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# Roadmap to Employment And Change in Control Agreements (Customary Provisions, Noncompete Issues, Excess Parachute Tax and §409A Rules)

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## RELEVANCE OF EMPLOYMENT AND CHANGE IN CONTROL AGREEMENTS TO MERGERS AND ACQUISITIONS

Employment and change in control agreements are relevant to corporate transactions for a number of reasons. Often, severance offered by these agreements is triggered on a termination only after a change in control, 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 after the 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). Some change in control agreements provide for some type of bonus on a change in control even absent any termination of employment.

Employment agreements may be relevant in a transaction even if there are no change in control provisions. Executives may be terminated as a result of a transaction, and the general severance provisions in their employment agreements will become relevant. Even if no termination is contemplated, the terms of the employment agreements may be important for due diligence purposes. Additionally, new employment or retention agreements will often be negotiated with those executives the buyer wants to retain, to replace existing arrangements the executives have.

## PROTECTIONS AFFORDED EMPLOYEES WITH OR WITHOUT EMPLOYMENT CONTRACTS

Under the ''employment-at-will'' doctrine, absent an employment contract (or a severance contract or policy), an employee in the U.S. will generally be considered an ''employee at will'' and can be terminated even 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.[2] Employee handbooks or policies in many states may impose a severance obligation. There are also various state and federal nondiscrimination

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[2] *See, e.g.,* Ballum, ''Employment-at-Will: The Impending Death of a Doctrine,'' 37 *Am. Bus. L. J.* 653 (Summer 2000); BNA Individual Employment Rights Manual ¶505:51 (2010).



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rules that must be adhered to. In the absence of these exceptions, however, an employee will only be protected through employment or severance agreements.[3]

## PROVISIONS OF EMPLOYMENT AGREEMENTS

The most relevant employment agreement provisions for transactions are those regarding severance and change in control. Nevertheless, a proper understanding of all the terms of employment agreements is helpful in understanding the agreements and in negotiating new agreements.

*Term.* Employment agreements will generally have fixed terms, e.g., for two- or three-year periods. Agreements often provide that they will automatically renew at the end of the term, e.g., for one-year terms, unless notice is given by either party. These are often referred to as ''evergreen'' provisions. On occasion, agreements provide for rolling evergreens (or true-evergreens), which have a rolling term that automatically renews daily for the full term.[4]

*Title/Duties.* The position of the executive will typically be stated, although employers may want some flexibility to change the role as needed. This section of the agreement may state to whom the executive will report. It may also state that the executive will be nominated to the board.[5] The executive may be required to devote substantially all his or her business time to the work of the company. There may be limitations on other activities. The localities where he or she is to work may be stated.

*Compensation.* Salary may be payable in accordance with company payroll practice. The agreement may provide that the salary will be reviewed annually. There may be inflation protections.

*Bonus.* Often, bonuses are provided at the discretion of the employer. Some agreements may set forth the minimum bonus amount and may specify the performance criteria of the bonuses. The bonus should be payable within the first 2½ months after the year vested in order to avoid nonqualified deferred compensation under §409A.[6] For the top five executives of public companies, §162(m) may prevent setting forth minimum bonus amounts in the agreement.[7] There will often also be a description of the equity compensation to be granted (often with specifics of grant, vesting, etc.). Equity compensation may or may not be subject to performance goals.

*Benefits and Perks.* An employment agreement will typically specify the benefits and perks to which the executive is entitled. These could include entitlement to benefits in the company's pension and welfare plans, vacation, company car, use of aircraft, country club fees, 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 now a 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.

*Severance.* Employees cannot compel employers to continue to employ them, and generally, the only protection the employee has is to provide for specific severance if the employee is terminated.

Executive employment agreements typically provide that on termination of the employee ''without cause,'' the employee will receive severance for a certain period of time. ''Cause'' will often be defined to include (1) conviction or plea of ''nolo contendere'' (some include ''or 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, or sometimes (4) breach of material provisions of the contract. The agreement will often give the executive an opportunity to cure.

Many employment agreements also allow the employee to quit for ''good reason'' and treat the quitting as a constructive termination by the employer, entitling the employee to the same severance he or she would have received 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) relocation. Some agreements also add failure of a successor company to assume the agreement as a ''good reason.'' See the discussion be-

[3] Employment terms of senior executives are now required to be disclosed in the annual proxy and are receiving increased scrutiny from shareholders.

[4] If the agreement is intended to be for the fixed term only and not to renew, this should be specified in the contract, as 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.*, 246 N.Y.S.2d 395 (1963). Also, if the term does not automatically renew, the renewal would likely need to be disclosed on Form 8-K.

[5] In most companies, the CEO is also appointed as Chairman of the Board of Directors. However, there have recently been shareholder efforts to split the CEO and chairman roles in order to provide more accountability and to control CEO compensation.

[6] *See* Regs. §1.409A-1(b)(4)(i). All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise stated.

