)(B)(i); Reg. §1.409A-1(i)(l). A key employee under §416(i) is an employee who is: (1) an officer with annual compensation greater than $130,000, as adjusted for inflation ($170,000 in 2016), with no more than 50 employees or 10% of employees (whichever is less) treated as officers; (2) a 5% owner, or (3) a 1% owner with annual compensation greater than $150,000. Officers of subsidiaries could also be part of the top 50 officers. §416(i); Reg. §1.416-1, Q&A-T12-T20.

If the severance is payable over several years, it would appear that the arrangement could be bifurcated, if so designated, so that payments for the first few months could be paid under the short-term deferral exception, and for remaining payments the 6-month delay under §409A would be satisfied because six months will have elapsed by then.

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deferred compensation to be paid in the future for employee debt must be limited to $5,000 per year and paid on the same schedule as the debt payments. In addition, offsetting deferred compensation distributions with repayment of the clawback, even if done on the original payment date, could be a prohibited substitution under Reg. §1.409A-3(f).

Employment Agreement Provisions Regarding §409A. Employment agreements, particularly those with severance provisions, will typically include §409A related provisions. The following is a summary of some of the common provisions, which may or may not be applicable in a certain situation, and which may need to be modified or expanded, depending on the other provisions of the agreement: (1) the intent of the parties is that payments and benefits under the agreement comply with §409A, and the agreement will be interpreted in accordance with this intent; (2) the executive will not be considered to have terminated employment with the employer for purposes of any payments under the agreement that are subject to §409A until the executive has incurred a ''separation from service'' from the employer within the meaning of §409A; (3) if an amount is to be paid in two or more installments for purposes of §409A, each installment will be treated as a separate payment; (4) if the agreement specifies the terms of a bonus arrangement, a provision may be added that payments of bonus amounts will be made in no event later than the last day of the applicable 2½ month period as defined in regulations under §409A; (5) if the executive is deemed on the date of the executive's ''separation from service'' to be a ''specified employee'' (as defined by §409A), then, with respect to any payment or benefit that is considered to be deferred compensation under §409A payable on account of a separation from service, such payment will be made on the earlier of the first day of the seventh month commencing after the executive's separation from service or the date of the executive's death; (6) the amounts reimbursable to the executive will be paid in no event later than the last day of the year following the year in which the expense was incurred, and the amount of expenses eligible for reimbursement during one year will not affect amounts reimbursable or provided in any subsequent year; and (7) an employer may want to insert a provision in the agreement that the employer makes no representation that the agreement or any or all of the payments described in this agreement will be exempt from or comply with §409A, and that the executive agrees to pay all taxes imposed on the executive by reason of rights granted and payments made under the agreement, including any related interest or penalty.

AGREEMENTS IN TRANSACTIONS — ASSUMPTION, RENEGOTIATION

Assumption of Employment Agreements in Transactions. In a stock deal or a merger, the employment, change in control or severance agreements would generally be automatically assumed by the buyer. If the buyer wants to avoid assuming these obligations, the parent/seller would have to assume the obligation, or the seller would have to terminate and pay out the agreements prior to the closing. Alternatively, the agreements could be renegotiated (or exchanged for equity or other awards) with the employees' consent, as discussed below.

In an asset sale (or sale of a subsidiary if the agreements are with the parent) the buyer would not automatically assume the employment and change in control agreements. Very often, the buyer will agree to assume the employment agreements, or the buyer may be seen as a successor employer under general successor liability principles.[113]

Often the employment and change in control agreements will provide that non-assumption of the agreements will trigger a right to quit for good reason, or will be considered a breach of the agreement by the seller, giving rise to an obligation to pay severance. Again, renegotiation of the agreements may be necessary to avoid this result.

Note that if there are double-trigger severance provisions pursuant to which severance for termination after the change in control is greater than severance before change in control, the company may want to terminate the executive prior to the transaction to avoid the enhanced severance.[114] To avoid this result, employment and change in control agreements will often provide that if termination occurs shortly before a change in control this will also be considered a change in control.

