Law360 Tax Authority
a LexisNexis® company

Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The Art Of Drafting Executive Employment Agreements: Part 2

By **Mark Poerio** (November 22, 2019, 4:45 PM EST)

Mark Poerio

This is the second of a two-part article that addresses issues often arising during the negotiation, drafting and review of executive employment agreements with a focus on terms, provisions and contractual language that implicate economically significant matters. Both employer and executive perspectives are presented in a discussion that tracks the flow of a typical employment agreement.

This is intended to provide a heads-up for material issues. Due to the high stakes and complexity of these agreements, experienced legal counsel should be sought for sound and thorough advice.

Part 1 covered positions and reporting relationships, commencement dates and relocation scenarios, salaries and bonuses, and health benefits, among other issues.

Part 2 focuses on terms for different types of terminations, Internal Revenue Code Section 409A impacts on executive deferred compensation, change-of-control and golden parachute provisions under IRC Section 280G, and taxation of excess parachutes under IRC Section 4999.[1]

Termination Scenarios and Protections

Severance

The terms and conditions for severance involve a high-stakes combination of business, legal and tax considerations. Whether the interests are those of the employer or an executive, attention to the details of particular severance events generally has material impact, although the implications are often not appreciated until a termination of employment becomes imminent or occurs unexpectedly.

Release Requirement

There is a sound reason for the employer's counsel to follow the routine practice of conditioning severance on an executive's execution of a claims release, namely, who would want to pay severance and then be sued for more? Employers may find themselves cornered if an employment agreement promises severance but omits a release requirement.

However, if an employer does not require a release of claims, that should come as a pleasant surprise to the executive and his or her counsel. On the other hand, an executive who faces a release requirement should at least seek to limit it to the standard form the employer uses. It is even better to attach the current form as an exhibit, both to get a sense of what to expect and to have an opportunity to challenge the employer's later efforts to significantly broaden the release terms.

On occasion, a senior executive has the leverage (and budget) to negotiate the terms of the required release, and that generally is beneficial. For instance, most employers require a nondisparagement provision but are reluctant to offer that protection to terminated employees. Nevertheless, it is difficult for an employer to argue against mutual assurances of nondisparagement, especially at the start of a new employment relationship.

For-Cause Termination

In the interest of being concise, many employers opt for "cause" definitions that single out a few obvious trigger events (e.g., conviction of a felony, theft, dishonesty, insubordination). Employers should nevertheless bear in mind that insofar as reasonable, the longer the list, the greater the protections.

Because a for-cause termination triggers extreme consequences (from lost benefits to reputational damage), in reviewing an employment agreement, the executive’s counsel will be wary of subjective measures, such as incompetence, which warrant concern and attention. Also, with respect to trigger events relating to workplace conduct (in contrast to a felony conviction), it makes sense to seek due process protections such as notice of the alleged misconduct, an opportunity to be heard, and an ability to cure.

Without-Cause Termination Severance

For both parties, the core questions revolve around the executive's severance benefits for a termination without cause: What, how much and when?

Employers write employment agreements to follow the simplest construct promising severance equal to a multiple of salary. That approach may work below the C-suite.

However, senior officers typically receive severance that takes into account their most recent bonuses (actual or target level) as well as full or partial accelerated vesting of stock awards and the continuation of employer-subsidized health benefits. Survey data about peer practices warrants consideration to determine appropriate severance levels.[2]

So-called garden leave often makes sense as a vehicle for severance, especially for employers who desire to sideline an executive in order to effectuate a strategy for retaining key clients, customers and employees. Paying severance over time, rather than in a lump sum, also encourages executives to honor their post-employment covenants relating to trade secrets, nonsolicitation and noncompetition.

When reviewing an agreement for the executive, it makes sense, of course, to maximize severance and to collect it as soon as possible after termination of employment. See the link in footnote 2 for survey data, because negotiations for severance often turn on industry practices, not to mention the relative strength of each party's bargaining position.

Resignation With or Without Good Reason

It is common for employers to pay no severance if an executive resigns without good reason. For senior executives, a carefully designed good-reason provision generally provides the same severance that is promised for a without-cause termination. A minimum notice period before resignation could assist with transitions, especially when coupled with a garden leave alternative that the employer may elect to impose (and pay for by retaining the executive on payroll as an active employee for the garden leave period).