[7] 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 preestablished objective performance goals. §162(m)(4)(C); Regs. §1.162-27(e). A minimum bonus amount would generally not meet these requirements.



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low regarding §409A issues with severance payable on a quit for good reason.

Many employment agreements contain ''double triggers,'' whereby the severance will be payable (or will be payable in a greater amount) only if the above terminations occur in connection with a change in control. These are dealt with below in the discussion of 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 is typically six months to three years of pay, or sometimes pay for the remainder of the term of the employment agreement, or on occasion, the greater of the remainder of the term or one year. 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. Note that due to the economic downturn and a greater focus on corporate governance in compensation, shareholder proposals, and tighter criteria by Risk Metrics Group, there has been a downward shift in the amount of severance, with three times multiples being the exception rather than the rule.

Severance is often 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. More often, however, severance is payable in a lump sum on termination. Because of the §409A restrictions on nonqualified deferred compensation, severance payable in a lump sum may be required to avoid deferral of income (although, as discussed below, there may still be a deferral of income even for lump sums for certain quit-for-good-reason triggers).

*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 very typical of 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, it will be treated as liquidated damages, and there is no duty to mitigate liquidated damages.[8] Therefore, if the intention of the parties is that the severance should be mitigated by new employment, the employment agreement must 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.

*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.[9] Employees may be resistant to agreeing to such a provision. Such a condition should be valid even for Age Discrimination in Employment Act (ADEA) waivers.[10] If an ADEA waiver is sought, the severance provision should state that severance will not be payable until the end of the ADEA seven-day revocation period.

*Noncompetition and Nonsolicitation Provisions.* These provisions are discussed below.

*Confidentiality and Trade Secrets.* Employment agreements often provide that the employee or former employee may not disclose any trade secrets, customer lists, or other confidential information. Such disclosure may be prohibited in any event under the law of unfair competition. However, the agreement will often spell out these restrictions. 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 provisions often

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[8] *See, e.g., Boyle v. Petrie Stores Corp.*, 518 N.Y.S.2d 854 (1985) (where CEO was terminated without cause and contract provided for lump sum severance, there was no duty to mitigate because it was liquidated damages); *Victory Sign Industries, 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 (1975) (contract provision that on termination without cause employee would receive compensation and bonus until end of term liquidates the damages clause and removes case from ordinary rule requiring employee to mitigate damages).

[9] Some employment lawyers have questioned the validity of conditions in employment agreements conditioning all severance on the executive 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.

[10] Under ADEA, as amended by the Older Workers Benefit Protection Act of 1990, waivers for age discrimination for employees age 40 or older must meet the following conditions: (1) be in writing and understandable; (2) specifically refer to ADEA rights or claims; (3) may not waive rights or claims that may arise in the future; (4) be in exchange for valuable consideration; (5) advise the individual in writing to consult an attorney before signing the waiver; (6) provide the individual at least 21 days to consider the agreement; and (7) give the individual at least seven 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 USC §626(f)(1); 29 CFR §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), and 29 CFR §1625.33 (as amended in 2000 in response to *Oubre*).



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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 beneficial to employers in that they can avoid jury trials, which are often sympathetic to individual plaintiffs. Also, arbitrations are much speedier, do not involve discovery, and may often yield a more equitable outcome.[11]

*Choice of Law.* Choice of law provisions will choose the state law governing the agreement. Choice of law provisions will generally be upheld if there is some connection between the chosen jurisdiction to the employment situation. Attorneys may want to put in choice of law provisions 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 employees can be assigned by the employer to a successor company or that they 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.

*Other Provisions.* Other provisions typically in employment agreements include: notice provisions, amendment by consent of both parties, severability of agreement if certain provisions are held to be invalid, etc.

## 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). They are typically provided only to senior management.

*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 under which, upon a change in control, certain amounts will be paid to the executives even absent a termination. This is not severance but, rather, a change in control bonus. These are becoming less common in public companies because of shareholder concerns that change in control benefits are intended to mitigate loss of employment but not as a bonus.

The more common change in control provision is a ''double-trigger'' provision under which the executive will receive severance benefits if (1) there is 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 before a change in control) there is a termination by the company without cause or the executive quits for good reason. Sometimes, an employment agreement may provide for a certain amount of severance on a termination without cause or quit for good reason, and provide for an enhanced severance benefit if such termination takes place after a change in control.

*Modified Single-Trigger.* Sometimes, a change in control provision will state that 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.'' [12] Often, the definition of ''good reason'' is so broadly defined that the executive in effect has the ability to ''walk'' on a change in control.[13] This has also become less popular because of shareholder concerns that this, in effect, is a single trigger.

