CHAPTER 11

EXECUTIVE COMPENSATION PLANNING

A. THE EXECUTIVE EMPLOYMENT AGREEMENT

1. COMMON MYTHS

The use of carefully crafted employment agreements in large organizations is forever expanding down to deeper levels to hedge against the risk of expensive litigation and the loss or dilution of valued proprietary rights. Many closely held businesses still resist the need to get things in writing with those who can do the most damage. The owners cling to the old notion that a piece of paper can't make a bad employee good or a good one better. So why bother?

Usually the reluctance to come of age on this one is a result of inertia and ignorance. A program of using smart agreements with key employees takes real effort. Since many closely held businesses do not have a separate human resources person (much less a department), the burden of the effort falls on the chief executive officer or some other high-ranking officer who already has a more-than-full plate. Add to this a few common myths that question the whole value of the effort and it's easy to let this "priority" drop to the bottom of the stack. Following are a few of the myths that often get in the way.

Myth 1: Advantage Employee. The myth is that the document produces more for the employee, less for the company. Why else would only a privileged few in the company have their own agreement? The truth is that nearly all of the key provisions in an executive employment agreement primarily benefit the company in a big way. Such provisions include termination rights, confidentiality covenants, post-employment competition restrictions, intellectual property protections, work effort requirements, dispute resolution procedures, choice of law designations and more. Even the compensation provisions benefit the company by spelling out the limits and defining expectations.

Myth 2: A Front-End Downer. The myth is that it's counterproductive to get tangled up in legal minutiae during the courting phase with a new key executive. The focus should be on positive business challenges and synergies, not potential problems that may never surface between the company and its newest arrival. The myth ignores a basic truth – nearly all prospective employees

long for the details of the whole deal. Showing that the key issues have been fairly thought through and incorporated into a document tailored for the new executive will not be viewed as a negative or an unjustified preoccupation with the dark side of business relationships. If done right, it will confirm that the company has its act together, values relationships based on detailed mutual understandings, and regards the prospective employee as a valuable part of the management team. It can actually be an "upper" that removes uncertainties and facilitates a more complete understanding of the objectives and priorities of both parties. And if an insurmountable conflict surfaces during the process, all will benefit from its early detection.

Myth 3: It's Easier After the Honeymoon. The myth is that the details of the employment relationship with a key employee are easier to hash out after the employee has been on board for a while. Everyone knows more; expectations are clearer. It's wrong. The problem is that the job won't get done. Once the employee is in the saddle, what interest will the employee have in dealing with post-employment noncompetition restrictions, broad employer termination rights, dispute resolution procedures and the like? In most situations, the company will be left with two lousy options to push the agenda along. It can get tough and demand its agreement, which may undermine morale, mutual respect, and all the other intangibles that strengthen individual business relationships; or it can offer something more, which can get expensive. Far and away the best time to work out the details and document the deal is just before the starting gun when both parties are anxious to find common ground and move forward.

Myth 4: Money Vagueness Works. The myth is that it's always smarter to not spell out the details of incentive compensation in an employment agreement. Far too often the matter is settled with a salary and some vague bonus discussions that create expectations of more money but do nothing to perpetuate individual performance objectives. The difference between real success and baseline mediocrity in many businesses is the ability and drive of the key employees who are charged with making it happen. The ability factor is tied directly to the executive's focus on specific targets of success. The drive factor is a function of how badly the executive wants to be better than good. Smart incentive compensation can keep the fire hot under both factors. Here are the key factors to consider.

- **Understandable.** The executive must be able to understand all specifics of the incentive. It can't be too complicated or tied to factors that are foreign to the executive.

- **Measurable.** The incentive should be objectively measurable. It should not be based totally on someone's discretion or will, although some subjectivity may be factored into the process. For example, the incentive for an accounts receivable manager may be a percentage of salary based on the percentage of accounts collected within 90 days (e.g., a 7 percent bonus for an 85 percent collection rate, a 10 percent bonus for a 90 percent collection rate, etc.). The plan also may give the company's CEO the discretion to increase any earned bonus by up to an additional 50 percent if the employee turnover rate in the

accounts receivable department in a given year is less than 75 percent of the company's average. Such a bonus plan would be measurable and keep the manager focused on two critical success elements – collection percentages and employee turnover.

- **True Incentive.** The incentive must be large enough to matter. If the amount at stake is insignificant, the employee may pay lip service to the objectives without ever believing that there are serious concerns that warrant additional effort and commitment.

- **Calculation Factors.** The factors that affect the calculation of the bonus should be within the control of the executive. For the CEO and CFO, it may be the overall performance of the company. But there is usually a need for more specificity down the executive ladder. For the vice president of sales, it may be the volume from new customers. For a production VP, it may be the average employee cost for each unit produced. The key is to identify specific success factors that will result in the company becoming stronger as the executive makes more. It is the classic win-win.

- **Visible Time Monitors.** Techniques that enable the company and its executives to track and monitor progress on a regular basis, at least once a month, are vital. This need for regular monitoring may require some special periodic accounting reports or some custom adjustments to the company's computer information system, but the benefits usually easily justify any added up-front effort or expense.

2. KEY ELEMENTS OF THE AGREEMENT

Ten Essential Considerations for Any Employment Agreement[1]

Theodora Lee, Lisa Chagala
Littler Mendelson, P.C.

As employment agreements become increasingly common, company counsel and human resources professionals must be alert to the specific terms of every employment contract. Failure to consider each and every term and how it will affect the employment relationship of each and every applicant and employee may have disastrous consequences. Thus, whether or not the agreement is a highly-tailored, long-negotiated agreement for an executive, or a standardized contract used for a rank-and-file employee, several key considerations apply. The following provides an overview of certain considerations; however, given the complexity of the subject matter, consultation with an experienced employment attorney is highly recommended.

1. Defining the Term of Employment

The determination of the employment term is essentially a question of management objective. Does management wish to have maximum flexibility to

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terminate the employment relationship at any time without notice? Or, does management wish to create a contractual incentive to encourage an employee to remain in employment for a certain period of time? There are essentially three types of employment provisions that may be applied to achieve these management objectives. These provisions are commonly referred to as "at-will," "drop dead," and "evergreen" clauses.

In an at-will employment relationship, either party may terminate the employment relationship at any time. The primary advantage of an at-will employment relationship is flexibility. The main disadvantage of the at-will employment relationship is that there is no incentive, in the form of a "stick," for the employee to remain employed for any period of time. Some employers choose to combine an at-will provision with a notice period. This provides the employer – and the employee – a minimum time period to make alternative arrangements in light of the upcoming termination.

A "drop dead" clause is a provision that provides that the employment relationship will end upon a particular date. The advantage of this approach is that it provides a specific end to the employment relationship. The main disadvantage of this approach is that the employer will be bound to employing the individual through the specified date. This may be costly for the employer if, for example, technologies change or it is later discovered that the individual does not possess the necessary skills for the job. To address the chance that the employment relationship will continue beyond the specified date, employers may combine a "drop dead" provision with an at-will provision, providing that the employment relationship will continue for a specific period of time (until the "drop dead" date) and thereafter will be at-will.

An "evergreen" provision is a clause that states that the employment relationship will continue for a certain period of time and then automatically renew for successive periods unless either party gives notice of intent to terminate within a certain timeframe. This has the advantage of permitting the contract to continue indefinitely, such that the incentive to remain in the employment relationship continues indefinitely. However, the automatic renewal may become more of a hindrance than help. As years pass, the employer may forget to provide notice of termination within the required timeframe.

Regardless of what employment term the employer chooses, the duration of the contractual employment relationship should be defined within the contract. Even if employment is for a stated period, it should be clear that employment may be terminated for cause at any time, and cause should be defined.

If a "drop dead" or "evergreen" provision is used, the employer should include a provision that allows the employer to terminate the employment relationship "for cause" without penalty. Cause is normally defined within the contract and varies, including extreme levels of dishonesty and nonperformance on the part of the employee. The employer will, in most cases, want the contract to survive termination of the employment relationship, to ensure that contractual protections relating to intellectual property and arbitration, for example, are effective beyond the end of the term of the employment relationship.

2. Compensation

Traditionally, employment contracts set forth the terms of compensation for the individual, including the amount of base salary the individual is entitled to receive, when pay raises would occur, and what formula would apply to calculation of incentive compensation. Employers traditionally set forth each aspect of the total rewards structure, including base salary, future salary increases, incentive compensation arrangements such as bonus programs, commissions, and stock options, and benefits programs such as medical, retirement, and stock purchase programs.

3. Arbitration

An arbitration clause is a provision that secures an employee's consent to binding arbitration as a means of resolving disputes between the employee and the employer. Such clauses can be especially valuable in disputes over termination of employment, which often trigger large claims for damages. The value of arbitration clauses in the employment context have been debated among legal professionals and human resources professionals (and within the popular press) for years. Most employers have determined resolution of disputes through arbitration offer several advantages. Arbitration can be significantly less costly than resolving a dispute through the court. Disputes are often resolved much faster through arbitration than through the courts. Disputes resolved through arbitration are significantly more private than those resolved through the courts. Additionally, the outcome of the case may be more predictable with the use of an arbitrator than a jury. On the other hand, employers have also experienced several disadvantages in arbitration. Some employers experience an increased number of disputes, due to the reduced cost to an employee of bringing a claim. Judicial review (through appeal or otherwise) is extremely limited, leaving little wiggle room in the event of a disappointing arbitration result. Furthermore, arbitration may have negative employee relations consequences, as employees may believe (perhaps incorrectly) that arbitration erodes their substantive rights. These advantages and disadvantages must be weighed before deciding whether or not to implement a mandatory arbitration policy.

4. Protections of Intellectual Property

In today's increasingly competitive marketplace, employers must protect and preserve the key assets that are essential to competitive advantage. Often, these assets are in the form of intellectual property. Employers are willing to take great efforts to preserve confidential information and intellectual property from walking out the door (and to a competitor) with a terminated employee. Employment agreements are simply one factor within a program for protecting intellectual property. Normally, such program includes informing employees and others on an ongoing basis of confidentiality requirements and adopting company-wide policies for trade secret protection. Without a comprehensive, company-wide policy, it is not likely that any clause within any employment agreement will be effective.

One means of protecting valuable intellectual property is with a covenant

not to compete. Such covenants restrict the activities of an employee after the employee stops working for the employer. Because non-compete covenants are post-employment restrictions on an employee's ability to earn a living, they are viewed in most states with disfavor and are narrowly construed. Generally, courts view covenants not to compete as enforceable only to the extent they are necessary to protect the employer's interest in its goodwill, confidential information, and customer relationships. Covenants not to compete must be narrowly tailored as to the time, geographic scope, and prohibited activity necessary to protect a legitimate employer interest. Defining what activity is prohibited is critical. Typically, the covenant will prevent persons from working for a competitor for a specific period of time in specific locations, may even name the competitors to which the clause applies, and specifies the particular work that is prohibited.

State law considerations cannot be ignored. States impose varying standards to determine whether or not covenants not to compete are enforceable, and some states altogether do not permit covenants not to compete. California is famous (or infamous) in this regard. An employer who uses a non-compete clause in California not only risks having the clause declared unenforceable, but also risks being found to have committed an unlawful business practice by including the clause in its agreements. For this reason, state law must be carefully analyzed before placing such a covenant into an employment agreement.

Non-disclosure covenants are clauses that preclude the employee from disclosing or making use of the employer's confidential information. Whether or not such provision is enforceable is a matter of state law. Generally, in order to be enforceable, such provision must be properly restricted as to time and territory and the employer must have a strong proprietary interest in protecting trade secrets. Again, analysis of state law is essential for ensuring that such a clause is enforceable and that the employer does not act unlawfully in requesting that the applicant or employee enter into such a covenant.

5. Work Effort

A provision regarding "work effort" generally states that the employee shall apply his or her best efforts at all times. The provision may also state that the employee must devote his or her entire work time and effort to the employer and will not engage in other gainful employment during the term of employment with the employer. This type of provision has certain advantages that are appealing to any employer. Restrictions on the employee's time avoids scheduling conflicts and prevents situations where transfer of intellectual property may occur.

However, important legal considerations exist for such provisions. Many jurisdictions prohibit certain restrictions on an individual's personal time. For these reasons, "work effort" provisions must be carefully drafted. A blanket prohibition on moonlighting may be replaced with a requirement that employees must avoid actual or potential conflicts of interest, or the appearance of conflicts of interest, as well as outside activities that would interfere with the employee's loyalty to the employer and ability to fulfill all job responsibilities.

6. Prior Commitments

A "prior commitments" clause is a clause that requires the employee (or applicant) to certify that he or she is not subject to any contractual commitments (such as employment agreement with former employers) that conflict with the obligations to the new employer. Such clause is important for two reasons. As a practical matter, an employer will want to know if it will only receive the benefit of part of the employee's knowledge.

7. Choice of Law Provision

A "choice of law" provision is a clause within an agreement that indicates what state law will apply in the event of a dispute. The choice of law provision is particularly important in the arena of the employment relationship. Many aspects of the employment relationship are governed by state law. Choice of law provisions are presumptively valid in most jurisdictions. However, a choice of law provision may be overcome if, for example, the jurisdiction does not have a reasonable relationship to the circumstances of the employment relationship. Choice of law provisions may also be overcome if they pose a hardship that effectively eliminates an individual's substantive rights. A provision that effectively precludes an individual from having his or her day in court (for example, requiring a disabled or financially-strapped individual to travel cross-country for litigation) will not likely be enforced. Furthermore, statutory protections (such as state wage and hour or anti-discrimination laws) may set forth specific provisions for extra-territorial reach and, thus, cannot be overcome with a contractual choice of law provision.

8. Integration and Amendment

An integration clause states that the terms of the contract constitute the complete and exclusive statement of the terms of the agreement, and that no other agreements, oral, written, or otherwise, which are not stated in the agreement will be valid. The integration clause is particularly important in the employment setting.

The provision for amendment of the agreement is similarly important. The provision for amendment specifies how the agreement may be amended. Such provision is important in the event that the employee claims that the agreement was modified after execution.

