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Provisions In Executive Employment Agreements Receiving Increased Scrutiny

Executive employment contracts in general and contracts for chief executive officers (CEOs) in particular have recently come under increased scrutiny from regulators, the media, institutional investors and others. This *Client Alert* will focus on some of the particular provisions generating criticism.

EVERGREEN PROVISIONS

Most employment agreements have a term. Some have fixed terms, which means that they expire after a set period, say three years, and have to be renegotiated if they are to continue. Most executive employment agreements have “evergreen provisions,” which means that they automatically renew after the initial term for successive terms of an agreed upon length so long as neither party gives advance notice of an intent not to renew. The problem with such executive employment agreements is not so much their evergreen nature, rather it is the severance the executive receives if the contract is terminated. If the employer terminates the executive without “cause,” the agreement will typically provide the CEO with the salary, bonus and other benefits he would have received for the remainder of the term. For an agreement with a three-year evergreen provision, this means that the executive will be entitled to three years of severance benefits.

SEVERANCE BENEFITS

Severance benefits serve several purposes:

- ♦ They provide the CEO with a source of income if things don't work out and he or she is terminated without “cause” or resigns for “good reason;”
- ♦ They allow an employer to attract and retain an executive; and
- ♦ They aid in enforcing noncompete and other post-termination obligations.

All these purposes are currently being questioned. Why, critics ask, are severance benefits rarely subject to an offset for other compensation earned during the severance period? Granted, comparable positions for former CEOs are not easy to come by, and no one is suggesting that a former CEO be required to find another position to “mitigate” his loss of income. On the other hand, if the CEO is lucky enough to find another position, perhaps even one that pays more, isn't the severance a windfall?

While acknowledging the advantage severance benefits provide in attracting CEOs, critics also question whether such benefits are required to retain established CEOs, particularly if they have already accumulated sufficient wealth from their employer through bonuses, stock options and incentive plans.

If severance benefits are paid in installments, they can be used to enforce noncompete and other post-termination obligations because the employer can cease payments if the CEO fails to honor his or her obligations. However, most severance benefits are paid in a lump sum shortly after termination, which means that discontinuing payments is not an option and the employer will have to sue for breach of contract to recover the severance payments. This undercuts the argument that severance payments aid in enforcing post-termination obligations.

Cash

A typical CEO agreement will provide for severance pay that is a multiple of the CEO's base compensation, perhaps two times the base in the case of severance, and three times in the case of a severance in connection with a change in control.

The base is typically the CEO's average salary and bonus for a stated period. The base period over which the base is determined should not be so short as to allow the manipulation of benefits, or be based on the highest salary or bonus during the base period.

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Continuation of Medical and Other Insurance Type Benefits

Many CEO agreements provide for the continuation of medical and other insurance coverage for a specified period following termination. An agreement that provides for the continuation of health benefits beyond the 18 months of coverage permitted under COBRA can cause problems. If the medical benefits are insured and the employer wants to insure these additional benefits, the employer will have to obtain an endorsement to its insurance contract to provide for coverage beyond the end of the COBRA period. If it obtains such coverage or is self-insured, the employer may have to account for it on the basis of the accounting rules for post-retirement medical benefits, and disclose these benefits in its proxy.

When to Provide Severance Benefits?

Termination Without Cause

Typically, a CEO agreement will only provide for severance benefits if the CEO is terminated without "cause." There is a wide variation among agreements as to what constitutes cause. Typically, a contract includes a number of events, fraud or criminal conduct, for example, that constitute "cause." The problem areas are the more subjective situations, such as malfeasance or incompetence. Critics argue that termination for poor performance, resignation under pressure or failure to renew the contract should not qualify as termination without "cause."