*Window Period to Quit.* It is fairly common to see employment agreements that — 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 some transition period (e.g., after one year). This has the effect of serving as a retention agreement 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 or 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 (unless new board is elected by old board and not in a proxy contest), (2) the incumbent board ceasing to be a majority, (3) (approval by share-

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

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

[13] 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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holders of) sale of substantially all of the assets of the company to an unrelated entity or a liquidation of the company, or (4) (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.[14] Some agreements provide that shareholder approval of the transaction (and not merely the consummation of the transaction) would be a change in control, so that even if the deal falls apart, the executives would receive the benefits.[15]

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

*Vesting of Equity Awards.* Change in control agreements typically provide that stock options and other nonvested equity awards will become vested on a change in control.[16]

*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 for such highly compensated employees. Before the Patient Protection and Affordable Care Act of 2010 (PPACA), §105(h) applied only to self-insured plans. Under PPACA, insured plans are now also subject to the §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). Thus, with regard to self-insured plans or new insured plans, post-employment health benefits received only by executives or senior management would fail the nondiscrimination rules of §105(h), and the benefits would be taxable to such executives. As an alternative, for self-insured or new insured plans, the employer could increase the cash severance but not pay any COBRA or plan insurance premiums. The executive could purchase individual coverage, which would not be a group health plan and would not be subject to the §105(h) nondiscrimination rules.

*Retirement Plan Benefits.* Change in control agreements will often provide the executive with benefit accrual credit under any nonqualified pension plans in conjunction with the severance. Sometimes, the credit under the nonqualified plan will also make up for 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.[17] In the case of a §401(k) plan, the §415 regulations allow severance paid within 2½ months or the end of the plan year of the termination to be treated as valid §415 compensation and to be included in the §401(k) deferrals.[18]

*Business Judgment Rule and Validity of Change in Control Agreements.* On occasion, courts have struck down unreasonable change in control agreements.[19] In most cases, however, change in control arrange-

[14] Some 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 change in control unless there is also a sale of substantially all of the assets.

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

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

[17] On occasion, particularly where the executive is receiving the severance over a period of time, the company 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.

[18] Regs. §1.415(c)-2(e)(3) (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 (presumably only the severance for compensation that would have otherwise been paid during such 2½-month or end-of-year period) (such as regular pay, overtime, commissions, bonuses, etc.), is treated as compensation for purposes of §415(c)(3). Regs. §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.

[19] *See, e.g., Black & Decker Corporation v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988) (in response to tender offer, company offered alternative recapitalization plan, thus putting the 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 plan treated competing bids unfairly); *Tate & Lyle PLC v. Staley Continental, Inc.*, 9 EBC 2031, 1988 WL 46064 (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 (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



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ments have been upheld under the business judgment rule.[20]

*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 agreements may give 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. Noncompetes secured in exchange for the severance are often very valuable to the employer. On the other hand, care must be taken that the provision of change in control severance does not cause the executive to quit right after the transaction to receive the severance. It should 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 not be in the best interest of the company.

## NONCOMPETE PROVISIONS AND AGREEMENTS

*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.

*Enforceability of Noncompetes.* State laws vary regarding enforceability of noncompete agreements. Generally, noncompetes will be enforced in most states if the restrictions are reasonable in geographical scope and time period, and if they are necessary to protect legitimate business interests.

For example, in New York, which is fairly liberal in allowing noncompete restrictions, the noncompetes 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.[21] In New Jersey, noncompetes will be enforced only if reasonable under the circumstances.[22] Texas and Florida statutes restrict noncompetes unless they

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management but actually encouraged officers to quit).

[20] *See, e.g., Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio 1987), *affirmed without op.*, 815 F.2d 76 (6th Cir. 1987) (upheld parachutes adopted by company after being subject to tender offer; applied *Unocal* analysis that to apply business judgment rule in a takeover, the directors must establish reasonable grounds for believing there was a danger to corporate policy and effectiveness, and that the bounds of the defensive measures are reasonable; held that parachute agreements are in shareholders' best interest because they are triggered only if management employees are fired or discharged after change in control and §280G cap in contract ensured that severance would be reasonable; but CEO's single-trigger parachute was unreasonable); *Tate & Lyle PLC v. Staley Continental, Inc.*, 9 EBC 2031, 1988 WL 46064 (Del. Ch. 1988) (approved parachute arrangements adopted before 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 as good faith responses to possible takeover attempt, but retirement plan for outside directors and funding trust were held not valid); *Nomad Acquisition Corp. v. Damon Corp.*, Fed. Sec. L. Rep. (CCH) ¶94,040, 1988 WL 383667 (Del. Ch. 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); *International Insurance Co. v. Johns*, 874 F.2d 1447 (11th Cir. 1989) (five-year consulting noncompete agreement with former chairman in connection with merger and performance units that were payable on a 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 was 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 a majority of the board in response to takeover threat were reasonable under *Unocal* analysis because board properly determined in good faith that the corporation faced threat warranting defensive response and severance agreements were not disproportionate to the 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), court held that: directors relied in good faith on financial expert who advised the board on employment agreement; directors' lack of substantive due care is foreign to business judgment rule; waste by the 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 Litigation*, 2006 WL 1562466, 37 EBC 2756 (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 a no-fault basis a 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 in 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).