9. Liquidated Damages

A "liquidated damages" provision states an amount of money the employee will have to pay if he or she breaches the contract. Liquidated damages provisions will be enforceable only if the actual damages would be extremely difficult to ascertain. Additionally, the amount of the liquidated damages must be "reasonable." Determining whether to include a liquidated damages provision is not an exact science and is, thus, a matter of balance and judgment. With little or no potential for damages, the employee will have little incentive to comply with the terms of the agreement. For example, an employee considering termination before the end of the employment relationship will balance the cost

of the breach of the employment agreement with the value he or she will receive by going to work for the new employer. Similarly, an employee considering improper use of an employer's confidential information will weigh the costs of violating the contract with the value he or she will receive from exploiting that confidential information.

10. Execution and Document Retention Strategies

After all the effort in drafting the agreement, the final steps are most crucial: making sure the agreement is executed and retained. Retention and accessibility of the executed employment agreement is key. Steps must be taken to ensure that executed employment agreements make their way from supervisors' desks and file drawers to the company's formal document retention system.

3. CONFIDENTIALITY AND NON-COMPETE PROTECTIONS

Ten Traps to Avoid in Drafting Enforceable Confidentiality, Non-Compete, and Non-Solicitation Agreements

David J. Carr[2]

"The mistakes may be easy to make, but they're also fairly easy to avoid."

It exists as a realm of time and space, restrictions and caveats, prohibitions and exceptions, tricks and traps. The Twilight Zone? No. The Non-Compete Zone. Industrial espionage and violation of non-competes happen every day in the United States; often, they happen at the same time. What prevents your clients from being victimized? What prevents you from committing malpractice when you draft a non-compete agreement? Based on my years of practice in this area, I now provide you with my thoughts on how to avoid at least 10 (in reverse order) of the most common mistakes in this area of legal document drafting. Hopefully, this aids you in drafting the most bullet-proof, non-compete/non-solicitation/trade-secret-protecting documents possible, in this ever shifting area of practice.

Mistake 10: "What Trade Secrets?" In the recent case of *Rogerscasey, Inc. v. Nankoff,* 2002 U.S. Dist. LEXIS 7165 (S.D.N.Y. Apr. 22, 2002) *aff'd,* 50 Fed. Appx. 461 (2d Cir. 2002), two former employees of a pension fund investment consulting firm who started a competing firm were ordered by a court to not disparage their former employer, misappropriate its confidential information, or solicit its remaining employees. However, the employees were

2. Copyright © 2004 the American Law Institute and David J. Carr. Reprinted with the permission of Mr. Carr and the American Law Institute-American Bar Association Continuing Professional Education. David J. Carr is a Partner in the Labor and Employment Law section of Ice Miller. Mr. Carr is a veteran labor negotiator and has handled numerous labor arbitrations, union avoidance and other collective bargaining matters. He also has substantial experience representing employers in wrongful discharge lawsuits and employment discrimination investigations, including sexual harassment situations. This article is based on a paper the author prepared for the 2002 ABA Regional Institute Labor And Employment Law, The Basics: Trade Secrets, Covenants Not To Compete And Non-Solicitation Agreements, sponsored by the ABA's Section of Employment Law. This article is not intended as legal advice.

permitted to solicit their former employer's clients. Why? The judge found that the former employees' knowledge of clients' investment philosophies and strategies did not constitute a trade secret. Solution: Wrap your key customers and their information in:

- Trade secret status;
- Contractual proprietary status (fallback position); or
- Non-solicitation status.

You want to make as many claims as possible to protect your information. Perhaps you will not win on the non-compete claims, but you may get the same relief under your state's version of the Uniform Trade Secrets Act.

Mistake 9: "Bigger Is Better." Overbroad covenants often get thrown out, so restrictions must be reasonable. Covenants not to compete are enforceable in most states if there is a protectable interest and if the restraint is reasonable in light of legitimate interests sought to be protected. In many states, overbroad restrictions will cause the entire non-compete to be rendered unenforceable. *Licocci v. Cardinal Assocs., Inc.,* 445 N.E.2d 556, *vacated on other grounds* (Ind. 1983); *Donahue v. Permacel Tape Corp.,* 234 Ind. 398, 127 N.E.2d 235 (Ind. 1955); *Waterfield Mortgage Co. v. O'Connor,* 172 Ind. App. 673, 361 N.E.2d 924 (1977); *see also Seymour v. Buckley,* 628 So.2d 554, 558 (Ala. 1993) (applying Indiana law pursuant to license agreement's choice-of-law clause).

The employer must be able to show that the covenant is a "clear and specific restraint" not a "general restraint of trade," which is void as against public policy, and that it is "reasonable with respect to the covenantee, the covenantor, and the public interest." *Fumo v. Medical Group of Michigan City*, 590 N.E.2d 1103, 1109 (Ind. Ct. App. 1992) (*citing McCart v. H & R Block, Inc.*, 470 N.E.2d 756, 763 (Ind. Ct. App. 1984). "The ultimate determination as to whether a covenant not to compete is reasonable is a question of law for the court." *Smart Corp v. Grider*, 650 N.E.2d 80, 83 (Ind. Ct. App. 1995) (*citing Hahn v. Drees, Perugini & Co.*, 581 N.E.2d 457, 459 (Ind. Ct. App. 1991).

Reasonableness Factors. Thus, to determine whether a covenant is reasonable, courts generally consider three factors:

- Whether restraint is reasonably necessary to protect the employer's business;
- The effect of the restraint on the employee; and
- The effect of enforcement upon public interest.

Waterfield Mortgage Co., supra, *Donahue,* supra.

Courts have defined reasonableness as follows:

- "'Reasonableness is to be determined from the totality of the circumstances, i.e., the interrelationship of protectible interest, time, space, and proscribed activity.'" *Fumo,* supra, 590 N.E.2d at 1109 (*citing McCart,* supra, at 764, *quoting Frederick v. Professional Bldg. Maintenance Indus.*, 168 Ind. App.

647, 344 N.E.2d 299, 302 (Ind. Ct. App. 1976)). The length of time and geographic area restrictions should be no greater than is reasonably necessary to protect the employer's legitimate business interest;

- "A covenant not to compete is unreasonable when it is broader than necessary for the protection of a legitimate business interest in terms of the geographical area, time period, and activities restricted." *Smart Corp.,* supra, at 83 (*citing Fogle v. Shah*, 539 N.E.2d 500, 503 (Ind. Ct. App. 1989));

- "A covenant not to compete must be sufficiently specific in scope to coincide with only the legitimate interests of the employer and to allow the employee a clear understanding of what conduct is prohibited." *Id.* (*citing Field v. Alexander & Alexander of Ind., Inc.*, 503 N.E.2d 627, 635 (Ind. Ct. App. 1987)).

Geographic Scope. Absent special circumstances, such as an employee's knowledge of trade secrets or confidential information, the geographic restriction should be no broader than the employee's—not the employer's – geographic area of work. *See, e.g., Cap Gemini Am. v. Judd*, 597 N.E.2d 1272, 1288 (Ind. Ct. App. 1992) (noncompetition agreements purporting to restrict computer analysts – former employees of a company that provides computer software programming and analytical services for clients – from competing in the three-state area of Indiana, Ohio, and Kentucky, i.e., the area served by the branch in which they worked, were unreasonable because the area was broader than the geographic scope in which the employees, individually, actually worked); *Commercial Bankers Life Ins. Co. v. Smith*, 516 N.E.2d 110, 114-15 (Ind. Ct. App. 1987) (covenant restricting competition in state of Indiana was unreasonable where employee worked primarily in northern Indiana).

Activity Restrictions. With respect to activity restrictions as they relate geographic restrictions, note that: "the availability of the particular specialty practiced by the [employee] is a matter to be considered by the trial court in looking at the totality of the circumstances. Where a specialist offers services uniquely or sparsely available in a specified geographical area, an injunction may be unwarranted because the movant [former employer] is unable to meet the burden of showing that the public would not be disserved." *Fumo,* supra, at 1109. (declining to find, as a matter of law, that activity restriction on practice of gastroenterology was unreasonable and void as against public policy, given "intensely contested factual issue of whether the gastroenterology services (absent [former employee's] services) offered in the proscribed area are so deficient as to expose the public to unnecessary risks").

"Unique Competitive Advantage." The former employer must demonstrate "that the former employee has gained a unique competitive advantage or ability to harm the employer before such employer is entitled to the protection of a noncompetition covenant." *Hahn v. Drees, Perugini & Co.*, 580 N.E.2d 457, 459 (Ind. Ct. App. 2d Dist. 1991).

Reasonable Duration. The duration of the covenant must not be excessive. What is or is not excessive may vary with the nature of the former employee's job

and the employer's protectable interest. But a duration of several years is not necessarily unreasonable. For example, Indiana courts have generally affirmed covenants for terms of one to three years after employment ends. *See, e.g., Licocci v. Cardinal Assocs.*, supra; *4408, Inc. v. Losure*, 373 N.E.2d 899 (Ind. Ct. App. 1978). However, Indiana courts have occasionally upheld covenants for terms of five years after employment ends. *See, e.g., Rollins v. American State Bank*, 487 N.E.2d 842, 843 (Ind. Ct. App. 1986); *Miller v. Frankfort Bottle Gas*, 202 N.E.2d 395 (Ind. Ct. App. 1964); *Welcome Wagon v. Haschert*, 127 N.E.2d 103 (Ind. Ct. App. 1955); *but see Captain & Co. v. Towne*, 404 N.E.2d 1159 (Ind. Ct. App. 1980) (two-year covenant not enforceable).

Covered Employees. In the absence of a geographical limitation, the covenant must list a specific limited class of persons with whom contact is prohibited. *Commercial Bankers Life Ins Co. of Am. v. Smith*, supra; *Field v. Alexander & Alexander of Ind.*, 503 N.E.2d 627 (Ind. Ct. App. 1987). *See also College Life Ins Co. of Am. v. Austin*, 466 N.E.2d 738 (Ind. Ct. App. 1984) (lack of durational and geographic limitations renders covenant void as against public policy); *Ebbeskotte v. Tyler*, 142 N.E.2d 905 (Ind. Ct. App. 1957) (a covenant indefinite as to time but very narrowly limited in geographic area is enforceable). In *JAK Productions, Inc. v. Wiza*, 986 E2d 1080 (7th Cir. 1993), the Seventh Circuit strongly reaffirmed the Indiana "blue pencil" rule for noncompete clauses in employment agreements, and highlighted the importance of defining the employer's protectable customers in the employment agreement. Here, the court allowed a customer restriction to be enforced by the employer, even where the restriction required court-imposed limitations to be enforceable.

Mistake 8: "One Size Fits All, Right?" A post-employment restrictive covenant also must be ancillary to the main purpose of an employment or compensation agreement. *Ohio Valley Communications v. Greenwell,* 555 N.E.2d 525 (Ind. Ct. App. 1990); *Woodward Ins. v. White,* 437 N.E.2d 59 (Ind. 1982) (covenant is valid when covenant and contract have significant nexus to employment situation such as to render covenant ancillary to employment situation and necessary to protect legitimate rights of the employer). So one size does not fit all. This maxim is also jurisdictional: You should never assume that a non-compete agreement enforceable in one state will be enforceable in all states, or that your choice of law provision will be respected in all states.

Mistake 7: "We'll Let the Court Tell Us What's Enforceable." Blue penciling is limited in many states. Some courts refuse to rewrite contracts after the fact; and some courts will only strike language, not add new language. *See, e.g., College Life Ins. Co. of Am v. Austin,* supra (absence of temporal and area terms made covenant overbroad and court declined to rewrite covenant so as to make it reasonable); *Donahue v. Permacel Tape Corp.,* supra (court declined to enforce three-year restriction that purported to restrict competition in United States and Canada). As the Indiana Court of Appeals put it in *Smart Corp. v. Grider,* supra, at 83-84 (Ind. Ct. App. 1995):

"If the covenant as written is not reasonable, the courts may not create a reasonable restriction under the guise of interpretation," because to do so would

subject the parties to an agreement they have not made. *Licocci v. Cardinal Associates, Inc.,* supra. However, if the covenant is clearly separated into parts and some parts are reasonable and others are not, the contract may be held divisible and the reasonable restrictions enforced. *Id*. In such cases, unreasonable provisions are stricken and reasonable provisions may be enforced under the blue pencil process. *Hahn [v. Drees, Perugini & Co.* (1991), Ind. App., 581 N.E.2d 457,] 462. Blue penciling must be restricted to applying terms which already clearly exist in the contract and the court's redaction of a contract may not result in the addition of terms that were not originally part of the contract. *Id*. Simply put, if practicable, unreasonable restraints are rendered reasonable by scratching out any offensive clauses to give effect to the parties' intentions. *Seach v. Richards, Dieterle & Co.* (1982), Ind. App., 439 N.E.2d 208, 215." *See also Licocci v. Cardinal Assocs.*, supra, at 452 (if covenant is clearly separated into parts and some parts are reasonable and others are not, contract may be held divisible and reasonable restrictions may then be enforced); *Welcome Wagon v. Haschert*, supra (court upheld five-year limitation against former employee of advertising and sales promotion business as to city in which employee had performed services, but declined to enforce restriction as to any other city in which employer was doing, or planned to do, business).

Courts Are Not Obligated to Blue Pencil. But the courts are not compelled to blue pencil. *See Frederick v. Professional Bldg. Maintenance Indus.*, 168 Ind.App. 647, 344 N.E.2d 299, 302 (Ind. Ct. App. 1976) (if restrictive covenant is unreasonable, court may not enforce reasonable restriction under guise of interpretation). For instance, where the geographic term is too severe, the court may decline to blue pencil, even if the terms of the covenant are separable. *South Bend Consumers Club v. United Consumers Club*, 572 F.Supp. 209 (N.D. Ind. 1983) (a franchisee's covenant not to compete for two years within 25 miles of any of franchisor's outlets was unreasonable as a matter of Indiana law and court declined to blue pencil).

Mistake 6: "We Don't Need No Stinkin' Consideration." We all know about the famed barleycorn (or was it a peppercorn?) at midsummer. Many states require independent consideration for an employment contract. Delay in signing the non-compete after employment commenced is dangerous, because the job is often sufficient consideration; continued employment may not be enough. The consideration can be nominal: one day's extra notice on termination, a holiday – whatever. But there has to be something.