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[113] The general common law rule is that a company that purchases assets of another company is not automatically responsible for the seller's liabilities. There are four exceptions: (1) where the purchasing company expressly or impliedly agrees to assume the selling company's liabilities; (2) where the transaction amounts to a ''de facto merger,'' looking to four factors that favor such a finding, continuation of the enterprise, continuity of shareholders, the seller ceasing its ordinary business operation and liquidating as soon as possible, and the purchaser assuming those obligations ordinarily necessary for the uninterrupted continuation of normal business operations of the seller; (3) where the purchaser corporation is a ''mere continuation'' of the seller, which occurs where there is a common identity of the officers, directors and stockholders in the selling and purchasing corporations, and only one corporation remains; and (4) where the transfer of assets is for the fraudulent purpose of escaping liability for the seller's debts. *See* 15 Fletcher, *Cyclopedia of the Law of Private Corporations*, §§7122, *et seq.*

[114] Depending on the state, such practices may violate obligation to deal in good faith with employees.

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Renegotiation of Agreements in Transactions. As discussed above, if there is a right to walk after a change in control and receive severance, or there is a liberal definition of ''quit for good reason,'' the buyer may want to renegotiate with executives it wants to retain in order to avoid having the executives quit in order to receive the severance. The buyer may also want to renegotiate if the agreement has too large a parachute.

The renegotiated agreements may provide for comparable terms with the buyer, or they may provide slightly different benefits. Often the executives are enticed to cancel existing agreements in exchange for new equity awards by the buyer.

Retention Agreements. In connection with a transaction, a retention program or agreement may be designed as an incentive to continue employment with the employer, to ensure business continuity and to allow employees to focus on their jobs. Retention agreements may also provide a buyer with the opportunity to evaluate personnel and determine which employees it wants to retain in the long term. A retention program is often limited to key employees, but may also include a broad range of employees. Whether the buyer needs to retain key employees on a continued basis or through a transition period may determine the terms of the retention program.

For a CEO, a typical retention agreement may be two years, the award may equal, e.g., a full year base and bonus, and vesting could occur ratably or on some other schedule for two years. To avoid §409A issues, the retention agreements should require that the employee be employed on the date of payment. Most retention agreements pay out in cash, but some may pay out in equity awards (e.g., restricted stock). On termination without cause, there may be an accelerated payment of the unpaid balance.

SEC DISCLOSURE REQUIREMENTS RELATING TO EMPLOYMENT AGREEMENTS

Public companies must disclose various aspects of executive compensation and employment agreements as part of their proxy disclosure in the Summary Compensation Table and other tables, as well as in the Compensation Discussion and Analysis.[115]

The Dodd-Frank Act §951 requires public companies to have a nonbinding shareholder advisory vote to approve incentive compensation of its named executive officers (say on pay), including a vote on whether the advisory votes must be held every one, two or three years.[116] Section 951 also requires a shareholder advisory vote on golden parachutes.

The Dodd-Frank Act §953(a) would require companies to disclose the relationship between the executive compensation paid and the total shareholder return (pay for performance).[117]

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[115] *See* 17 C.F.R. §229.402 (Item 402 of Regulation S-K).

Item 8 of Schedule 14A, which is governed by Item 402 of Regulation S-K (17 C.F.R. Part 229), provides for disclosure regarding compensation of directors and named executive officers. Named executive officer is defined as the principal executive officer, the principal financial officer or one of the three highest paid executive officers other than the CEO and CFO.

Pursuant to Item 402(b) of Regulation S-K, executive compensation disclosure must begin with a narrative disclosure in the ''Compensation Discussion and Analysis'' section, which details the elements of compensation, why each element of compensation was included, the policy for allocating between cash compensation, noncash compensation and different forms of noncash compensation, aspects of performance taken into account in making compensation decisions, how the various forms of compensation structured, whether benchmarking was used and certain other information regarding compensation.