[21] *Service Systems Corp. v. Harris*, 341 N.Y.S.2d 702 (4th Dep't 1973); *Mallory Factor v. Schwartz*, 536 N.Y.S.2d 752 (1st Dep't 1989); *International Paper Co. v. Suwyn*, 951 F. Supp. 445 (S.D.N.Y. 1997).



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are reasonable restrictions necessary to protect legitimate business interests.[23]

California by statute appears to entirely void noncompetes, 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.'' [24] The Ninth Circuit allowed ''narrow restraint'' enforcement of noncompetes that are very limited, but the California Supreme Court rejected this exception.[25]

*Blue-Penciling Noncompetes.* 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.[26] For example, in New York, restrictive covenants will be blue-penciled.[27] Often, employment agreements will add language to specifically provide for blue-penciling.

*Consideration for Noncompetes.* Employees are often 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 noncompetes merely with beginning employment or continuing employment, even if only employment at will.[28]

*Clawbacks.* A ''clawback'' provision in an employment contract or equity compensation award may provide that the executive will forfeit some or all outstanding stock awards and even the proceeds or stock received from such an award if the employee engages in financial statement errors, or in fraud or misconduct with material harm to the company.[29] There is case law supporting clawback provisions.[30]

## SECTION 280G EXCESS PARACHUTES AND GROSS-UPS

*Section 280G Generally.* Severance provided under employment and 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.

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[22] *Community Hospital Group, Inc. v. More*, 183 N.J. 36 (2005).

[23] Texas Business & Commerce Code §15.50; Florida Statutes Annotated §542.335.

[24] California Business & Professional Code §16600.

[25] The Ninth Circuit provided a narrow restraint exception in, e.g., *Campbell v. Trustees of Leland Stanford Jr. University*, 817 F.2d 499 (9th Cir. 1987) (exception to Cal. Bus. Prof. Code §16600 where one is barred from pursuing only a small or limited part of a business, trade or profession); *General Commercial Packaging v. TPS Package Engineering, Inc.*, 126 F.3d 1131 (9th Cir. 1997) (contract valid if noncompete is only for a small or limited part of business, trade or profession, i.e., a 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 the 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).

In addition, a Ninth Circuit case has held that California courts may respect a different state choice of law even if the employee is working in California. *IBM v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999).

[26] See Dare, ''Judges Should Have Power to 'Blue-Pencil' Noncompetes,'' 18 *Va. Law Wkly.* 427 (9/29/03), finding that 29 states will blue-pencil restrictive covenants, while five states refuse to do so. The following are among the states that generally will blue-pencil restrictive covenants: New York, New Jersey, Florida, Massachusetts, North Carolina, Connecticut, Maryland and Pennsylvania. The following states generally will not blue-pencil restrictive covenants: Indiana, Georgia and California.

[27] *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).

[28] *See, e.g.,* in New York, *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).

[29] Section 304 of the Sarbanes-Oxley Act of 2002 requires disgorgement for the CEO and CFO of bonus and incentive compensation that the executive receives within the 12-month period following the release of financial information if there is a restatement of the financial statements because of material noncompliance and misconduct. SEC proxy disclosure rules require discussion in the Compensation Discussion & Analysis regarding policies for recovery of awards or payments if performance measures on which they are based are restated.

Companies have increasingly been imposing clawback provisions for executive officers for performance-based awards. Sometimes, clawbacks require recoupment of gains from selling the stock at a high price where the financials are later restated. Clawbacks may be triggered by material restatements and are often limited to cases in which there was fraud or misconduct. Sometimes, the clawback applies to other executive malfeasance as well. Often, the clawback is subject to discretion of the board. Clawbacks can reach back, e.g., one to five years before restatement of financing, and occasionally are unlimited.

[30] *IBM v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (employee exercised stock options tied to forfeiture clause and went to work for a competitor; court allowed restrictive covenants tied to forfeiture of stock options); *Lucente v. IBM*, 310 F.3d 243 (2d Cir. 2002) (stock options and restricted stock could be cancelled when employee went to work for competitor because employee had a choice whether to enter into noncompete).



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*Excess Parachute Payment as Parachute Payment over Base Amount.* Section 280G provides that ''excess parachute payments'' are nondeductible by the employer. Section 4999 imposes a nondeductible 20% excise tax on receipt of excess parachute payment. An ''excess parachute payment'' is the excess of any ''parachute payment'' over the ''base amount.'' [31] 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.[32] The ''base amount'' is the individual's average annual taxable compensation (Form W-2 compensation) payable in the most recent five taxable years ending before the year in which the change in control occurs.[33] If the three-times-base-amount threshold is met, the entire excess over the base amount (and not just over three times the base amount) is an excess parachute payment. If the three-times-base amount is not met there will be no parachute payment and, therefore, no excess parachute payment.[34]

*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 common 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 cutback, but if the executive would be worse off with the cutback, the amount will not be cut back. For senior executives of large corporations, there is often not a parachute cutback, but instead, a parachute gross-up provision to reimburse the executive for any excise taxes on the excess parachute, as well as any income tax on the excise tax and any interest and penalties, so that the executive will not incur any loss as a result of the payments being an excess parachute. Institutional shareholders and Risk Metrics Group do not look favorably on excess parachute gross-ups. Some agreements are silent, in which case, there will be neither a cutback nor a gross-up.