In most states, a covenant not to compete signed at the inception of employment provides sufficient consideration for the covenant not to compete. *Advanced Copy Prods. v. Cool*, 363 N.E.2d 1070 (Ind. Ct. App. 1977) (provision requiring 30 days' notice of termination is sufficient consideration to support covenant not to compete). In *Ackerman v. Kimball Int'l Inc.*, 652 N.E.2d 507 (Ind. 1995) (employer's promise in employment agreement, made nine years after employment began, to continue to employ employee at-will, and ratification of non-superseding termination agreement, made in 1994, gave consideration for afterthought covenant in employment agreement; expressly adopting and incorporating by reference portion of court of appeals opinion on this issue,

contained at *Ackerman v. Kimball Int'l Inc.*, 634 N.E.2d 778, 780-81 (Ind. Ct. App. 1994)); *see also Rollins v. American State Bank*, 487 N.E.2d 842 (Ind. Ct. App. 1986). In Indiana, the promise of continued employment is currently sufficient consideration for a covenant not to compete. *Leatherman v. Management Advisors*, 448 N.E.2d 1048 (Ind. 1983).

Mistake 5: "Who Cares Whether It's Assignable?" What was that in law school about non-assignability of personal service contracts? With respect to non-competes, they must be assignable and assigned in the purchase agreement. Failure to assign can be disastrous.

A number of courts follow the general rule that personal service contracts, including covenants not to compete, may *not* be assigned. *Norlund v. Faust*, 675 N.E.2d 1142 (Ind. Ct. App. 1997), *clarified on other points*, 678 N.E.2d 421 (Ind. App. 1997); *SDL Enters., Inc. v. DeReamer*, 683 N.E.2d 1347, 1349 (Ind. Ct. App. 1997). However, an exception to this general rule exists when:

- The original agreement specifically allows assignment by the employer (*Peters v. Davidson*, 359 N.E.2d 556, 562 (Ind. Ct. App. 1977)); or

- The employee consents to the assignment. *Norlund*, supra, at 1151; *SDL*, supra, at 1349-50.

Nonetheless, the wise counsel will always include a "savings clause" in the non-compete. *See Dicen v. New Sisco,* 806 N.E.2d 833 (Ind. App. 2004).

Assignment Permitted In Original Agreement. Many courts are able to apply the first exception by merely reading the original contract. If the original contract contains language which provides that the rights and obligations under the agreement are assignable and transferable, then the non-compete agreement may be assigned without consent from the employee. *Peters*, supra, at 558. It should be noted, however, that the actual facts in *Peters* were similar to those in *Norlund*, in that the employee continued to work without objection after the assignment. *Id.* Consequently, the court probably could have also based its holding on the "consent" exception discussed below, rather than merely relying on the language of the original contract.

Employee Consent. In Indiana, the second exception to the general rule forbidding assignment relies more heavily on the court's discretion. A non-compete agreement may be assigned absent any language in the agreement regarding assignability if the employee subsequently consents to the assignment. *Norlund*, supra, at 1151; *SDL*, supra, at 1349-50. The court in *Norlund* held that this "consent" may arise solely from the actions of the employee. *Norlund*, supra, at 1152. The court held that an employee has consented to an assignment if:

- The employee knew of the assignment; and

- The employee knowingly continues his employment with the assignee. In *Norlund*, the court found that an employee had consented to the assignment by continuing employment with the assignee after learning that the assignment took place. *Id.*

Mistake 4: "It's Protectable if I Say It's Protectable, Dangnabit!" An employer can't just pluck a "protectable interest" out of thin air. It has to exist independently of the non-compete. Customer goodwill and trade secrets are legitimate protectable interests. Putting janitors under a non-compete is futile and dangerous. Most courts will not enforce a covenant not to compete unless an employer can show a protectable interest. "It is evident where the underlying protectable interest appears minimal, courts are apt to closely scrutinize the terms of the restraint." *Slisz v. Munzenreider Corp.,* 411 N.E.2d 700, 705 (Ind. Ct. App. 1980). "In Indiana, a noncompetition covenant may be valid to prevent an employee from using his employment relationship for his own benefit or for the benefit of a competitor." *Cap Gemini Am. v. Judd,* 597 N.E.2d 1272, 1288 (Ind. Ct. App. 1st Dist. 1992) (*citing Commercial Bankers Life Ins. Co. v. Smith,* 515 N.E.2d 110, 112 (Ind. Ct. App. 1987)). In Illinois, existing customers are the employer's protectable interest; however, the employee also has a protectable interest in his or her pre-existing relationships. *See Lawrence & Allen, Inc. v. Cambridge Human Resource Group, Inc.,* 685 N.E.2d 434, 441 (Ill. Ct. App. 1997).

Typical Protectable Interests. Covenants have been enforced to protect an employer's confidential information, customer lists, goodwill, investment in special training or techniques, and actual solicitation of customers. *See, e.g, In re Uniservices*, 517 F.2d 492 (7th Cir. 1975) (former employer has no protectable interest in customer lists and information that can be obtained by lawful surveillance, but information on customer requirements, habits, and preferences may be confidential and, thus, a protectable interest); *McCart v. H & R Block, Inc.*, 470 N.E.2d 756 (Ind. Ct. App. 1984); *Captain & Co. v. Towne*, 404 N.E.2d 1159 (Ind. Ct. App. 1980); *Welcome Wagon v. Haschert*, supra. As stated in *Hahn*, supra, at 460:

> "[An employer is] entitled to protect the 'good will' of its business, which includes such things as 'names and addresses and requirements of customers and the advantage acquired through representative contact....' *Donahue [v. Permacel Tape Corp.*, 234 Ind. 398, 127 N.E.2d 235, 240, (1955)]. Included also in [the former employer's] protectable good will interest is the right, via a proper covenant not to compete, to restrict a former employee from enticing away the employer's old customers. *Id.* at 241; *see also Licocci [v. Cardinal Assocs.*, 445 N.E.2d 556, 563 (Ind. 1983).]"

Generally, an employer has no protectable interest in restricting contact with its past customers or clients. *Hahn,* supra, at 461. Although *Seach v. Richards, Dieterle & Co.*, 439 N.E.2d 208 (Ind. Ct. App. 1982), may be read to create a narrow exception to the general prohibition against restricting contact with a former employer's past clients, the *Seach* court itself expressed skepticism of the practice of restraining former employees from doing business with past customers of their employers. *Hahn,* supra, at 461. The *Seach* court stated:

> "Such a limitation [regarding when past clients with whom contact is prohibited may have been customers of the employer] *might* take the

> form of proscribing contact with customers who have done business with the employer within one year prior to the employee's termination of employment. Any limitation would necessarily have to reflect the nature of the business involved in setting what is a reasonable time limit, and would also have to be formulated to protect and accommodate the valuable interests of the employer, such as customer lists and in-house knowledge." *Seach,* supra, at 214 n.4 (citation omitted); *Hahn, supra*, at 461 n.4. For purposes of this opinion, and generally, a "present" client is a client that did business with [the employer] during [the employee's] employment...."

Hahn, supra, at 460 n.3. *See also Smart Corp v. Grider*, supra, at 83 ("A former employer has a legitimate business interest in restricting its former employees from enticing away the employer's old customers"), citing *Hahn*, 581 N.E.2d at 460).

No Protectable Interest In Employee's General Knowledge. However, an employer has no protectable interest in the general knowledge, information, and skills gained by an employee in the course of his or her employment. *Brunner v. Hand Indus.*, 603 N.E.2d 157 (Ind. Ct. App. 1992) (metal polisher; clause in employment contract requiring employee to repay costs of training, on basis of sliding scale increasing from $2,200 for less than two months' work to $20,000 for 24-36 months' work, is unreasonable anticompetitive restraint rather than attempt to recoup legitimate training expenses; sliding scale could have made employees liable for amounts greater than all wages they had received from employer).

In *Brunner*, the defendant employee was a polisher of orthopedic products for plaintiff employer. As a condition of employment the employee was required to execute a noncompete agreement. The agreement stipulated that if he were to take employment with a competing business, he would have to reimburse the employer, ostensibly for the investment in his training, pursuant to a payment schedule based on length of service with the employer. The employee left the employer's service and the employer attempted to enforce the agreement. The court of appeals held that the agreement unreasonably restricted the protectable interests of the employee and was thus unenforceable. The court noted that the record did not disclose that the employee had taken customer lists, confidential information, or other trade secrets with him. In addition, although the agreement specified no definite duration of employment, the employer was attempting to impose a substantial burden on the employee for his acquisition of "general knowledge and skills." The final straw seemed to be the fact that, under the reimbursement scheme, it was possible for a departing employee to be liable for more than all of the wages he received during employment.

Trade Secrets. Courts will also enforce a covenant to protect a "trade secret" as that term is defined by the Uniform Trade Secrets Act, Ind. Code § 24-2-3-2 (2004). *Ackerman v. Kimball Int'l, Inc.*, supra. However, in 1995, the state supreme court in *Ackerman*, "wr[o]te to clarify that otherwise unenforceable covenants not to compete do not automatically become enforceable solely

because an employee is in possession of trade secrets." *Id*. at 508. Information that is readily or easily available is not a trade secret under the Act. *College Life Ins. Co. of Am. v. Austin*, supra.

Blacklisting/Tortious Interference Claims. Many states will look very seriously at an employer's misuse of a non-compete provision in terms of potential counterclaims *against the employer!* In *Bridgestone/Firestone v. Lockhart*, 5 F.Supp.2d 667 (S.D. Ind. 1998), a federal district court not only refused to find for the employer on the employer's attempted enforcement of a non-compete, it found for the employee on the employee's claim against the employer for alleged "blacklisting" – using the non-compete as a means of interfering with the employee's future employment opportunities. In so doing, the court awarded the employee $50,000 in attorneys' fees, and seriously considered awarding punitive damages.

Subsequent decisions have limited these "blacklisting" claims. *Burk v. Heritage Food Service Equipment*, 737 N.E.2d 803 (Ind. Ct. App. 2000). ("Blacklisting" may not be asserted by the employee if the employee voluntarily resigned from employment.) Nonetheless, tortious interference claims appear viable for many situations where an employer engages in overzealous pursuit of non-compete enforcement.

Mistake 3: "I'm Not Paying an Ex-employee Not to Compete." Courts show far more generosity to employers, and their non-compete provisions, when they are actually paying ex-employees not to compete. "In-term" covenants may be much broader in scope. Any issue of bad faith by the employer will hurt the enforcement of the covenant, and may create claims for breach of the duty of good faith and fair dealing. *See Weiser v. Godby Bros.,* 659 N.E.2d 237 (Ind. Ct. App. 1995). Consider adding language to your non-compete paying the employee some percentage of base salary to serve as a consultant for one year after the end of employment, with the additional caveat that no competing conduct will occur by the employee anywhere in the world during that period.

Mistake 2: "Why Would I Want to Talk to an Employee Who Has Quit?" There are a few good answers to this:

- To make sure they know their non-compete obligations;
- To make them commit to paper that they haven't taken anything; and
- To show you care about trade secrets.

Mistake 1: "Warranties Are for Used Cars." This notion is wrong on quite a few levels, but its potential for mischief with respect to non-competes is huge. Always ask questions, and be sure to get the employee's signature. You don't want to find something in the trunk of the employee's car after discovery has commenced. Key language:

Employee hereby warrants and represents as follows:

a. That the execution of the Agreement and the discharge of Employee's obligations hereunder will not breach or conflict with any other contract,

agreement, or understanding between Employee and any other party or parties.

b. Employee has ideas, information and know-how relating to the type of business conducted by SmartCo., and Employee's disclosure of such ideas, information and know-how to SmartCo. will not conflict with or violate the rights of any third party or parties.

I hereby affirm and attest that I have also returned, or will return by _______, all copies of any of the above listed items. I understand that while I have the right to use in any future employment any general knowledge of the trade/industry obtained as a result of my employment with SmartCo., I must at all times conform my conduct to the requirements of the applicable trade secrets law, and my SmartCo. non-compete obligations.

As required by the law of trade secrets, I will not misappropriate (e.g., use or disclose to any third party) any trade secret of SmartCo. I recognize that the penalties for a trade secret violation may include disgorgement of profits, payment of royalties, compensatory damages, punitive damages, and attorneys fees. I understand that I can ask SmartCo. to render an opinion as to whether SmartCo. considers certain knowledge to be a trade secret, if such a question should arise.

CONCLUSION. Armed with these 10 tips, go forth and serve your clients well. However, beware that this area of law remains volatile, fluid, and oft-litigated. Admonish clients to review and update their agreements at least every two years.

PROBLEM 11-A AND 11-B

11-A. Larry Smyth is the primary owner and CEO of a growing computer hardware distribution company. The company has 120 employees, which includes 10 managers. Larry feels that there is a compelling need to boost employee morale. He believes the problem is at the top. Seven of his 10 managers are "just logging time." Most employees are paid by the hour. The managers are all salaried. The company has sporadically paid bonuses in the past, but bonuses are not something any employee expects.

Larry has decided to adopt a cash bonus program for his 10 managers, in hopes that the plan will fire up the managers to get the place hopping. He has decided to divide 25 percent of the pre-tax income of the business among the 10 managers in equal shares each year. The bonuses will be paid within two weeks of the completion of the year-end financials.

Larry has asked you to draft a bonus plan document that can be reviewed and approved by the other two shareholders (both of whom serve on the Board) and the managers. He has also asked you to share your thoughts on his plan. What do you think of Larry's plan? Why might it be a waste of money? How might it backfire and create bigger morale problems? Is it oversimplified? What are the components of an effective cash bonus plan that Larry should consider? Is this something that a lawyer should even be concerned about? Why do you think Larry would ask your opinion?

11-B. Duke Longer, the CEO of Waldon Technologies, has just completed a negotiation to hire Jane Smith, a talented software designer. Jane will relocate from Boston to Seattle. Jane's salary will be high by Waldon's standards. Duke wants to ensure that Jane is "tied to the company for at least three years" but that the company "can get out of the deal after three years." Duke also wants to ensure that everything that Jane creates while working for the company will remain the exclusive property of the company.