From the executive’s perspective, the terms and conditions for a good-reason resignation, with severance benefits, tend to track the safe harbor definition and processes that are set forth in regulations under IRC Section 409A, which governs taxation of nonqualified deferred compensation. Nevertheless, tweaks to that definition can create material protections for an executive.

Death or Disability

Both parties to an employment agreement have an interest in being sure to identify how much is payable and under what terms.

Rabbi Trust for Nonqualified Deferred Compensation

A trust of this kind enables an employer to deposit funds with an independent financial institution and then to use those funds to pay future deferred compensation or severance benefits. Income taxation for the executive is deferred until trust payments are made, provided that the assets of the trust remain subject to the claims of the employer's general creditors. As a result, rabbi trusts are said to provide executives with change-of-heart protection (against having the employer renege on payment), but they cannot protect against an employer's bankruptcy.

Most employers omit rabbi trust protections from their employment agreements and instead establish rabbi trusts as a complement to their deferred compensation programs. However, while rabbi trust protections are almost never offered for standard severance situations, a senior executive with leverage could reasonably seek to include a "springing" rabbi trust provision within an employment agreement.

The springing provision would require funding of the trust upon a change in control and could be structured to enable the executive to collect post-closing severance directly from the rabbi trust. This construct will reduce the executive's risk of having to litigate against an acquirer who resists paying.

Change in Control

Principal terms for change-in-control benefits include the definition of change in control, the amount payable and the inclusion of a protection period.

Definition

Both parties have a shared interest in thoughtfully defining what does — and does not — constitute a change in control, because that event usually triggers enhanced severance benefits.

Amount Payable

If an executive's employment terminates on or after a change in control, the employer often provides an increased multiple of termination pay or some accelerated vesting of the executive's stock awards.

Protection Period

Exclusively post-transaction protected periods are the norm. It is quite uncommon for employers to provide enhanced change-in-control benefits to executives who terminate employment before a closing. However, when representing the executive, seek to negotiate an employment agreement that identifies a protected period (such as one month before the closing) when an eve of closing involuntary termination would result in the payment of change-in-control benefits.[3]

Taxes, Disputes and Boilerplate

Taxes

Withholding

For drafting and negotiation purposes, Davidson v. Henkel Corp. is instructive.[4] That litigation arose because the employer mistakenly failed to withhold Social Security, or Federal Insurance Contributions Act, taxes on the participant's nonqualified deferred compensation plan account as it became vested, thereby causing the executive to pay otherwise avoidable FICA taxes as plan distributions were made during retirement. In ruling for the former employee, the court noted that failing to apply withholding in a manner that would reduce the participant's tax burden was inconsistent with the design and purpose of the plan, which — as a deferred compensation plan —

includes advantageous tax treatment.

With an eye toward avoiding claims of the kind asserted in the Henkel case, draft an employment agreement (or benefit plan) for an employer to avoid hard-wiring how FICA and employment taxes will be handled (even implicitly).

When reviewing for an executive, recognize that it is tough to constrain employer discretion over withholding terms, but being proactive about how withholding taxes apply to nonqualified deferred compensation can avoid bad surprises, such as those the plaintiff suffered in the Henkel case due to the employer's oversight.

Golden Parachute Provisions

Employers lose tax deductions, and executives incur excise taxes, when a change in control triggers so-called golden parachute penalties under IRC Sections 280G and 4999. Although that creates a mutual interest in avoiding violations, the parties often differ about how best to fend off future problems.

The most basic employer precaution involves automatically cutting back severance (along with other amounts treated as parachute payments) in the employment agreement to the golden parachute limit (roughly three times pay). But, if representing the executive, you can employ, and try to negotiate, a variety of alternatives, sometimes called modified or limited cutbacks, that are more favorable to the executive than an automatic cutback.