*Contingent on Change in Control.* To be a parachute payment, the payment must be contingent on the change in control. It is contingent on change in control if the payment would not have been made if no such change occurred, even if the payment is also conditioned on another event.[35] A payment can be contingent on a change in control even though it is also contingent on the occurrence of a second event.[36] Thus, a double-trigger severance arrangement could be contingent on a change in control although payment is made only if there is also a termination. Also, severance or termination within one year of a change in control may be presumed to be a parachute even if the severance in the agreement does not require a change in control.[37] If the change in control accelerates the time of payment, it is treated as contingent on change in control.[38]

*Sale of Subsidiary if Not One-Third of Assets Not a 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'').[39]

A change in ownership occurs when one person, or two or more persons acting as a group, acquire ownership that would cause that person to own a majority of the total fair market value or total voting power of stock.[40] 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 en-

[31] §280G(b)(1).

[32] §280G(b)(2)(A).

[33] §280G(b) and (d).

[34] §280G(b)(2)(A)(ii).

[35] Regs. §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. Regs. §1.280G-1, Q&A-22(b).

[36] Regs. §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.*

[37] *See, e.g., American Medical International, 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 a parachute payment).

[38] Regs. §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, 98th Cong., 2d Sess. 851 (*Ex.* 4) (1984). *See also* Regs. §1.280G-1, Q&A-22(c) and examples in Q&A-22(e).

[39] §280G(b)(2)(A)(i).

[40] Regs. §1.280G-1, Q&A-27.



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dorsed by a majority of the current board.[41] 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.[42]

The rule for change in effective control would apply only to transfer of stock of a parent corporation, but not for transfer of stock of a subsidiary corporation, because §280G(d)(5) and Regs. §1.280G-1, 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. Thus, sale of stock of a subsidiary in the consolidated group would be a change in control only if it constituted a change in ownership of a substantial portion of the parent's assets under Regs. §1.280G-1, Q&A-29.[43]

*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.[44] 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 before the change in control.[45] 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.[46] Courts are skeptical, however, of sham arrangements entered into to replace parachute payments.[47]

*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 corporation status.[48]

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.[49] The payment must be approved by more than 75% of vot-

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[41] Regs. §1.280G-1, Q&A-28(a).

[42] Regs. §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.*

[43] Regs. §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 surviving entity''). *See also* Regs. §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).

[44] §280G(b)(4)(A); Regs. §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's historical compensation, and (3) compensation of comparable services by other individuals. Regs. §1.280G-1, Q&A-40.

[45] Regs. §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.*

[46] Reasonable compensation for personal services includes reasonable compensation for holding oneself out as available perform services and refraining from performing services (such as a covenant not to compete). Regs. §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 services 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. Regs. §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 noncompetes for purposes of the §280G reasonable compensation rule.

[47] *See, e.g., Balch v. Comr.*, 100 T.C. 331 (1993), *affirmed sub nom. Cline v. Comr.*, 34 F.3d 480 (7th Cir. 1994) (severance agreement that was amended to comply with the golden parachute restrictions but where the difference was made up through a minor consulting agreement with the successor was a sham and the entire amount was viewed as a severance payment, and therefore, it was a parachute payment that exceeded the §280G limits).

[48] §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 such an 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. Regs. §1.280G-1, Q&A-6(a)(1). Members of an affiliated group are *not* treated as one corporation for this purpose. Regs. §1.280G-1, Q&A-6(b).

[49] §280G(b)(5)(A) and (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. Regs. §1.280G-1, Q&A-7(b)(4).



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ing power of all the stock entitled to vote immediately before the change in control.[50] 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.[51] Thus, if the executive is not willing to risk that the vote on the purchase (which must 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.[52] 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.[53]

## 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 are subject to immediate taxation and penalties unless they comply with various requirements of §409A(a) relating to advance elections, limitations on distributions, and barring of accelerations.[54] 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).[55] Severance plans are not excluded from the definition of a deferred compensation plan.[56]

*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.[57] However, once an individual separation agreement is signed providing for the severance over a period of time, this may require a six-month wait for key employees. Individual employment agreements or

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[50] Regs. §1.280G-1, Q&A-7(a)(1). Except as otherwise provided in regulations, the normal voting rules of the corporation are applicable. Regs. §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 six-month period immediately before and ending on the change in control, provided the disclosure rules are met. Regs. §1.280G-1, Q&A-7(b)(2).