Jane wants assurance that her high salary will be protected for the long-term. Her move from her hometown of Boston and her family is viewed as a sacrifice that is justified only by the promise of "big bucks" for the long-term. Plus, Jane routinely creates software on her off hours that has nothing to do with her job. She wants to make it clear that she will own all rights to such off-hour creations.

What middle-ground solutions should the attorneys for Waldon and Jane explore in putting together the employment agreement?

B. DEFERRED COMPENSATION: SERPs

1. THE RETIREMENT CHALLENGE

Many executives rank retirement planning as their number one financial concern. They want to know that they are going to "have enough" and are not going to outlive their financial resources. For many executives, the solution is a special supplemental executive retirement plan (SERP) provided by their employer. The company's regular qualified retirement plan is too watered down to do the job. An old-fashioned savings program is too tough, and social security, even if available, is hopelessly inadequate.

For decades companies have recognized the value of individually-tailored retirement arrangements for their key executives. These arrangements are routinely used to recruit and retain valuable executives. The substantial benefits that accrue under the plan over time create a powerful incentive for the executive to toe the line and not even consider flirting with the competition.

A key factor in many SERPs is life insurance. Often, it is the life insurance that breathes life into the SERP, hedges the financial risks for the company, and makes the whole effort "doable." The question is often asked: Why life insurance as opposed to some other investment? The answer lies in the three "tax-frees" of life insurance: the tax-free death benefit, the tax-free inside buildup within the policy, and the tax-free loan withdrawal privileges.

2. A SERP EXAMPLE

Peter is 55 years of age. He is the chief executive officer of a growing manufacturing company and has served in that capacity for five years. The company is privately owned, and Peter has no hope of ever receiving any equity. The stockholders consider Peter indispensable to the ongoing success of the company and want to ensure that he remains in his position for at least another 10 years. They want to bind him to the business. Peter is concerned about his retirement needs and has voiced that concern to the owners.

A deal has been worked out to provide Peter a special supplemental retirement benefit that will commence on his retirement at age 65. The benefit, equal to 70 percent of Peter's highest average salary during any remaining three-year period of his employment with the company, will be paid monthly so long as Peter or his wife is living. Peter estimates that the annual benefit should be at least $250,000 if he continues to receive salary increases as he has in the past. Absent death or disability, Peter must remain with the company to age 65 in order to receive the benefit. If he dies or becomes disabled before age 65, the benefit will commence on the second month following his death or permanent disability.

The plan accomplishes the objectives of both parties. The company and its owners are assured of Peter's continued service and loyalty, and Peter's retirement concerns are put to rest. Following are brief reviews of the tax traps, structural options, collateral consequences, and funding alternatives that often need to be considered in the planning process for such a plan.

3. SERP TAX TRAPS

The plan for Peter is based on the premise that no income taxes will need to be paid on any SERP benefits accrued under the plan until the benefits are actually paid to Peter or his wife. As a deferred compensation plan, a SERP is subject to the tax traps that need to be carefully watched whenever income is deferred.

a. The Constructive Receipt Trap

The first tax trap is the constructive receipt doctrine. Income is taxable in the year in which it is "received by the taxpayer."[3] If the constructive receipt doctrine applies to a SERP, the executive will be in the unfavorable position of having to pay taxes on money that he or she has not received. The mere deferral of the actual receipt of income will not guarantee deferral for tax purposes because the phrase "received by the taxpayer" encompasses "constructive receipt" as well as actual receipt of income.[4] Income is constructively received by a taxpayer when it is "credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given."[5]

The constructive receipt trap can be an issue in those situations (unlike Peter’s) where an executive elects to defer the receipt of compensation in order to fund a SERP benefit. The key is such situations is to ensure that the executive makes the election to defer the income before the services are rendered and the compensation is earned.[6] The constructive receipt doctrine may also become a problem if the executive at any point in time is given the unrestricted right to draw money out of the plan.[7]

3. I.R.C. § 451(a).
4. Reg. § 1.451-1(a).
5. Reg. § 1.451-2(a).
6. Rev. Proc. 71-19, 1971-1 C.B. 698, amplified Rev. Proc. 92-65, 1992 C.B. 428; I.R.C. 409A(a)(4)(B)(i).
7. Reg. § 1.451-2(a). See Martin v. Commissioner, 96 T.C. 814 (1991) for a discussion of the facts that

b. The Economic Benefit Trap

The second trap is the economic benefit doctrine. Even if the employee is not deemed to have constructively received the income, the employee's opportunity to defer taxation may be derailed if he or she receives an economic benefit from the deferred amount that is the equivalent of cash.[8]

The doctrine usually surfaces when the employer's obligation to pay the deferred compensation is somehow "funded" and the employee acquires an interest in the funding vehicle. Examples include an escrow account for the executive, a trust vehicle to fund benefits for an executive,[9] an annuity contract naming the executive as an owner,[10] and a life insurance policy that guarantees the executive the cash value of the policy in the event of employment termination.[11]

In structuring any deferred compensation arrangement, the planner needs to keep both the constructive receipt doctrine and the economic benefit doctrine in mind. The economic benefit doctrine is clearly the more nebulous of the two and the one that often causes the greatest concern. A red flag should go up whenever an employee (1) receives a substantial economic or financial benefit from a non-qualified funding vehicle, particularly if the benefit is not forfeitable; (2) has the ability to assign his or her rights under that funding vehicle to an outside third party; or (3) has any other right or capacity to convert his or her rights under the funding vehicle to cash.

c. The Section 83 Trap

The third trap is found in Section 83 of the Internal Revenue Code. It's similar to the economic benefit trap. Section 83 provides that, when property is transferred to an employee as compensation for services, the employee is taxed on the fair market value of the property at the time it is received if the property is transferable or is not subject to a substantial risk of forfeiture.[12] If the property is subject to a substantial risk of forfeiture, as is the case when the employee's rights to the property are contingent upon the employee remaining in the service of the employer, no tax will be incurred until that risk of forfeiture lapses or the property becomes transferable.

As regards a deferred compensation plan such as a SERP, the positive news is that the regulations under Section 83 provide that an unsecured and unfunded promise of an employer to pay deferred compensation does not constitute "property" for purposes of Section 83.[13] If the participant receives nothing more than the unsecured contractual promise of the company, there is no Section 83 problem. In all other cases where the participant is offered something extra, it is

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impact such an application of the constructive receipt doctrine.

8. Rev. Rule 60-31, 1960-1 C.B. 174 (Example 4); Sproull v. Commissioner, 16 T.C. 244 (1951), affirmed per curiam 194 F.2d 541 (6th Cir. 1952); Rev. Rule 62-74, 1962-1 C.B. 68; Commissioner v. Smith, 324 U.S. 177 (1945).

9. Sproull v. Commissioner, 16 T.C. 244 (1951), affirmed per curiam 194 F.2d 541 (6th Cir. 1952); Jacuzzi v. Commissioner, 61 T.C. 262 (1973).

10. Brodie v. Commissioner, 1 T.C. 275 (1942).

11. See, for example, Frost v. Commissioner, 52 T.C. 89 (1969).

12. I.R.C. § 83(a).

13. Reg. § 1.83-3(e).

necessary to take a hard look to see whether Section 83 has been triggered.

Plus, as described below, section 409A has now breathed new life into Section 83 when an offshore funding vehicle or an employer financial health trigger is used in connection with a nonqualified deferred compensation arrangement.[14] If Section 83 applies and the deferred amounts are not subject to a substantial risk of forfeiture, the employee will be hit with a current tax.

d. The Reasonable Compensation Trap

The fourth trap is the old "reasonable compensation" requirement of Section 162. This trap focuses on the tax treatment to the company, not the participant. The company wants to secure a deduction when the deferred compensation is paid to the employee. If the compensation is being paid to a shareholder/employee and is determined to be excessive within the meaning of Section 162, the company will lose its deduction.[15] The result is a double tax. Reasonableness is based on the facts and circumstances that exist at the time the contract is made, not those that exist when the contract is called into question.[16] For planning purposes, the challenge in any potentially troublesome situation is to carefully document the facts and circumstances that support a "reasonableness" determination at the time the plan is adopted by the company so that, if required, a sound case can be made at a later date.

e. The 409A Traps

As deferred compensation tax traps go, the newest and toughest kid on the block is section 409A,[17] which was added by the America Jobs Creation Act of 2004. This section imposes specific statutory requirements that every nonqualified deferred compensation plan must meet. It does not replace the traps described above; it adds to them.[18] The 409A statutory requirements are not unduly burdensome in most normal situations; they are primarily designed to cause problems for those who play on the outer limits of the other traps. But they have real teeth. If a Section 409A requirement is violated, the participant is immediately taxed on all deferred amounts that are not subject to a substantial risk of forfeiture, plus he or she gets hit with an interest charge calculated at a rate one percent above the normal underpayment rate ***and an extra 20 percent tax*** on the deferred amount included in income.[19] Section 409A is not a "no harm, no foul" statute. It can hurt. Here are brief descriptions of some of the key Section 409A requirements:[20]

- Amounts deferred under the plan may not be distributed[21] before the participant's separation from service,[22] the participant's disability,[23] the

14. I.R.C. § 409A(b).
15. Reg. § 1.162-7(b)(1).
16. Reg. § 1.162-7(b)(3).
17. I.R.C. § 409A.
18. I.R.C. § 409A(c).
19. I.R.C. § 409A(a)(1).
20. Extensive regulations to Section 409A were finalized in 2007. Reg. § 1.409A.
21. I.R.C. § 409A(2).
22. For a "specified employee," the separation from service requirement is not met if a payment is made before the date which is six months after the separation of service. A "specified employee" is a key employee (as defined in section 416(i) without regard to paragraph (5)) of a corporation any stock of which is publicly

participant's death, the specified time or payment schedule in the plan, a change in the ownership or control of the corporate employer or a substantial portion of the assets of the corporate employer,[24] or the occurrence of an unforeseeable emergency.[25] What is not permitted is fuzzy payout language or schedules designed to give executives discretion over when they can get the deferred amounts.

- The plan may not permit the acceleration of the time or schedule for the payment of benefits, except as provided by regulations.[26]

- The plan may not give an employee an election to defer compensation earned during a taxable year after that year begins. The election must be made by the close of the preceding taxable year.[27] There are two exceptions. If it's the employee's first year in the plan, the election may be made within 30 days after the employee becomes eligible, but the election may relate only to services performed after the election.[28] Also, for performance-based bonuses that are based on services rendered over a period of at least 12 months, the deferral election may be made no later than 6 months before the end of the period.[29]

- The plan may not give an employee an election to further delay the payment of benefits under the plan unless the plan requires that (i) any such election not take effect until at least 12 months after it is made, (ii) the extended deferral period is not less than five years (except in the case of death, disability and unforeseeable emergency), and (iii) any additional delay in an election relating to a specified time or fixed payment schedule provision must be made at least 12 months before the first scheduled payment under such provision.[30]

- Assets held outside the United States and set aside (directly or indirectly) to pay benefits under a deferred compensation plan will be considered property under Section 83, thus triggering a recognition of taxable income for the employees, plus the 409A interest charge and the 409A extra 20 percent tax.[31] Lesson: Do not earmark any assets that are held in offshore accounts as having anything to do with a deferred compensation plan.

- Employer assets that become restricted to the provisions of a deferred

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traded. I.R.C. § 409A(a)(2)(B); Reg. § 1.409A-1(i)(1).

23. Disability generally requires a condition that can be expected to result in death or can be expected to last for at least 12 continuous months and that prevents any "substantial gainful activity" or that entitles the participant to receive income replacement benefits for not less than three months under an accident and health plan covering employees of the company. I.R.C. § 409A(a)(2)(C); Reg. § 1.409A-3(i)(4)(i).

24. See Reg. § 1.409A-3(i)(5).

25. An "unforeseeable emergency" means a severe financial hardship resulting from (i) an illness or accident of the employee, a spouse or a dependant, (ii) a loss of property due to casualty, or (iii) similar extraordinary and unforeseen circumstances beyond the control of the employee. I.R.C. § 409A(a)(2)(B)(ii); Reg. § 1.409A-3(i)(3)(i).

26. I.R.C. § 409A(a)(3). The Regulations provide that accelerated payments may be permitted to fulfill a domestic relations order, to pay income taxes due upon a vesting event under a plan subject to section 457(f), and to pay FICA taxes on compensation deferred under the plan. Reg. § 1.409A-3(i)(4).

27. I.R.C. § 409A(a)(4)(B)(i); Reg. § 1.409A-2(a)(3).

28. I.R.C. § 409A(a)(4)(B)(ii); Reg. § 1.409A-2(a)(7).

29. I.R.C. § 409A(a)(4)(B)(iii). Reg. § 1.409A-2(a)(8). At a minimum, the bonus must be contingent on performance criteria and may not be substantially certain at time of deferral. Reg. § 1.409A-1(e)(1).

30. I.R.C. § 409A(a)(4)(C); Reg. § 1.409A-2(b).

31. I.R.C. § 409A(b)(1),(3),(4).

compensation plan as a result of a change in the employer's financial health will be considered property under Section 83, thus triggering a recognition of taxable income for the employees, plus the 409A interest charge and the 409A extra 20 percent tax.[32] Lesson: Don't include in the plan any provision dealing with a change in the employer's financial health.