Resignation for Good Reason

CEOs can be effectively terminated by changing their responsibilities. Accordingly, most CEO agreements treat a resignation for "good reason" as an involuntary termination, thereby entitling the CEO to the same severance benefits as if he was terminated without cause. The final regulations under section 409A of the Internal Revenue Code (the "Code") allow severance benefits to be paid immediately without a six-month delay if they are payable only on account of an involuntary separation, including resig-

nation for "good reason." The regulations under section 409A recognize the following events as providing the basis for a "good reason:" (1) a material diminution in the executive's base compensation; (2) a material diminution in the executive's authority, duties, or responsibilities; (3) a material diminution in the authority, duties, or responsibilities of the supervisor to whom the executive is required to report, including a requirement that a executive report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation; (4) a material diminution in the budget over which the executive retains authority; (5) a material change in geographic location at which the executive must perform the services; or (6) any other action or inaction that constitutes a material breach of the terms of the applicable employment agreement. This has led to the amendment of a number of agreements so as to comply with the 409A definition of good reason. Any such amendments must be completed by December 31, 2008 in order to comply with the transition rules under Code section 409A.

Effect of \$1 Million Deduction Limitation Under Code Section 162(m)

Code section 162(m) precludes a publicly traded corporation from deducting compensation in excess of \$1 million paid to a CEO and a handful of other executives for any year. There are a number of exceptions, most notably for stock options and other "performance based compensation." Severance payments typically do not run afoul of this limitation because an executive is covered by the restriction only if employed on the last day of the employer's tax year. This means if a CEO resigns or is terminated shortly before year-end, section 162(m) no longer applies for that year. However, Congress may consider amending section 162(m) in the future to eliminate the year-end requirement, thereby subjecting severance benefits to the deduction limit of Code section 162(m). Following the recommendation of the

Joint Committee of Taxation, in connection with a proposed increase in the minimum wage, the Senate Finance Committee on January 17, 2007, unanimously approved the Small Business and Work Opportunity Act of 2007 (the "Act"). If enacted into law, section 314 of the Act would expand the definition of a "covered employee" under section Code section 162(m) to include anyone who:

- ♦ Was the CEO or acted in the CEO's capacity any time during the taxable year;
- ♦ Was one of the four most highly compensated officers for the taxable year (other than the CEO); or
- ♦ Was a covered employee of the employer (or a predecessor) for any preceding taxable year beginning after December 31, 2006, or was a beneficiary of such a covered employee with respect to any remuneration for services performed by the covered employee (regardless of whether the services were performed during the taxable year in which the remuneration was paid).

The penalty for exceeding the \$1 million limitation under Code section 162(m) falls only on the employer – it loses a deduction for anything paid in excess of that limit. Accordingly, publicly traded employers entering into new or amended employment agreements may want to protect themselves against future amendments to Code section 162(m) by providing that any amounts that would otherwise not be deductible because of Code section 162 will be deferred until they are deductible. Such deferrals will not run afoul of Code section 409A.

CHANGE IN CONTROL BENEFITS

Change in control benefits are typically calculated like severance benefits except that the multiplier may be higher, e.g., three times the base instead of two times.

Why Provide Them?

The purpose of a change in control benefit, sometimes called a golden parachute, is to protect an executive in situations in which new owners might refuse to honor formal or informal severance arrangements in place at the target company. It is also meant to foster a CEO's objectivity. In theory, a CEO with a change in control benefit will be encouraged to seek out the best deal for shareholders rather than one that is the most rewarding to himself personally.

When To Provide Them?

Change in control benefits can be categorized either as being "single trigger," meaning that they require only a change in control, or "double trigger," which requires both a change in control and a termination of employment within a specified period, e.g., one year, after the change in control.

Single Triggers

Single trigger change in control provisions have been criticized as providing windfalls to CEOs because the CEO can continue working and still receive his change in control benefits. However, frequently when a company is acquired, a management shakeup results and the CEO of the target will often be terminated. The advantage of a single trigger benefit is that so long as the "change in control" is defined to comply with the definition of change in control under Code section 409A, the benefit can be paid immediately after the change in control without regard to the six-month delay for payments triggered by a termination of employment.