[51] Regs. §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 similarly* Ginsburg and Levin, Mergers, Acquisitions and Buyouts, ¶1506.6.1 (July 2005).

[52] Regs. §1.280G-1, Q&A-7(b)(1). Thus, obtaining 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 or more disqualified individuals. There can be a single vote on all payments to multiple disqualified individuals. *Id.*

[53] Regs. §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 and Levin, Mergers, Acquisition, and Buyouts, ¶1506.6.1 (July 2005), suggesting that, in practice, it may be hard to take advantage of the shareholder approval exception, 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 or her 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). Regs. §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 the NYSE; an acquiror buys more than one-third of the assets out of bankruptcy with the sale triggering parachute payments to executives, and the bankruptcy court approves the sale; ruling held that although the sale out of bankruptcy is a change in control, it is at that time a nonpublic company, and the 75% of shareholder approval and disclosure requirement is met by the disclosure and approval by the bankruptcy court); PLR 200212013 (shareholder approval requirements would be satisfied by the bankruptcy court's approval of a plan of reorganization, as the creditors' committee and the bankruptcy judge represented the shareholders, and the shareholders were not otherwise eligible to approve payments under the plan of reorganization).

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

[55] Regs. §1.409A-1(b)(4)(i).

[56] §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). Regs. §1.409A-1(b)(9). For example, according to the Preamble to the §409A final regulations, the right to a gross-up payment for taxes payable due to the application of §280G constitutes separation pay only if a separation from service is required to obtain the payment.

[57] Regs. §1.409A-1(b)(1).



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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.* If severance arrangements pay out only 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 of termination.[58] Therefore, it is important to draft change of 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-times-pay/two-year exception below.

*Test for When Quit for Good Reason Is Considered Involuntary Separation.* If 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).[59] If the good reason trigger is viewed as a voluntary termination, this would be considered a vested right even before termination, and therefore, the severance would not meet the 2½-month short-term deferral exception, and the severance would be subject to the requirements of §409A, which would require a six-month delay for key employees of public companies. Likewise, if there is a right to walk for any reason (even if only after a change in control), this would result in cause a voluntary termination and, therefore, not meet the short-term deferral exception.[60]

For good reason to be treated as an involuntary separation, the avoidance of §409A must not be a purpose of the good reason trigger.[61] 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.[62]

*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. These conditions include: (1) the amount must 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 must 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.[63] A good reason condition may consist of one or more of the following conditions: (1) a material diminution in the employee's base compensation; (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 or employee 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.[64]

Note that the failure to have a successor assume the plan is not a valid §409A good reason. However, it

[58] 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). Regs. §1.409A-1(n)(1).

[59] Regs. §1.409A-1(n)(2)(i).

[60] Even if the right to walk is only within a window of, e.g., the 13th month, there would not be a valid §409A good reason (even with respect to payments made before the 13th month), and the six-month delay would be required (unless in all instances payment will be made within a short-term deferral period). The requirements to sign a release for severance will likely not make the payment into a nonvested right. Note that even if the good reason is voluntary, if there is a double-trigger with change in control, there would presumably be no vesting before the change in control.

[61] Regs. §1.409A-1(n)(2)(i).

[62] *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. *Id.*

[63] Regs. §1.409A-1(n)(2)(ii).

[64] Regs. §1.409A-1(n)(2)(ii). It is recommended to generally adhere to the safe harbor as a precaution for the executive. Some variations that are not significantly different (e.g., material dimi-



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should be permissible to provide in a covenant elsewhere in the agreement that the employer will obtain consent of the successor to assume the contract, and then it may be a material breach of the agreement which is covered as an unforeseeable emergency.

Notice 2007-78 provides that an amendment to an existing ''good reason'' definition made before December 31, 2007 (or December 31, 2008 under Notice 2007-86), for amounts that are not yet vested will be valid and will not be considered a prohibited extension of a forfeiture condition. Likewise, if a good reason provision is subject to a substantial risk of forfeiture (e.g., it is a double-trigger based in part on change in control that has not yet occurred), then it can be converted to a safe harbor good reason in 2008.[65]

Severance cannot be delayed until completion of a noncompete (unless it meets short-term deferrals) because noncompetes are not good §409A substantial risks of forfeiture.