- If the company maintains a single-employer defined benefit plan that has not been adequately funded (i.e., is considered "at risk" within the meaning of Section 430(i)), any assets set aside for the payment of deferred compensation benefits to the company's chief executive officer, the company's four highest paid officers, or any individual subject to Section 16(a) of the Securities Exchange Act of 1934 will be treated as property taxable under Section 83.[33]

4. STRUCTURAL BASICS AND COLLATERAL CONSEQUENCES

A SERP is a private contract between the company and the executive. The primary components of the contract are: (1) the formula or basis for determining the amount of the SERP retirement payments; (2) the circumstances under which the SERP payments will be paid or not paid; and (3) the method of payment, such as a lump-sum cash-out, monthly installments, a life annuity, or some combination of these. The contract may contain other provisions based on the circumstances and the purpose of the SERP. The company gets no tax deduction until the amounts are actually paid to the executive, and the executive realizes no taxable income until the benefits are received.

a. Plan Early. The key to preserving the tax deductibility of the benefit payments under a SERP, particularly when the employee is also an owner of the business, is to establish the SERP many years prior to the date of retirement. If a SERP is established just prior to retirement, the IRS may challenge the company's deduction for the payments on the ground that they represent unreasonable compensation for a short period. If the employee is a stockholder, there is always the risk that the payments will be considered dividends or buy-out payments rather than true retirement benefits. In such a situation, the key is to make sure that the retirement benefit accrues over a sufficient number of years such that it is fair and reasonable compensation for services rendered during the years of accrual.

b. Benefit Formula. The company has flexibility in structuring the benefit accrual formula under the contract. The only limitation in structuring the arrangement is that it be reasonable. The formula may accrue a fixed sum each year, may be based on a defined monthly benefit at retirement, may be adjusted for inflation, may be based on accumulated years of service, or may consider any other factors that are reasonable. The retirement benefit accrual should be prospective, not retroactive. Typically a SERP does not involve deferral elections by the executive; it just specifies the benefits that will be paid by the company and the conditions of payment. From a tax standpoint, the safest approach is to structure the SERP so that the supplemental retirement benefit accrues after the date the agreement is executed. And, as previously noted, the amount of the

32. I.R.C. § 409A(b)(2),(3),(4).
33. I.R.C. § 409A(b)(3).

accrued benefit under the plan each year plus the amount of the current compensation must, in combination, constitute reasonable compensation for services rendered during the period.

c. Elective Deferrals. The SERP benefit can be structured as an elective benefit, similar to a 401(k) plan. With this approach, the employee is given the right each year to elect to defer an amount of compensation that will be paid out at retirement or termination of employment. Alternatively, the SERP can be structured as an add-on, employer-provided benefit that doesn't involve any employee election. If the elective approach is used, the key is to make sure that the deferral election is in writing and that the election to defer compensation for any given taxable year is made prior to the beginning of that year. If the election to defer compensation earned during a given year is made after the year begins, the employee will be taxed currently on the deferred amount and will be subject to the interest and extra 20 percent tax provision of Section 409A – a disaster.

d. Method of Payout. Another issue that must be addressed in the SERP agreement is the method of paying out the benefit. Typically the payout form is described in terms of a monthly payment for life or a term of years. Often the SERP provides for a lump-sum payment upon the death of the employee prior to retirement. The key is to ensure that the payout options are definitive enough to conform to the permissible payout options of Section 409A. Another important feature of many SERPs is a provision that gives the company the option to cash out any accrued benefits if the company is sold. This provision will help the company bail out proceeds received from the sale with tax-deductible dollars. Also, such a cash-out feature will benefit the purchaser who has no interest in picking up the SERP liability or perpetuating the SERP plan. A SERP can be structured to impose golden handcuffs on key employees. There are no restrictions on conditions or forfeiture limitations. The plan may provide that the benefits are reduced or eliminated if a key employee signs on with a competitor or voluntarily departs before retirement.

e. Regulatory Requirements. As with other nonqualified deferred compensation plans, SERPs are not subject to the same type of IRS and Department of Labor regulatory requirements that plague qualified retirement plans. A SERP needs to steer clear of any Section 409A foul-ups and the other tax traps. ERISA regulations are no big deal so long as the benefits are unfunded at all times and are made available only to a select group of highly compensated employees.

f. Funding. The SERP should be an unfunded obligation of the company in order to qualify for the ERISA exemption and avoid an early tax hit to the employee. This means that the company cannot set aside funds in a separate trust that is legally earmarked for the benefit of the SERP participants and is beyond the reach of the company's creditors. Although legal funding is taboo, the company can still prepare for the day when the SERP payments will commence. This is done by establishing an informal funding program. The company sets aside cash or other property to cover its future payment obligations to the executive. The key is that the assets set aside must continue to be owned by the company and be subject to the claims of the company's creditors.

g. FICA and Social Security. The SERP offers a potential FICA benefit. SERP benefits are considered earned for FICA purposes when the benefit is accrued and no longer subject to a substantial risk of forfeiture.[34] So, for example, if an executive accrues a $70,000 annual SERP benefit and is already receiving cash compensation in excess of the social security taxable wage base, the additional $70,000 of SERP accrual does not increase the amount of non-medical FICA taxes either for the executive or the corporation. And since the SERP benefit was potentially subject to non-medical FICA taxes when accrued, no non-medical FICA taxes are due when the SERP benefit is paid. The other social security issue is whether the SERP benefits, when paid, will reduce social security benefits. Fortunately, SERP benefits are counted as earned income when accrued, not when paid, for purposes of determining the benefit offset. So the receipt of the SERP benefit will not reduce social security benefits if the SERP recipient is otherwise eligible.

h. Impact on Qualified Retirement Benefits. Another aspect of a SERP that has to be kept in mind is its potential impact on qualified retirement plan benefits. If an executive's current income is less than it would be if a SERP benefit were not being accrued, this lower income level may reduce the amount that is being accrued for the executive under the company's qualified retirement plan. It depends on the benefit accrual formula of the qualified plan.

i. Financial Statement Impact. A factor to consider in designing a SERP is the effect it will have on the company's financial statements. Since the accrued SERP benefit is a liability of the company, it must show up on the books as a liability. Care will need to be taken to make sure that the SERP liability does not cause the company to violate any loan-to-net-worth ratios or other covenants in loan agreements that are tied to the company's book net worth. Loan agreements should be reviewed and possibly revised to avoid this result.

The foregoing are some of the basic factors to consider in structuring a SERP. Since the SERP offers a nonqualified benefit through a private contract between the employee and the company, there is considerable flexibility in structuring the terms to meet important objectives.

5. THE NO-FUND FUNDING OPTIONS

Let's return to the indispensable executive, Peter, in the above example. Peter understands that the supplemental retirement benefit he has worked out with the company is a special nonqualified benefit designed specifically for him. He further understands that the company's payment obligation is a general unsecured liability of the company. His payment rights are no better than those of a general, unsecured creditor of the company. Finally, Peter understands that if the company takes any steps to formally fund the benefit by legally earmarking a pot of money for him, the odds are that he will be taxed currently on the amount of the accrued benefit. Peter likes the idea of knowing that he will not have to pay any taxes under the program until he begins receiving benefits at age 65.

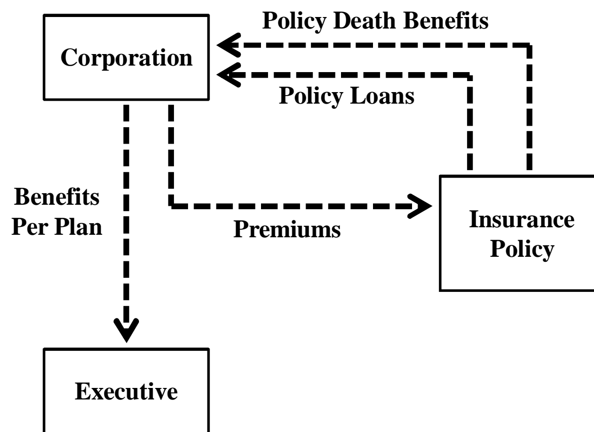
34. I.R.C. § 3121(v)(2)(A).

With all this understood, Peter would like to have the company take action to start informally funding the benefit. He realizes that the benefit could represent a significant liability of the company by the time he reaches age 65. He is concerned that, as he grows older, the owners may become nervous about the size of that liability and may try to renegotiate the liability or take some other action that could jeopardize his right to receive the promised benefit. Peter figures that the best way to head off any future problem is for the company to start preparing for the day when it will have to write his retirement checks.

a. Company-Owned Insurance Funding

One option for funding the benefit is a high-cash-value life insurance contract owned by the company. The company would be both the owner and the beneficiary of the policy. Substantial premium payments would be made on the policy for the next 10 years. The earnings within the policy would accumulate on a tax-deferred basis. When Peter reaches age 65, there would be a substantial cash value in the policy that would offset, at least in part, the company's liability to Peter. The company could commence a program of borrowing from the policy the after-tax cost of the retirement payment that would be due Peter. The company's interest deduction on such borrowings would be limited.[35] When Peter dies, the company would receive a tax-free death benefit that would reimburse the company for all or a substantial portion of its payments to Peter under the program. Peter would have the comfort of knowing that the company has affirmatively taken steps to fund the program for his benefit. Although the policy would internally be tied to Peter's agreement, he would have no legal rights to the policy.

Illustration A: Corporate Owned Insurance Funding

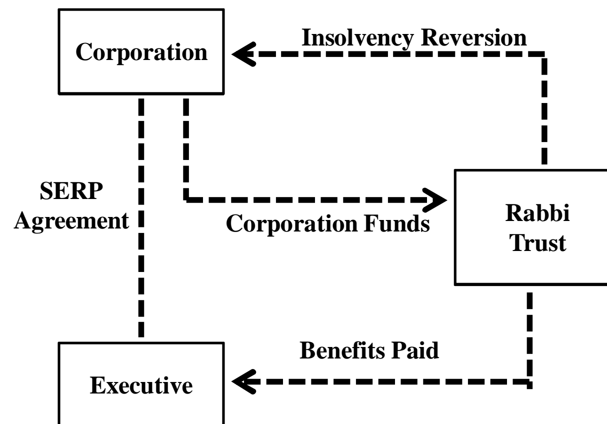


35. I.R.C. § 264(e)(1) limits interest deductions on indebtedness against policies insuring the lives of key employees to interest charges on $50,000 of such indebtedness.

b. Rabbi Trust Option

A second option would be a "Rabbi" trust. The Rabbi trust is an irrevocable trust established by the company. The company would make periodic contributions to the trust that would be invested by the trustee. The trustee of the trust would be authorized to make investments and to use the assets of the trust for only two purposes. First, the assets could be used to pay Peter's benefit under his SERP. Second, the assets could be used to pay claims of the creditors of the company. Although the Rabbi trust would lock up funds for Peter's retirement benefit, it would not protect those funds from claims of the company's creditors. If the company were to experience serious financial problems, Peter's benefit might be lost.

Illustration B: Rabbi Trust Option



The value of the Rabbi trust is that it provides some protection to Peter while preserving the tax deferral. The trust precludes the company from using trust assets to finance other corporate priorities. For ruling purposes, the IRS has imposed a number of requirements in order for a Rabbi trust to qualify: (1) trust assets must be held for the sole purpose of paying benefits under the plan, except the assets may revert to the company if the company becomes bankrupt or insolvent; (2) the company's management must have an express duty to notify the trustee of the company's bankruptcy or insolvency; (3) if the trustee receives such a notice, the trustee must stop all payments from the trust and hold the assets until directed to make payments by appropriate court order; (4) state law must not grant Peter any priority rights to the amounts held in the trust; (5) the trust cannot be funded with securities of the company; and (5) the trust may not contain an insolvency trigger or any other provision that might frustrate the rights of other creditors of the company.[36] In addition, Section 409A prohibits use of a Rabbi trust that holds assets outside the United States or that springs into

36. Rev. Proc. 92-64, 1992-2 C.B. 422.

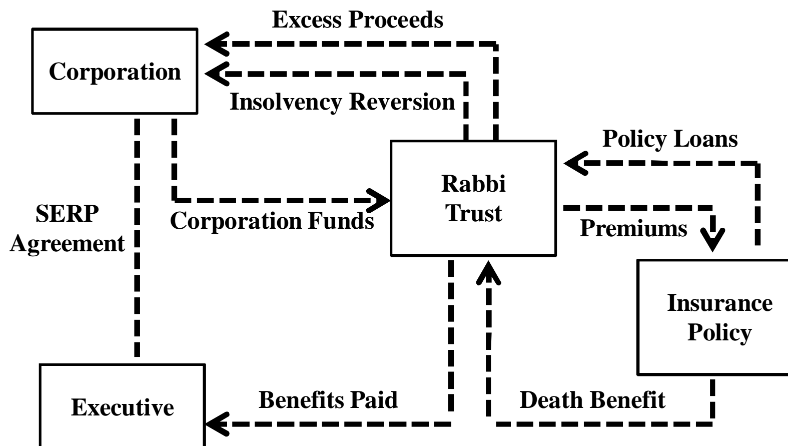
existence or becomes subject to new restrictions upon a change in the company's financial health.[37]

The bottom line is that the Rabbi trust strategy may provide Peter with some protection in the event of a change in control, a change in management, or a change in the company's desire to pay the benefit.

c. Rabbi-Owned Insurance Option

A third option is to combine the life insurance with the Rabbi trust. Here the trust is both the owner and the beneficiary of the policy that insures Peter's life. The trust makes all the premium payments with the amounts contributed to the trust by the company. The earnings in the policy accumulate on a tax-deferred basis. When Peter reaches age 65, there will be a substantial cash value in the policy that will be owned by the trust and used to fund Peter's benefits. The company could commence a program of borrowing from the policy to use such borrowings and other trust assets to make the retirement payments to Peter. When Peter dies, the trust would receive a tax-free death benefit that would cover all amounts due Peter's estate or spouse following his passing under the terms of the plan and potentially allow the company to recover a substantial portion of its payments to the trust. In this situation, Peter would have the added comfort of knowing that the company would not own and control the policy, so there would be no risk of the company choosing to use the policy to help fund some other corporate priority. The Rabbi trust would provide these added protections with respect to the policy.

Illustration C: Rabbi Owned Insurance Option



d. The Split-Dollar SERP

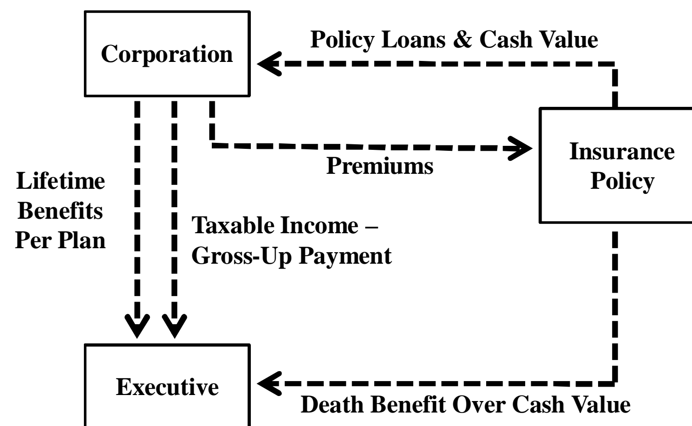
As Peter studies the insurance options for his SERP, he may decide that he would like to structure the insurance program to provide his family with an

37. I.R.C. § 409A(b)(1) & (2).

insured death benefit and to save substantial estate taxes. He proposes that the company fund the SERP with a split-dollar insurance program.