Double Triggers

Double triggers are more common than single triggers but are subject to the criticism that they create the wrong incentives by rewarding employees of a target company whose employment is terminated, while not rewarding those employees who remain behind to integrate the combined companies. Because double trigger benefits are contingent upon termination of

employment, they are subject to the six-month delay required under Code section 409A unless the termination is involuntary or the CEO resigns on account of "good reason." The definition of "change in control" need not be 409A compliant in the case of a double trigger.

280G Gross-Ups

Code section 280G imposes a 20 percent excise tax penalty on the executive if the change in control payments exceed three times an executive's average W-2 compensation over the preceding five years.

This tax can be arbitrary in operation. Because it applies to amounts in excess of average compensation during the five years before the year of the change in control, executives that have exercised their non-qualified stock options in prior years will have an increased base, thus penalizing CEOs who hold their options instead of exercising them.

CEO agreements typically deal with the 280G problem in one of three ways: (1) "grossing up" the payment so the CEO receives the full value of the package net of the excise tax; (2) capping the parachute payment at \$1 less than the safe harbor amount; or (3) reducing the parachute payment to the safe harbor if doing so would put the CEO in a better position than doing nothing. The first approach is most generous to the CEO but can be very expensive for the employer. Once the excise tax is triggered, it applies to any payment that exceeds the average W-2 compensation (not just the portion exceeding three times pay). The net result is that the extra cost to the employer can far exceed the benefit to the executive of the additional gross-up. The second approach restricts the value of the package to the CEO. The third approach balances these interests somewhat.

PERQUISITES

CEO employment contracts often provide for a variety of perquisites including tax,

financial, estate planning, legal and accounting services, club dues, cell phone charges, etc. The amount of criticism these benefits generate far outweighs their economic cost to the company or the corresponding benefit to the executive. Accordingly, these types of benefits may not be worth the disclosure problems and animosity they create. Instead, it might be better just to gross up the CEO's salary to cover these expenses.

CLAWBACKS

Clawbacks are increasingly common in CEO agreements for several reasons.

First, Section 304 of the Sarbanes-Oxley Act of 2002 requires the CEO and chief financial officer (CFO) of a public company to reimburse the company for certain incentive- and equity-based compensation as well as gains realized on the sale of company stock for the 12 months following issuance of erroneous financial statements. The SEC has yet to pursue an action to enforce the provisions of 304, and does not provide shareholders with a private cause of action. The absence of a specific statutory remedy has forced companies to consider self-help.

Second, following the back dating or misdating of stock options, there has been an increased investor call for businesses to recover top management pay improperly paid due to restated financial statements following accounting mistakes.

Third, the SEC now lists companies' recoupment policies as an example of an item that generally should be described in the Compensation Discussion and Analysis section of their proxy statement.

As a drafting matter, how far should a clawback policy go? Some of the issues to be addressed are:

- Should the CEO merely forfeit outstanding awards, or should he have to repay benefits already gained?

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- ♦ What type of behavior should trigger a clawback?
 - Sarbanes-Oxley violations?
 - Competition?
 - Other disloyal acts?
- ♦ How long after termination should the clawback apply?
- ♦ Who should decide whether a clawback should occur?
- ♦ What should be forfeited or recaptured?

Typically, clawback provisions are not set forth in employment agreements, but rather are included in the underlying compensation plans.

CONCLUSION

Ultimately, market forces will dictate what CEOs are paid. However, it is likely that CEO agreements will change in the near future in form, if not in overall compensation, in reaction to criticisms by the media and institutional investors.

ABOUT THE AUTHOR

Larry Hansen has more than 20 years of experience in the area of taxation, with emphasis on employee benefits and executive compensation. He has represented national clients in many complex corporate and employee benefits transactions, including plan mergers and terminations.