Notice 2007-78 also provides that until further guidance is issued, an extension of an employment agreement 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.* When payment of severance is conditioned on the employee's signing a release of claims (e.g., an ADEA release) in the form attached to the agreement,[66] and the employee can sign the release at any time, this could cause the severance arrangement to fail to be a short-term deferral or not have a fixed payment date, according to IRS officials.[67] One solution that practitioners had used was to provide a fixed deadline in which to execute the release, e.g., the release must be executed and not revoked by the 60th day following termination, and to agree in advance upon the terms of the release. This way, the ADEA 21-day period to consider the release, or the 45-day period in connection with an exit incentive program or other employment termination program, as well as the seven days to revoke, can be satisfied before the expiration of that period. In addition, in order to avoid an employee's ability to control the year of payment (which is impermissible under Regs. §1.409A-3(b)), a provision could also be added to require that if the end of the 60-day deadline in which to execute and not revoke the release will extend into the next year (e.g., terminations on or after November 1), the severance will be paid no sooner than the next taxable year. IRS officials have indicated, however, that such a solution will not work, because there would be an impermissible toggle by the employee being able to have a different pay option, depending on whether the employee terminates before or after November 1 (and a specific date in each year, in the IRS officials' view, would not fit within the ''toggle'' rule exception of Regs. §1.409A-3(c)). Thus, the solution that IRS officials would require is that regardless of whether the release is executed right away, the severance payment will only be made 60 days after termination, provided that an irrevocable release is in place by then.[68]

Note that many of the above requirements apply only if the severance arrangement is subject to §409A, but if the severance can be paid within the short-term deferral period (e.g., has a valid §409A good reason definition) or within the two-times-pay/two-year 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, regulations provide for 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 if the amounts may also become payable for

nution in base and bonus) would probably not raise IRS objections.

[65] Notice 2007-78, 2007-41 I.R.B. 780, §IV.A. (and Notice 2007-86, 2007-46 I.R.B. 990, §4). *See also* Hogans and Collins, ''Internal Revenue Section 409A: Ten Traps for the Unwary,'' §IV, Vol. 08 *BNA Pension & Benefits Daily* No. 4 (1/8/08).

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

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

[68] This solution is supported by Notice 2010-6, 2010-3 I.R.B. 275, which 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 employee's ability 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. Continued health coverage is generally not subject to §409A, and therefore, the timing of payment/reimbursement for it is not an issue. So, even if the employer wants to condition health benefits on executing a release, one would not have to wait the full 60 days, just until the release is executed. It might even be possible to have the health benefits made retroactive (depending how agreement is worded).



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some other reason, even if 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.[69]

*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 two times the employee's pay or two times the §401(a)(17) limit ($245,000 in 2010) and the severance is paid by the end of the second calendar year following the year of separation.[70] 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.[71] If there is payment on a noncompliant good reason or on a termination for any reason (even if only after a change of control), the requirements for an involuntary severance would not be met. Note that the §402(g) limit payment exception ($16,500 in 2010) discussed below can be added to the two-times §401(a)(17) amount (so that in total with 2010 COLA numbers, up to $506,500 would be allowed). See also the above discussion of 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.[72]

*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 §409A 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 before 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.[73] However, the six-month delay for specified employees would still apply to such reimbursements. If the expense reimbursement payments are made on account of termination, there are more broad exceptions that entirely exempt the payments from §409A. If plans provide for reimbursements (even if not otherwise excludible from gross income) for expenses that could be deducted as business expenses or for 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).[74] Amounts that would be excludible from gross income would, in any event, be exempt from §409A.[75]

There is also an exception for severance providing for medical benefit reimbursements, provided they do not extend beyond the COBRA period.[76] It is arguable that the six-month delay could run concurrent with the COBRA period, thus avoiding the need for a six-month delay, even if §409A would otherwise apply.[77] Note also that the medical reimbursement exception is

[69] Regs. §1.409A-1(c)(2)(i)(D); Preamble to §409A final regulations.

[70] Regs. §1.409A-1(b)(9)(iii). This exemption is similar to the safe harbor to treat severance plans as welfare plans under DOL Regs. §2510.3-2(b). Under a transition rule, severance plans adopted before Dec. 31, 2005, could be terminated until the end of calendar year 2005 in order to terminate participation or cancel a deferral election. A plan 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, 2005-2 I.R.B. 274, Q&A-19(d).

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

[72] Regs. §1.409A-1(b)(9)(ii).

[73] Regs. §1.409A-3(i)(1)(iv).

[74] Regs. §1.409A-1(b)(9)(v), *as amended by* 72 Fed. Reg. 41620 (7/31/07), to remove a misleading comma. The same exception would apply to employer payment of premiums for a self-insured plan. ABA Joint Committee on Employee Benefits, Q&As for IRS (2008), Q&A-26.

[75] *See, e.g.,* Regs. §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 includible in income [other than a cafeteria plan]." *See also* Regs. §1.409A-1(a)(5) regarding nontaxable medical arrangements, Regs. §1.409A-1(b)(4)(B) regarding short-term deferrals and receipt being when taxable, and Regs. §1.409A-1(b)(6) regarding no receipt if nonvested property is not taxable.

[76] Regs. §1.409A-1(b)(9)(v)(B).

[77] In addition, the medical reimbursement exception under Regs. §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.