Interestingly, the omission of any provision relating to golden parachute taxes can also work, because the parties would then negotiate at the time of a change in control to figure out how best to address any golden parachute implications. Because the golden parachute penalties can be so severe, waiting until the last minute is nevertheless a risky strategy. Everyone positions better to run golden parachute calculations well in advance, in order to consider precautions and to avoid later surprises.[5]

Section 409A

In addition to ordinary income tax, an additional 20% tax and late-payment penalties could result from compensation, stock award and severance programs that violate the nonqualified deferred compensation rules set forth in Section 409A. Concern should arise any time compensatory payments could occur later than the calendar year in which vesting occurs, with a particular tax nightmare looming if the exercise price for stock options does not reflect (at minimum) a good faith determination of the fair market value of the underlying shares as of the grant date.[6]

A decade after Section 409A passed, it’s now common for employment agreements to address the statute’s effect in either of two ways. On the one hand, most agreements include extensive compliance-oriented provisions to address timing issues associated with reimbursements, the six-month delay rule for specified employees of public companies, and a savings mechanism (to support interpreting the agreement to avoid Section 409A violations).

On the other hand, there is ordinarily an express disavowal of employer liability for Section 409A penalties, as well as any other taxes imposed on income that the executive recognizes pursuant to the employment agreement. Significantly, in this regard, Section 409A's 20% excise tax and late-payment penalties are imposed on executives, with the employer merely having the legal obligation to report violations and to make required income tax withholdings.

Although employers lead the drafting of employment-related agreements and equity awards, it is exceedingly rare for an employer to agree to indemnify executives for Section 409A taxes and penalties. As a result, executives should have their own Section 409A counsel provide a compliance review, especially for high-dollar agreements. Otherwise, a later discovery of Section 409A defects could find the executive bearing the tax loss.[7][8]

Indemnification

It generally suffices for an employment agreement to be silent on indemnification, on the premise the executive will have the same protections that the employer provides for other similarly situated officers and directors. But, if you're reviewing the agreement for the executive employee, you might include express provisions that secure firmer assurances and protections — sometimes merely as peace of mind. Note that indemnification protections can come from three main sources: insurance, the employer's governing documents (e.g., bylaws), or separate contractual provisions or agreements.[9]

Dispute Resolution

Attorney Fees and Other Costs

It generally benefits the employer to have the parties pay their own litigation expenses. This results if the employment agreement omits any provision about fee recovery. But a rough justice approach involves allowing the party who substantially prevails in a dispute to recover costs from the losing party. So, you might draft (or negotiate) an agreement where the executive has a right to recover from the employer if the executive substantially prevails (but not vice versa).

Governing Law, Arbitration and Exclusive Forum

Each party has an interest in litigating under the most favorable state law, in the most convenient place. Counsel for each side will normally weigh the alternatives and make recommendations. With respect to dispute resolution through arbitration, employers should generally ensure that their employment agreements reflect the employer's general preference for whether or not arbitration or mediation will be applicable and the terms of the alternative dispute resolution process. Executives will need special counsel to evaluate fair and reasonable protections and mechanisms for dispute resolution terms under the circumstances.

Mark Poerio is an attorney at The Wagner Law Group.

This article is excerpted from Lexis Practice Advisor®, a comprehensive practical guidance resource that includes practice notes, checklists, and model annotated forms drafted by experienced attorneys to help lawyers effectively and efficiently complete their daily tasks. For more information on Lexis Practice Advisor or to sign up for a free trial, please click here. Lexis is a registered trademark of RELX Group, used under license.

Law360 is owned by LexisNexis Legal & Professional, a RELX Group company.

[1] For additional Lexis Practice Advisor materials on this topic, see Executive Employment Agreement Resource Kit.

[2] Publicly available survey data is available here.

[3] For Lexis Practice Advisor materials on severance-related topics, see Severance Benefits Resource Kit.

[4] Davidson v. Henkel Corp. , 2015 U.S. Dist. LEXIS 722 (E.D. Mich. 2015).

[5] For Lexis Practice Advisor materials on the golden parachute rules, see Section 280G Resource Kit.

[6] For a checklist by which to identify potential Section 409A problems, see: https://www.executiveloyalty.org/tax---409a-checklist-employment-agreement.html.

[7] This occurred in Wilson v. Safelite Grp., Inc. , 930 F.3d 429(6th Cir. 2019) (affirming dismissal of plaintiff's suit against former employer for Section 409A taxes incurred by plaintiff arising from defective deferral elections under Section 409A on ERISA preemption grounds).

[8] For relevant Lexis Practice Advisor materials regarding the impact of Section 409A on executive compensation, see Section 409A Resource Kit.

[9] For sample indemnification language in Lexis Practice Advisor, see Indemnification Clause (Pro-employer) and Indemnification Clause (Pro-executive).