Pursuant to Item 402(c) of Regulation S-K, a comprehensive overview of the executive pay practices is to be disclosed in the Summary Compensation Table. The Summary Compensation table must disclose for the named executive officers for a 3-year period salary and bonus, dollar value of stock awards and option awards, nonequity incentive compensation and all of the compensation (such as prerequisites and other personal benefits and gross-ups and certain other benefits).

Other information required by Item 402 of Regulation S-K includes: disclosure of performance targets are to be disclosed when they are material elements of a company's compensation policies; a Grant of Plan-Based Awards Table, a narrative disclosure regarding the items in the Summary Compensation Table; a Grant of Plan-Based Awards Table, an Outstanding Equity Awards at Fiscal Year-End Table; an Option Exercises and Stock Vested Table; a Pension Benefits Table; and a Nonqualified Deferred Compensation Table. Items 402(b) and 402(d)-402(i) of Regulation S-K.

Item 402(j) requires disclosure about each contract, agreement, plan or arrangement that provides for payments to a named executive officer in connection with a termination, change in control or change of the executive's responsibilities.

[116] 15 U.S.C. §78(n)-1(a)(i); 17 C.F.R. §240.14a-21(a).

Final regulations on say-on-pay requirements were issued in 76 Fed. Reg. 6010 (Feb. 2, 2011), amending the Securities Exchange Act of 1934, §240.14a-21, which went into effect in 2011 (2013 for small reporting companies) and which provides for a nonbinding vote of the shareholders of the compensation of the named executive officers. An additional vote must be held covering the frequency of future say-on-pay votes.

The regulations also provide for a golden parachute vote with respect to transactions, and requires proxy disclosure of any golden parachute arrangements with named executive officer.

[117] The Dodd-Frank Act in §955 would require proxy disclosure on whether executives can engage in hedging to offset any decrease in the employer's stock. Regulations regarding this requirement were proposed in 2015. 80 Fed. Reg. 8486 (Feb. 17, 2015), proposing adding Instruction 6 to §229.402(b).

The Dodd-Frank Act in §956 requires financial institutions to make incentive compensation disclosures to allow shareholders to determine if the incentive compensation is excessive or could lead to material financial loss of the financial institution. Regulations

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The Dodd-Frank Act in §953(b) requires CEO ''pay ratio'' disclosure, which shows the difference between the compensation of the median employee and the CEO.[118]

See discussion above regarding Dodd-Frank Act §954 requirements for certain clawbacks for listed companies.

Adoption or amendment of employment agreements for senior executives of public companies may require disclosure on SEC Form 8-K, which must be filed within four business days after the event. If the company enters into a material definitive agreement not made in the ordinary course of business, or an amendment that is material, disclosure of the terms of the agreement or amendment is required on Form 8-K.[119] If the company appoints a new CEO, president, CFO, CAO or COO, disclosure on Form 8-K is required on appointment of executive officers and their compensatory arrangement, as well as material modifications to the arrangements.[120]

CONCLUSION

The treatment of employment and change in control agreements in transactions is one that requires careful analysis and caution, particularly in transactions, and a lack of foresight in dealing with these agreements in advance of transactions can lead to unwanted and unanticipated consequences.

regarding incentive compensation at financial institutions were proposed in April 2011 and re-proposed in May 2016.

[118] See addition of §229.402(u) of Regulation S-K at 80 Fed. Reg. 50,104 (Aug. 18, 2015) (disclosure required of median of annual total compensation of all employees of company (excluding CEO), annual total compensation of CEO, and ratio of median of annual total compensation of all employees to annual total compensation of CEO; disclosure is required in any annual report, proxy or information statement, or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K). This CEO pay ratio requirement will be in effect for the first fiscal year beginning on or after January 1, 2017 (with SEC disclosure required in 2018).

[119] *See* Item 1.01 of Form 8-K.

[120] *See* Item 5.02(c) of Form 8-K.

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