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needed only 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 discriminate in eligibility under §105(h)).[78] Before the Patient Protection and Affordable Care Act of 2010 (PPACA), §105(h) applied only to self-insured plans. Under PPACA, insured plans are now also subject to the §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). Thus, with regard to self-insured plans or new insured plans, the post-employment ''benefits'' (and not merely premiums) received only by the executives would be taxable to them. As an alternative, for self-insured or new insured plans, the employer could increase the cash severance but not pay any COBRA or plan insurance premiums. The executive could purchase individual coverage, which would not be a group health plan and would not be subject to the §105(h) nondiscrimination rules.

The §409A 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.[79] Further, the final regulations clarify that a right to a benefit that is excludible from income, for example, health coverage excludible under §105 (provided it does not fail §105(h)), is not treated as a deferral of compensation for purposes of §409A.[80]

*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 ($16,500 in 2010).[81] This can be ''stacked'' with the $490,000 amount (that is two times the §401(a)(17) limit) to allow deferrals of $506,500.

*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.[82] For example, if a termination occurred 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.[83] 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.[84]

*Consequences of Applicability of §409A to Severance Arrangements.* If 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 consequences under §409A: (1) a six-month delay would be required for key employees of public companies under §409A(a)(2)(B);[85] (2) distribution would have to be under a permitted §409A payment event under §409A(a)(2)(A), such as a fixed time/fixed schedule as defined in Regs. §1.409A-3(i)(1) or upon a separation from service as defined in Regs. §1.409A-1(h); (3) changes to time and form of payment may be subject to the restrictions of §409A; and (4) the deferral would have to be reported, as discussed below.

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

[79] Regs. §1.409A-1(b)(9)(v)(C). *See also* Regs. §1.409A-3(i)(1)(iv) regarding requirements for expense reimbursements for an active employee and when such reimbursements will be considered made at a fixed time or schedule.

[80] The §409A 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 (Regs. §1.409A-1(b)(9)(v)) (including plans providing in-kind benefits) that constitute nonqualified deferred compensation plans for purposes of §409A. *Id.*

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

[82] Regs. §1.409A-1(b)(9)(i) and Preamble to §409A final regulations, 72 Fed. Reg. at 19246.

[83] 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, such as the two-times-pay or §401(a)(17) exception, assuming that there is a valid §409A good reason definition.

[84] Regs. §1.409A-2(b)(2) (a plan can designate installment payments to be treated as a series of separate payments). *See also* Regs. §1.409A-3(c) (single time and formal benefit must be designated for each payment event).

[85] 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 six-month delay under §409A would be satisfied as six months will have elapsed by then.



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## ASSUMPTION OF EMPLOYMENT AND CHANGE IN CONTROL AGREEMENTS IN TRANSACTIONS

In a stock deal or a merger, the employment and change in control 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 before 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.[86] Often, the employment and change in control agreements will provide that nonassumption of the agreements will be a trigger for quitting for good reason, or will be considered a breach of the agreement by the seller. These may give rise to an obligation to pay severance. Again, renegotiation of the agreements may be necessary to avoid this breach.

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 before the transaction to avoid the enhanced severance.[87] For this reason employment/change in control agreements often provide that if terminations occur shortly before a change in control, they will also be protected.

## RENEGOTIATION OF AGREEMENTS IN TRANSACTIONS

As discussed above, if there is a right to walk after a change in control and receive severance, or if 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 walk in order to receive the severance. The buyer may also want to renegotiate if the agreement is 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 stock options, restricted stock or other equity awards by the buyer.

## 8-K REQUIREMENT

Public companies must disclose various aspects of executive compensation as part of their proxy disclosure in the Summary Compensation Table and other tables, as well as in the Compensation Discussion and Analysis.[88] A more immediate concern is SEC Form 8-K. Form 8-K must be filed within four business days after the event. Under Item 1.01 of Form 8-K, if the company enters into a material definitive agreement not made in ordinary course of business, or an amendment that is material, then disclosure of the terms of the item is required. Under Item 5.02(c), if the company appoints a new CEO, president, CFO, CAO or COO, disclosure is required on appointment of executive officers and their compensatory arrangement, as well as material modifications to the arrangements.

## CONCLUSION

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

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[86] 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) the purchasing company expressly or impliedly agrees to assume the selling company's liabilities; (2) 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) the purchaser corporation is a "mere continuation" of the seller, which occurs if there is a common identity of the officers, directors and stockholders in the selling and purchasing corporations, and only one corporation remains; and (4) the transfer of assets is for the fraudulent purpose of escaping liability for the seller's debts. *See generally* 15 Fletcher, *Cyclopedia of the Law of Private Corporations*, §§7122, et seq.

[87] Depending on the state, such practices may violate the employer's obligation to deal in good faith with its employees.

[88] *See* 17 CFR §229.402 (Item 402 of Regulation S-K). Item 402(e) requires a narrative in the Summary Compensation Table section with the material terms of the named executive officers' employment agreements, description of material modification of options or other award, and explanation of amount of salary and bonus in proportion to total compensation.



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