A split-dollar insurance contract is entered into between Peter and the company as part of the SERP agreement. The contract provides that the company is entitled to receive the cash value benefit under the policy, and Peter is entitled to receive the excess death benefit under the policy. The company is the owner of the policy, and Peter's rights under the split-dollar agreement are evidenced by an endorsement on the policy. If Peter's only right under the policy is a portion of the death benefit, the endorsement split dollar arrangement itself will not be considered a deferred compensation arrangement subject to Section 409A.[38] As the policy owner, the company has the right to borrow against the cash value to fund the after-tax cost of payments under the SERP. The contract is structured to have the company pay the entire premium. Peter must recognize as taxable income each year the value of the death benefit that he is provided, determined pursuant to a schedule published by the IRS. Peter transfers his rights in the policy to an irrevocable life insurance trust established for the benefit of his family. The value of the death benefit taxable to Peter each year is also deemed a gift from Peter to the trust.

Illustration D: Split Dollar Insurance SERP



What has Peter accomplished with this structure? From Peter's perspective, the one negative is that he is going to have a current tax hit each year. Usually this tax hit is minimal, although it will grow each year. Also, the company gets a corresponding tax deduction, and it may choose to use the tax benefit from the deduction each year to fund Peter's tax hit with a grossed-up bonus. The trade-offs for the annual tax burden are a few significant benefits for Peter. First, the split-dollar agreement obligates the company to fund the insurance premium each year. Peter has more than a SERP agreement that he hopes the company will

38. See IRS notice 2007-34, which specifically discusses the impact of Section 409A on split-dollar arrangements.

informally fund with insurance each year; he has a contractual promise that the insurance will be funded. Second, he has the assurance that, if he dies, the death benefit under the policy (to the extent it exceeds the cash value) will immediately be paid to his family. This is because the family trust owns that death benefit. Peter does not have to worry about the company collecting the death benefit and then deciding to pay his family out over time. Finally, the structure permits the family to receive the death benefit free of income and estate taxes, assuming the trust's rights in the proceeds are established at least three years before Peter's death. In contrast, if the company collects the death benefit and makes payments under the SERP contract, the payments are subject to estate taxes and to income taxes as income in respect of a decedent.[39]

How does the structure stack up for the company? The structure contractually obligates the company to fund the insurance. In return, the company is relieved of any liability under the SERP at the death of Peter, whether that death is pre-or post-retirement. Perhaps the most negative impact is that, while the company does receive the cash surrender value under the policy at Peter's death, it does not receive all the life insurance proceeds. If the portion of the proceeds payable to the trust established for Peter's family exceeds the amount the company would otherwise be required to pay at Peter's death under the plan, such excess would represent an added cost to the company and an added benefit to Peter's family.

The bottom line is that the split-dollar structure represents a stronger commitment by the company and will probably cost the company more in the long run. The employee has a great death benefit, some tax benefits at death, and more assurance that the company will stick with the program.

e. Bonus Insurance SERP

Assume the same facts, with one important twist. Peter has determined that security for the payment of the benefit is far more important than the tax deferral. He is willing to take a tax hit now for the security of knowing that his benefit is going to be paid, no matter what happens to the company. Also, he has figured out that if he has to take a current tax hit, the company gets a current tax deduction. He has convinced the owners of the company that the company should pass on to him the benefit of its early tax deduction by paying him a cash bonus to cover his current tax bill. He figures that he will have the perfect plan if he can just figure out a way to legally earmark funds to cover his benefit. Peter wants something simple and easy – something that everyone can understand.

The answer for Peter may be a bonus insurance plan, which involves no trust at all and no tax deferral. Here's how it works.

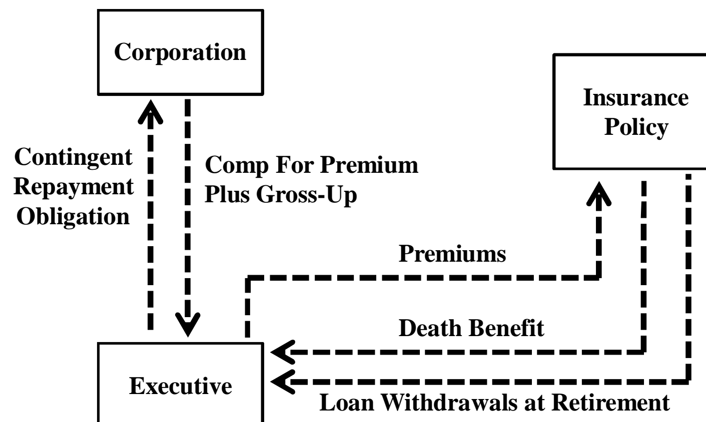
The company would adopt a bonus insurance plan for Peter. Peter would be the owner of the policy. Each year the company would bonus to Peter the amount necessary to fund the policy for Peter's retirement benefit, along with a gross-up bonus to cover any associated tax hit. The after-tax amount paid as a

39. I.R.C. § 691.

bonus to Peter each year would be structured to ensure that the value of the policy at Peter's retirement would be large enough to provide Peter his desired monthly benefits.

Peter would enter into an agreement with the company that would provide that, if Peter terminates his employment early, he would be obligated to repay to the company all or a portion of the amounts that the company had paid to Peter to fund the policy. This repayment obligation would arise by virtue of the employment contract, and the company would have no special right to enforce its rights against the insurance contract. If Peter terminates his employment and does not repay the amounts, the company would have a legal right to pursue Peter for all amounts due. When Peter retires, he could borrow against the cash value of the police to fund his monthly retirement benefits. At death, his family would be paid any residual death benefit under the policy.

Illustration E: Bonus Insurance SERP



This strategy may be an attractive candidate in those rare situations where the executive wants a secure asset, tax deferral is not an objective, the company wants some golden handcuff protections, and the company is willing to take the risk of recovering any forfeited amounts from Pete.

f. The Guarantor Option

Another option that may be used to provide Peter with added protection that his promised benefits will be paid is to have the payment of the benefits guaranteed by a third party that has deep pockets. If the company goes under and is unable to pay the benefits, Peter can look to the third party for payment. An alternative is a surety bond that would guarantee the company's payment obligation to Peter. The IRS has ruled that if the company neither pays the premium on the bond nor reimburses Peter for the bond, the mere existence of the surety bond will not trigger tax on the deferred income, even though the

employee has essentially acquired a guarantee of the payment.[40] If the company secures the bond and pays for the coverage, the likely result is that the employee will get hit with a current tax under the reaches of the economic benefit doctrine. Although some have felt that the surety bond may be the ultimate answer for the employee who has been promised a large supplemental retirement benefit, such surety bonds are not widely available and can be very expensive when they are available.

PROBLEM 11-C

11-C. Jurden Windows Inc. hired Justin, a new sales vice president, two years ago. Justin is 51 years old. In the words of the company CEO, Justin has "taken the company to the moon." He has used his contacts in the industry to cherry-pick the best salespersons and to put together a sales effort that has everyone talking. That's the good news. The scary news is that everyone wants Justin and his sales team, whose loyalty is more to Justin than to the company. Bottom line: the company needs to lock Justin up.

The CEO of the company knows that Justin, a big spender, is concerned about his retirement down the road. The CEO doesn't know much about Justin's financial situation, but suspects that Justin doesn't save and invest much. Justin has inquired on a number of occasions if something can be done to enhance the company's retirement plan, which is a vanilla 401(k) plan that puts the funding onus on the employee.

The CEO would like to adopt a special retirement plan just for Justin. Ideally, it would be a plan that would bind Justin to the company for the duration. The CEO has many questions: Is such a plan for one person legal? What are the tax impacts? How would the benefits under the plan be funded? The CEO feels strongly that the plan must offer Justin more than just a "naked promise" down the road. There needs to be "some teeth" to show that the benefits will be paid. Plus, the CEO says it "can't create a bunch of tax problems for Justin before he starts collecting following his retirement from the company."

Advise the company.

C. COMPENSATING WITH STOCK AND STOCK RIGHTS

Highly motivated executives often get to a point in their careers where something more than a salary and a bonus is required as an incentive. They want to own a portion of the business. They want to work ***with*** the business owner – not just ***for*** the business owner. Often the executive really doesn't understand or appreciate what an interest in the business represents. All the executive knows is that he or she wants to feel like an owner and be treated like an owner.

The lawyer may advise the employer who is faced with the challenge or the

40. PLR 84060022.

key executive who wants to be its beneficiary. Many employers view the challenge as a necessary evil and approach the task with suspicion, fear, and a natural propensity to drag out and procrastinate on the process. The employer usually recognizes the value of the key executive and wants to preserve loyalty and dedication. What the employer does not want to do is create a structure fraught with legal and tax complexities that unduly inflates the executive's expectations, diverts the executive's commitment or, worse yet, funds the executive's departure.

The advisor for the executive has a specific challenge – to clearly identify the real value of what is being offered or promised, and the associated pitfalls. This can be a formidable task, particularly sorting through the tax and legal tradeoffs. Complexity is the order of the day in dealing with stock options, restricted stock plans, phantom stock plans, stock right plans, and other types of ownership incentive programs.

1. Benefits And Burdens Of Stock Ownership

For purposes of this discussion, let's assume that XYZ, Inc. is a closely held manufacturing corporation that is equally owned by two individuals, Larry and Sue. The company has 150 employees and is very profitable. Jim, age 42, has become a key ingredient in the company's success. Jim manages the day-to-day field operations of the company and is the primary contact with certain of the company's most important customers. Jim has reached a point where he feels that he should own part of the company.

What are the real benefits to Jim if he acquires stock of the company? Whenever stock is acquired by an executive, there are seven potential benefits. Depending on the circumstances, some of these benefits may be of great value, and others may be of no significance. Let's review the seven benefits in light of Jim's situation.

The first benefit is the privilege to vote the shares. If Jim is issued voting stock, he will have a vote that he didn't have before. Shareholders of a corporation have the power to elect the board of directors of the corporation and to vote on major transactions involving the corporation, such as mergers, liquidations, and sales of the corporation's assets. This new vote may be of no real value to Jim. As a minority stockholder, he can always be outvoted, and there's no assurance that he'll be given an opportunity to serve on the board of directors. Since it is the board of directors of the company that really controls its affairs, the opportunity to serve on the board may be far more important than the opportunity to vote a few shares.

The second benefit that Jim receives is the right to receive dividends. In a publicly held company that regularly pays a dividend, that right may have real economic value. Most closely held C corporations, however, such as XYZ, Inc., do not pay any significant dividends. Since dividends are subject to a double tax, the closely held corporation would rather bail out its earnings in the form of tax-deductible payments to its shareholders through salaries, bonuses, rental payments and other arrangements. For this reason, the dividend advantage in the closely held corporation often is not significant as a practical matter.

The third potential benefit of stock ownership is the right to participate in any sale or liquidation of the business. If Larry and Sue decide to dispose of XYZ, Inc. down the road and Jim owns a share of its stock, he will be in a position to participate in the rewards generated from the sale. This can produce a significant economic benefit if the company is sold at a handsome profit. But the prospects of any such sale may be nonexistent or, at best, remote. Maybe Larry and Sue have no interest in selling the business and want to preserve the business for their next generation. Maybe there is no market for the particular business. This is an important factor that needs to be analyzed in reviewing the potential benefits of any ownership program.

The fourth potential benefit is growth potential. By acquiring an interest in the stock of the company, Jim acquires an asset that has growth potential. As the earnings of the business increase, the value of his stock also should increase. The real question to ask is: How is Jim going to realize a profit on the value of that stock? There is no established market for XYZ, Inc. stock. Since XYZ, Inc. is a closely held corporation, there should be a buy-sell agreement between the shareholders of the company. That agreement will specify the terms and conditions for buying stock owned by a shareholder. In many closely held corporations, the terms of the shareholder buy-sell agreement are the most important factors in assessing the value of the stock incentive program that is offered to the executive. It is through that agreement that the minority shareholder executive will realize the value of the equity interest.

The fifth potential benefit is the capital gains tax break realized on the sale of a capital asset. One of the principal incentives for issuing an executive stock as compensation is the opportunity to generate capital gains that are taxed at favorable rates.

The last two benefits that executives usually long for in these types of programs are the "feel better" benefit and the "treat me more equal" benefit. These are purely subjective factors. Many executives are convinced that they will feel better and be more secure in their jobs if they own a part of the company. They also believe that the owners of the company will treat them more as equals, more like partners, if they own an interest in the business. Often these subjective factors are of greater importance to the executive than those factors related directly to the economic benefits of the program.

Frequently the question is asked: Are there any disadvantages to an executive receiving an equity ownership interest in the company that he or she works for? There are a few potential disadvantages that should be carefully reviewed in every situation.

First, there is the potential disadvantage of triggering the recognition of phantom taxable income – taxable income that is not accompanied by any cash. In many stock ownership programs, the executive ends up with a stock certificate and a tax bill, but no cash. More on this potential disadvantage later.

Second, in rare situations there is the possibility that the executive may take on some additional liability exposure by becoming an owner of the business. If there are uninsured risks in operating the business and the affairs of the

corporation are neglected, there is a risk that the shareholders of the corporation may become personally exposed for certain debts and liabilities of the company. The executive may end up on the wrong side of a lawsuit in which a creditor of the corporation is trying to pierce the corporate veil to get directly to the corporate shareholders. Usually this risk can be mitigated or eliminated entirely by properly taking care of the corporate, legal and insurance affairs of the business. Suffice it to say, the executive who acquires stock in the corporation will want to be satisfied that the corporate legal affairs are in order.

There also are the potential disadvantages associated with the business losing money or possibly needing additional capital from its shareholders. If Jim is issued 10 percent of the stock of XYZ, Inc. and XYZ, Inc. then gets into financial trouble, Jim may have pressure put on him by Larry or Sue to help fund the operations of XYZ, Inc. by coughing up his share of the additional needed capital. Although Jim may have no legal obligation to make such a contribution, the pressure of being a co-owner with Larry and Sue may push him into having to fund his share of the shortfall.

Usually the biggest disadvantage is the opportunity cost in any situation where an executive takes an equity interest as part of his or her pay package. By taking stock in the company, Jim may lose the right to receive some alternative form of compensation that, in the end, may prove more valuable to him.

In each situation, the potential benefits and burdens of owning an interest in the company need to be carefully analyzed. In some situations, the executive may conclude that the benefits do not justify the burdens, the hassle, and the opportunity costs of alternative forms of compensation.

2. Factors In Assessing An Ownership Program

There are factors that should be analyzed in structuring or reviewing any equity ownership incentive program. Following are brief descriptions of eight key planning factors.

a. The Real Cost Factor

Does the program require that the executive bear a real cost by making an investment to acquire his or her stock in the company? Most stock option programs are structured to require that the executive write a check and make an investment before the executive can acquire stock in the company. Employers often feel that such an investment on the part of the executive is essential to accomplish the real objectives of the plan. They argue that, absent such an investment, the executive can't really lose any money and may not fully appreciate the value of what's been given. In contrast, many executives do not want to make an investment or lack the resources to make a significant investment to acquire an interest in the company. Their argument is that their investment has been and will continue to be in the form of quality executive services to the company and their willingness to forgo other opportunities. This issue of whether the executive is going to be required to come "out of pocket" to acquire his or her interest is a threshold issue in structuring and analyzing any

program.

b. The "Value Now" Factor

Will the program be structured so that the executive is given a stock interest that has a built-in economic value to the executive at the time it is given? As we will see, many programs are structured to simply give the executive an economic interest in future appreciation that accrues in the company's stock. The emphasis is on the future, not the present. Many stock option programs, stock appreciation right programs, and phantom stock programs are designed to give the executive an economic interest in future appreciation. There is no immediate economic value in the option or the right at the time it is given to the executive. In contrast, other programs are structured to give the executive an interest in the company that has a demonstrable economic value at the time it is given. Under such a program, the executive's net worth is increased at the time the executive is granted the option or the right. Many employers are willing to part with a portion of the future value in their company, but are unwilling to simply grant the executive, free of charge, an interest in the value that has already been created.

c. The Golden Handcuffs Factor

Is the program going to be structured to ensure that the executive can enjoy the full economic benefits only if the executive satisfies certain specified employment criteria? Many programs are structured to provide executives with significant economic benefits that depend entirely on the executive's willingness to remain loyal and dedicated to the company. If the executive prematurely terminates his or her employment with the company, fails to measure up to designated performance criteria, or elects to go to work for a competitor, the executive forfeits some or all of the economic benefits that accrued under the particular plan.

This factor can be extremely important from the executive's perspective. The executive has been given something of value, but it is conditional and contingent. It can be lost. Often specified, custom-tailored conditions need to be negotiated with each executive in order to satisfy the interests of all parties.

d. The Cash-Out Factor

This factor focuses on the mechanism that will be used to allow the executive to convert his or her stock interest to cash at an appropriate point in the future. This factor is not a consideration for the publicly held company whose stock is registered and regularly traded. In contrast, this Cash-Out Factor is particularly important to the executive of the closely held business. How is that executive going to realize a profit on the investment? A carefully drafted shareholder buy-sell agreement that specifies a reasonable basis for valuing the stock at appropriate points in time is critically important. It also is essential to develop a funding mechanism in many situations. This often requires that the business purchase a life insurance policy on the life of the executive to ensure that the company will have the required funds to cash out the executive if there is an untimely death. Cash-out provisions also have to be negotiated to deal with issues of employment severance, disability, retirement and expulsion.

e. The Phantom Income Factor

Is the program going to create taxable income for the executive before the executive has any cash to pay the tax liability? Many programs are structured to confer an economic value for the executive at the time the particular option or right is granted. The result is that the executive may be taxed on the fair market value of that economic benefit at the time it is received, even though no cash has been paid to the executive. This can create an intolerable situation for the executive from a tax standpoint. To remedy the situation, employers often are forced to bonus additional cash sums to the executive to cover the tax liability. As we'll see, many programs attempt to deal with this Phantom Income Factor by eliminating the Value Now Factor – that is, by granting no present economic benefit – or by maximizing the Golden Handcuffs Factor, which presents a substantial risk of forfeiture to the executive. The trade-offs can be significant for any executive.

f Employer's Tax Factor

The sixth factor focuses on the tax consequence for the employer. Does the program produce any tax advantages for the employer? The employer often find that the program has been structured to provide a tax deduction for options or rights granted to the executive, even though the employer has not expended any cash or liquid resources. Such a plan may reduce the tax liability of the employer and the overall costs of the plan. The executive, on the other hand, may be demanding that at least a portion of those tax savings should be reallocated to him or her to reduce the burden of any phantom taxable income.

g. The Fall-Out Leverage Factor

This factor focuses on the relevant positions of the executive and the company if there is a major blow-up between them. Who has the most leverage? If there is a falling-out and the executive believes that he or she has been abused in the process, the executive may have substantially more leverage by exercising rights as a stockholder. For this reason alone, many employers prefer plans that grant stock equivalency rights or phantom stock rights, but never provide real stock. Carefully drafted transfer restrictions and buy-sell agreements can help mitigate the fear generated by this Fall-Out Leverage Factor when real stock is issued. Often it is difficult to get a handle on the significance of this factor in a given situation because the parties don't want to even acknowledge the prospect of a major blow-up.

h. The Real Thing Factor

As we will see, incentive ownership programs can be structured without offering the executive any real equity interest in the company. Instead, the executive receives contractual payment rights structured to produce economic benefits that are the equivalent of stock ownership. Often these programs are unacceptable to the executive simply because they do not offer the "real thing." The executive isn't satisfied with anything less than stock, even though, from a tax and structuring standpoint, the executive may be better off receiving a carefully drafted stock substitute.

These eight factors are important considerations in analyzing any ownership incentive program. The following planning strategies focus on these factors. It is common to find that the company and the executive disagree on the importance of a particular factor or how it should be structured into the particular program.

3. SIX PLANNING STRATEGIES

a. Incentive Stock Options

The incentive stock option (ISO) is the strategy that presents the most technical requirements. It is available only to corporate entities, not entities taxed as partnerships.[41] The ISO gives the executive the right to buy stock from the company over a designated period of time on certain specified terms and conditions. It is designed to provide a tax benefit to the executive who receives the option.

With any stock option plan, there are three key points in time: the time the executive is given the option, the time the executive acquires stock through the exercise of the option and payment of the option price, and the time that the stock is sold by the executive and the sales price is realized in the form of cash. The appeal of an ISO is that the executive does not have to recognize any taxable income at the time of grant or the time of exercise, but rather only recognizes taxable income at the time of sale – when cash is available.[42] And any income recognized at the time of sale can qualify as capital gain income. There is one slight tax hitch. Although the executive does not have to recognize any phantom taxable income at the time of grant or at the time of exercise, if the fair market value of the stock at the time of exercise exceeds the option price (a circumstance that will exist in almost every case, for why else would the executive have exercised the option?), such excess fair market value at time of exercise will be treated as a tax preference item for purposes of the alternative minimum tax.[43]

What does it take for an option to qualify as an ISO so that the executive can enjoy the tax benefits of ISO treatment? There are a number of technical requirements, including the following:[44]

First, the plan under which the option is granted must be approved by the shareholders of the company within 12 months before or after the date the plan is adopted by the board of directors.

Second, each option must be granted within 10 years of the plan adoption. In other words, the plan is good for 10 years.

Third, the option period cannot be longer than 10 years, so the executive must make his or her election to exercise the option and acquire the stock within a 10-year time frame after it is granted.

Fourth, the option price cannot be less than the fair market value of the company's stock at the time the option is granted. Determining the fair market

41. I.R.C. § 422(b) requires that the recipient be an employee of a corporation.
42. I.R.C. § 421(a).
43. I.R.C. § 56(b)(3).
44. See, generally, I.R.C. § 422(a)-(d).

value of the stock of a closely held corporation can be a challenge. For this reason, there is a special provision that the ISO will qualify as long as a good faith effort is made to determine the fair market value of the stock.

Fifth, the option cannot be transferred, except in the case of the death of the executive.

Sixth, the executive who gets the ISO cannot own over 10 percent of the stock of the company.

Seventh, the total fair market value of all stock subject to ISOs which are first exercisable by the executive in any calendar year cannot exceed $100,000. The fair market value of the stock is determined at the time of grant.

Eighth, to claim the ISO benefits, the executive cannot sell the stock within two years of the date the option is granted, nor within one year from the date the stock is acquired through the exercise of the option. After exercising the option, the executive, Jim in our case, must hold the stock long enough to satisfy these periods in order to enjoy capital gains tax treatment.

Finally, the executive must have been an employee of the company or an affiliate of the company at all times from the date the option is granted until at least three months prior to the date upon which the option is exercised. In other words, if the executive leaves the employ of the company, the ISO must be exercised within three months of leaving in order to preserve the favorable ISO tax treatment.

The obvious question is this: Why wouldn't any executive and company (such as Jim and XYZ, Inc.) only want options that qualify as ISOs? After all, there is no taxable income until time of sale. The phantom income tax risks are eliminated. Also, the ISO can be structured with Golden Handcuffs features to protect the company. Usually this is done by providing that portions of the ISO can be exercised only after the executive has satisfied certain designated employment periods with the company. And once the option is exercised, the executive acquires the real thing – stock in the company.

Although certain advantages and structural opportunities exist, there are some major disadvantages to ISOs that are compelling in many situations. The result is that the ISO, although once very popular, has lost much of its appeal. First, from the executive's perspective, the ISO, by definition, flunks the Real Cost Factor and the Value Now factor tests. The executive must make a real investment before getting any stock, and the purchase price of the stock, by definition, must be equal to the fair market value of the stock at the time the option is granted. The option offers only a hope of future appreciation and no existing value. Jim may want some value now.

Second, the employer gets no deduction for the ISO. If the stock goes up in value and the employee, Jim in our case, recognizes a gain at time of sale, Jim will pay tax and the company will get no tax deduction. On a net tax basis, this is a costly, inefficient approach for moving value from the company to the executive. The executive is paying a tax bill with no offsetting tax benefit to the employer.

Finally, if the executive has an alternative minimum tax problem, the ISO may significantly aggravate that problem by creating an additional tax preference item at the time the option is exercised.

For these reasons, the ISO, although still a viable candidate and strategy, has lost much of its glitter. Many companies and their executives would be well advised to consider one of the less technical strategies.

b. The Nonqualified Stock Option

The second strategy is the nonqualified stock option. A nonqualified stock option is an option that does not qualify as an incentive stock option; it flunks one of the technical requirements. The executive still is given the right to buy a designated number of shares of the company's stock on specific terms and conditions. However, there are no rules governing the option price, the option period, or any other items. The parties are completely free to sculpt their own deal.

Are nonqualified options taxed the same as ISOs? Not a chance. Generally, the executive will not have to recognize any taxable income at the time the option is granted unless the option can be transferred by the executive or the option itself is tradable and has a readily ascertainable fair market value.[45] Because such options are almost never transferable by the executive and usually never have readily ascertainable fair market values, the time of grant is not a problem – certainly not in a situation involving a closely held business such as XYZ, Inc.

The tax problem comes at the point of exercise. When Jim exercises the option by paying the price and receiving the stock, Jim is required to recognize taxable income equal to the excess of the fair market value of the stock over the option price. If, in our example, Jim is given an option to buy 100,000 shares of stock at a price of $1.00 per share (for a total of $100,000) and Jim exercises the option at a time when the shares have a fair market value of $3.00 per share (or $300,000), Jim would be required to recognize $200,000 of taxable ordinary income at the time of exercise. Yet Jim has no cash from the transaction at this point. Jim's tax basis in the stock would be $300,000. At the time that Jim sells the stock, he would only have to recognize income to the extent the sale price exceeds $300,000.

It's important to note that there is a tax benefit to the corporation at the time of exercise. When the exercise occurs, the corporation gets a tax deduction equal to the income that Jim is required to recognize.[46] In our example, the corporation would get a $200,000 deduction at time of exercise.

If the parties have determined that they want to use stock options, nonqualified options offer great flexibility in structuring their arrangement. The option requires some investment, so there is a Real Cost Factor. But the option price can be below the existing fair market value of the stock. If, in our example, the stock has a value of $2.00 per share at the time of grant and the option price

45. I.R.C. § 83(e)(3); Reg. §§ 1.83-7(b)(1) & (2).
46. I.R.C. § 83(h).

is $1.00 per share, Jim effectively would have been transferred $1.00 of real value for each share at the time the option is granted. From Jim's perspective, this circumstance would satisfy the Value Now Factor because he has been given some of the existing equity in the company through the structure of the option price. Many employers have used these types of options to set exercise prices that are substantially below the existing fair market value of the stock at time of grant.

If some Value Now is built into a nonqualified option, care must be taken to comply with the requirements of Section 409A. Under Regulation § 1.409A-1(b)(5), a nonqualified stock option will be treated as a deferred compensation plan if the option price does not at least equal to the fair market value of the stock at time of option grant. Thus, a nonqualified option that has a preferred Value Now option price will lose a great deal of flexibility as to the timing of its exercise. To comply with Section 409A, the time of exercise would have to be specified at time of grant or be tied to a permissible payout event under Section 409A (separation for service, disability, death, change of control, or unforeseen emergency).

The executive would lose the capacity to pick the time to exercise the option. In view of the penalties triggered by a violation of 409A, any company that issues nonqualified options that are not intended to comply with the exercise limitations of Section 409A should take extreme care to ensure that the option price is not less than the stock's fair market value at time of grant. In recognition of the difficulty of valuing closely held business interests (and the high stakes for Section 409A non-compliance), the regulations to Section 409A permit the use of any reasonable valuation method, describe factors that will be used to determine the reasonableness of the valuation, impose consistency requirements, create a presumption of reasonableness for a one-year period, and create a special presumption for the good faith valuation of a start-up company's stock during the first 10 years of its active conduct of a trade or business.[47]

There is really no limit on the Golden Handcuffs feature that can be attached to the nonqualified option. For example, XYZ, Inc. could grant to Jim an option to purchase 200,000 shares of the company's common stock at a specified price. The option could be structured to provide that Jim would have the right to exercise the option with respect to one-tenth (1/10) of such shares (20,000) each year that Jim remains in the employ of XYZ, Inc. The effect is that Jim would vest in his right to acquire the full 200,000 shares over a 10-year time frame. If the company does well, Jim would have a strong incentive to remain loyal for a long period of time.

From Jim's perspective, the phantom taxable income created at the time of exercise is a real problem, but even this problem can often be resolved. Remember, the corporation is getting an offsetting tax deduction. The transaction is often structured so that the corporation lends the amount of its tax benefit at the time of exercise to the executive. This provides the executive with a source

47. Reg. § 1.409A-1(b)(5).

of funding to cover his tax liability at the time of exercise. Interest would be paid or accrued on the loan. The loan would be paid off at the time the stock is sold.

As an alternative, the company could elect to simply bonus to the executive the amount of its tax saving from the exercise of the option. A calculation would have to be made to gross-up the bonus to take into account taxes also saved as a result of the bonus paid to Jim. This would provide Jim with a source of cash to cover his tax liability at the time of exercise.

The net effect from Jim's standpoint is that the nonqualified option gives him some real value now, provides a source of funding his phantom tax liability, and presents no alternative minimum tax problems.

Stock options are viable strategies. The nonqualified option provides more structural flexibility, but does raise a phantom income issue that needs to be addressed in the planning process. One major disadvantage of any stock option program is that the executive doesn't own the stock – the real thing – until he or she steps up and pays the option price. So the benefits of actual stock ownership usually are delayed. This may be a real negative from the standpoint of many executives.

c. Bonus Stock

Bonus stock perhaps is the least technical and most straightforward strategy of all. Under this approach, XYZ, Inc. would adopt a stock bonus plan and transfer to Jim a specified number of its shares as compensation for services rendered. From Jim's standpoint, bonus stock offers some real pluses. There is no need to make a cash investment; there is no real cost. There is immediate value now; the existing value of the stock belongs to the executive, and the transfer of the stock is not deemed to be a deferred compensation plan subject to Section 409A.[48] A shareholder buy-sell agreement can be drafted to ensure that the Cash-Out Factor is satisfied. The executive owns the real thing now; there is no delayed enjoyment, as in the case of an option. Finally, the executive is entitled to vote the shares now and can immediately participate in all dividends and other rights.

But there are also disadvantages to bonus stock from the executive's perspective. Usually the executive is given fewer shares under a bonus stock plan than under some other type of plan, such as an option plan. It's only natural to expect that the company will be willing to transfer, free of charge, fewer shares under a bonus plan than it would be willing to sell for full value under an option program. The resulting disadvantage is that the executive has less opportunity to participate in the future appreciation of the company.

Bonus stock also presents a major phantom taxable income problem. The fair market value of the stock is taxed to Jim at the time the stock is transferred to him. As in the case of a nonqualified option, the company may find itself in the position of having to lend money to Jim to enable him to pay his phantom tax liability, or it may simply couple the stock bonus grant with a grossed-up cash

48. Reg. § 1.409A-1(b)(6).

bonus to cover the tax liability.

d. Restricted Stock

Restricted stock is bonus stock with a twist. The twist is that the stock has strings attached – restrictions. If one of these restrictions is violated, the company yanks the string and retrieves all or a portion of the stock. Suppose, for example, that XYZ, Inc. is willing to transfer to Jim $100,000 worth of stock now. No investment is required on Jim's part. There is immediate value now. Jim gets the real thing now. And, presumably, there is a buy-sell agreement to ensure the Cash-Out Factor. Further, suppose that XYZ, Inc. wants to make certain that the stock will cement Jim's loyalty and dedication to the company. So it places a restriction on the stock. For example, the restriction may provide that, if Jim leaves the company at any time during the next 10 years, he will forfeit all of the stock. Alternatively, it may provide that Jim vests in his right to keep the stock at a rate of 10 percent each year. So if he leaves at the end of five years, for example, he will be paid for 50 percent of the stock under the buy-sell agreement, and he will forfeit the remaining 50 percent. Alternatively, the restriction may provide that all or a portion of the stock is forfeited if Jim fails to hit certain sales volumes, or otherwise fails to satisfy some other objective measure of performance.

There is a significant tax consequence to this forfeiture feature. As long as a substantial risk of forfeiture exists, the executive does not have to pay tax on the stock that's been transferred.[49] In our example, Jim could be transferred $100,000 worth of stock and pay no tax at the time of transfer. If, after 10 years, the forfeiture feature goes away, Jim would be taxed on the full value of the stock at that time. Often the forfeiture provisions are structured to lapse over a period of years so that only a portion of the tax liability is recognized in any year. On the other side, the company gets a tax deduction equal to the amount of taxable income that Jim is required to report in the same year that Jim reports the income.[50]

There is another tax planning option that should be considered whenever restricted stock is used. The executive may elect to be taxed on the stock at the time the stock is received, rather than at the time the forfeiture provision lapses.[51] Why would an executive ever want to elect to recognize taxable income at an earlier point in time? If the stock value at the time the stock is received is very low and there is a substantial prospect that it is going to appreciate rapidly in the future, the executive may prefer to recognize the taxable income at the time the stock is granted at the much lower value. If the election is made to recognize income at the time of grant, there is no need to recognize any future taxable income until the stock is actually sold. There is a disadvantage with this election. If the executive elects to recognize the income at the time the stock is granted

49. I.R.C. § 83(a)(1); Reg. § 1.83-3(c). The existence of the forfeiture feature and the related tax deferral does not make the arrangement a deferred compensation plan subject to the new section 409A requirements. Proposed Reg. § 1.409A-1(a)(6).
50. I.R.C. § 83(h).
51. See, generally, I.R.C. § 83(b).

and the stock is then forfeited, the executive gets no offsetting deduction at the time of the forfeiture. Thus, the executive may be in a position of having paid tax on something that never produced any value. It's a calculated risk. If the executive's choice is to make the election, the company gets a deduction at the same time the executive recognizes the income.

Restricted stock is a flexible tool that can be used in many situations. As many stock option programs have lost their appeal, the restricted stock alternative has become more popular.

e. Stock Appreciation Right Strategy

The next strategy is different from the four previous strategies in one significant respect: the executive never gets the real thing. There is no stock. In lieu of receiving stock, the executive is given a contractual right to compensation that is structured to provide the same economic benefits as stock. Here is how it works.

Suppose XYZ, Inc. wants to give Jim the right to fully receive the value of all appreciation that accrues on 100,000 shares of its stock in the future. Jim doesn't want any stock options for a number of reasons. He doesn't want to have to pay a real cost, as is required by an option. The tax traps of options also are a problem for the parties. An ISO will produce no tax deduction for the company and may present an alternative tax problem for Jim. A nonqualified option, on the other hand, will produce phantom taxable income for Jim at time of exercise.

A stock appreciation right contract may be the answer. A contract is drawn that essentially states that the parties will pretend that Jim owns 100,000 shares of stock. He never really owns the stock. Usually the contract would establish a base price of the stock – say $1.00 per share – that would equal the current value of the stock. The contract would offer a number of economic benefits based on the pretend stock. It would provide that if a dividend is paid to the real shareholders of the company, then a corresponding amount of compensation would be paid to Jim on his 100,000 pretend shares. It would also provide that if the company is sold, merged, or goes public, Jim would receive the excess in the value of his pretend shares, at that time, over the base value of such phantom shares at the time the contract was awarded to him. For example, if the company is sold at a price of $3.00 per share down the road, Jim would be entitled to receive compensation income at a rate of $2.00 per share for the 100,000 pretend shares awarded to him under the contract. The contract would also provide that the stock appreciation rights would be valued at the time Jim dies, is disabled, or otherwise terminates his employment. The excess of the value of the rights at that time over the base value of $1.00 per share would be paid as additional compensation income to Jim. Golden Handcuffs features may be structured into the contract to provide Jim with incentives to remain loyal and dedicated to the company. Essentially, the contract is designed to provide Jim with the same economic benefits, in the form of compensation under the contract, that he would otherwise receive in the form of stockholder economic benefits if he actually owned the real stock.

What are the advantages to such a stock appreciation right arrangement?

There are a number of benefits. First, there is no threat of phantom income. Since all amounts paid to Jim are compensation under the contract, Jim will not have any taxable income until he actually receives payment. Second, there is no alternative minimum tax threat. Third, since all amounts paid to Jim represent compensation, the company receives a full deduction at the time of payment. This is a significant benefit to the company and may allow the company to pay Jim a larger benefit. In many ways, a stock appreciation right contractual arrangement is one of the most efficient strategies, from a tax perspective, for transferring upside stock value from the company to the executive.

Is there any tax disadvantage to such an arrangement? Historically, the biggest disadvantage to any such arrangement has been the absence of any capital gains or favorable dividend tax break for the executive. Because the executive never owns any stock, there is no possibility of creating a capital gain at time of sale or receiving dividends. To sweeten the deal for the executive, an added bonus may be provided to produce a net after-tax yield to the executive that is equal to the yield that would result if the pretend stock payment were taxed as a capital gain or dividend. Again, the company gets a full deduction for all amounts paid. Often, this capital gains or dividend bonus can be paid with the company still incurring a net after-tax cost that is less than what would be incurred if it purchased stock or paid a dividend under another strategy.

A stock appreciation right arrangement provides a number of flexible alternatives. There is no requirement that the executive make an investment in order to acquire rights to future appreciation in the stock. There is no risk of phantom income. The company gets a deduction. There is no alternative minimum tax risk. The Golden Handcuffs Factor and the Cash-Out Factor can both be accommodated in a variety of different ways through the contract. The company often prefers this type of arrangement because of the Fall-out Leverage Factor. If there is a major problem between the executive and the company down the road, the executive has a contractual right to payment, but does not own any stock in the company. Accordingly, the executive is not in a position to cause problems as a shareholder.

With a stock appreciation right plan, care must be taken to ensure that it avoids the reach of Section 409A or that it is structured to comply with the Section 409A requirements (i.e., no executive election rights as to timing or method of payout after the grant of the rights). There is no room for ambiguity. A stock appreciation right plan can avoid 409A treatment if there is no Value Now Factor (only appreciation following the grant is considered) and the plan includes no other deferred compensation element.[52]

The biggest disadvantage from the executive's perspective is that he or she never owns the real thing. The arrangement is a fancy employment contract. The subjective desires of being viewed and treated like an owner may never be realized. Often it's possible to overcome this fear by reemphasizing that the contract is being drawn to provide a real piece of the rock by offering economic

52. Reg. § 1.409A-(b)(5)(i)(C)(3).

benefits that, dollar for dollar, are structured to be the same as those that would be realized if stock were actually owned.

f. Phantom Stock Plan

The next strategy is the phantom stock plan. This strategy is the same as the stock appreciation right strategy described previously, with one significant twist. The strategy is structured to give full effect to the Value Now Factor and falls squarely within the reach of Section 409A. A contract is drawn that gives the executive the right to be compensated on the basis of certain pretend shares, but there is no existing base value price. At the time the contract is entered into, the executive is promised payments down the road based on the current value of the phantom shares, together with all future appreciation on those shares. It's as if the executive actually owned the stock now. Hence, the name "phantom stock."

Jim, for example, could be provided a phantom stock benefit that gives him the right to 100,000 phantom shares that have an existing value of $2.00 per share. This would be an attractive contractual right from Jim's perspective. Moreover, as the value of the stock in the company increases, the value of Jim's phantom shares would similarly increase.

Since such a phantom stock plan is subject to Section 409A, Jim can have no timing or payout elections after the grant of the rights. To comply with Section 409A, the time and method of payout must be specified at time of grant or tied to a permissible payout event under Section 409A (separation from service, disability, death, change of control, or unforeseen emergency).

Assuming the requirements of Section 409A are satisfied, is Jim required to recognize this Value Now Factor ($200,000 in our example) at the time the contract is entered into? The answer is "no" so as long as Jim simply has the contractual right to receive a payment for this amount as compensation in the future.[53] Thus, unlike the bonus stock and the restricted stock strategies described previously, Jim can receive a Real Value Now factor and avoid any phantom taxable income. The key variable is that he has received a contractual right to future payments, rather than a property right represented in the form of stock.

Again, the biggest disadvantage from Jim's perspective is that he has not received real stock in the company. Also, because Jim never receives stock, there is no opportunity for capital gains treatment. These potential disadvantages may pale in significance compared to the economic benefits being offered under the program and the fact that there is no threat of phantom taxable income. Plus, as described above, the plan can be structured to pay Jim compensation for any lost capital gains benefits and put him in the exact economic position as if he had received real stock. When the plan is dolled up to include such benefits, it is sometimes referred to as a "stock equivalency plan" – a term that may sound more appealing than "phantom stock."

53. An unfunded and unsecured right to receive money or property does not constitute "property" under the provisions of Section 83. Reg. § 1.83-3(e).

PROBLEM 11-D

Refer to Case Problem 11-C and Jurden Industries' challenge to lock in its star VP of sales, Justin. The CEO opened up discussions with Justin and, to everyone's surprise, Justin demanded a piece of the rock. He wants to participate in the equity growth of the company. He wants the rights of an owner. Specifically, Justin has requested (demanded?) the following:

1. He wants equity value now in recognition of the value he has already brought to the company. He doesn't want a deal that is based solely on the future appreciation of the company's stock.

2. He doesn't want to pay anything for his equity interest in the company. He figures that he has already paid through his efforts on behalf of the company.

3. He wants an official vote in the management affairs of the company. He isn't asking for control – just the right to be part of the inner circle.

4. He doesn't want to pay any income taxes on the equity interest that he receives until the stock is sold and cash is realized.

5. He wants the tax benefits of stock ownership – specifically preferred tax treatment on dividends and capital gains benefits at the time of sale.

Jurden's CEO is overwhelmed. He doesn't want to give Justin anything that is not tied to his future long-term performance on behalf of the company. The CEO asks: What happens if we give Justin stock and he stops performing or quits? How do we get the stock back? Do we have to buy it back? What happens to Justin's stock if there is a falling out down the road?

The CEO wants your advice. What do you recommend?