



Terminating a Senior Executive Key Benefits Issues

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A Note describing the key benefits issues to consider when the employment relationship with a senior executive is terminated. This Note does not address relevant state or local law. State and local statutes and regulations may impose additional requirements on employers in this topic area, but the information contained in this resource will be useful and relevant to employers in every state. State-specific surveys will be available to provide state-specific guidance in the near future.

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This Note reviews the key employee benefits and executive compensation issues that arise when a business organization terminates a senior executive and presents them as a step-by-step guide. This process involves:

- Assessing the benefits to which the executive is entitled on termination of employment under the plans and agreements that were in effect immediately before termination.
- Considering whether the organization wants to provide something different than what the executive is already entitled to at termination.
- Considering whether and how to document the separation package.
- Handling the other issues the organization might need to address after the individual has left the organization.

STEP 1: COLLECTING AND REVIEWING THE RELEVANT DOCUMENTS

The first step in managing employee benefits and executive compensation arrangements when terminating an executive is to collect all the documents that set out the pay and benefits to which the executive is entitled on termination. This step streamlines the administrative process of exiting the executive and sets out the initial agreements for purposes of allowing the parties to negotiate a different exit package if desired.

Although the relevant documents vary between organizations and executives, the following are the most common documents that an organization should identify and review:

- Employment agreements:
 - employment contracts;
 - restrictive covenant agreements; and
 - change-in-control/separation agreements.
- Qualified retirement plans:
 - plan documents; and
 - summary plan descriptions (plain language summaries of the terms and conditions of plans).
- Health and Welfare Plans:
 - plan documents;
 - summary plan descriptions; and
 - policies.
- Bonuses:
 - policies; and
 - grant/award agreements.
- Nonqualified Deferred Compensation Plans:
 - plan documents;
 - employee communication materials; and
 - grant/award agreements.
- Equity Incentives:



- plan documents;
- grant agreements;
- employment contracts;
- restrictive covenant agreements; and
- change-in-control/separation agreements.

STEP 2: REVIEW THE EXISTING ENTITLEMENTS

After collecting the relevant documents, the employer must determine the benefits the executive is legally entitled to on termination. The following section of this Note identifies the key issues the organization should identify and important questions the organization should answer in setting up the base line benefit package.

Severance Pay Entitlement

Severance pay is not mandatory. Typically, entitlement to severance pay arises from the executive's employment agreement or from the organization's severance plans or policies. The organization should review the terms of the executive's employment agreement and the organization's severance plans or policies, evaluate the eligibility criteria that apply to the entitlement to receive severance pay and conclude whether the executive is potentially eligible to receive severance.

Qualified Retirement Plan Distributions

Virtually all qualified retirement plans permit a distribution on a termination of employment. These are generally not negotiated rights, but rather are benefits that are provided under the express terms of the plan. The organization should notify the plan's administrator of the executive's termination of employment to begin the administrative process of distributing the assets.

Health and Welfare Plans

A terminating employee is entitled to continue his active group health plan coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). However, business organizations often agree to provide terminating executives with group health plan continuation rights beyond what COBRA requires. If applicable, the business organization should review the executive's employment agreement and the organization's severance plan or policy to determine

the scope of the executive's existing group health plan continuation rights.

For further information to assist in determining when COBRA continuation rights apply, see the US Department of Labor website.

Most other forms of health and welfare plan coverage end on or shortly after termination of employment (for example, the end of the month in which termination occurs). However, for certain forms of benefits (for example, group and supplemental life, long-term disability and certain forms of accidental death and dismemberment), the plan or policy may allow the executive to convert the group coverage into an individual policy.

The business organization should carefully review the plan documents, summary plan description and policies to fully determine the scope of the rights and responsibilities regarding the executive's termination of employment. The organization should also coordinate with the insurers so the insurers can address the administrative responsibilities that apply.

Bonuses

The organization must determine whether the executive is entitled to a bonus. Earned but unpaid bonuses are rarely an issue and are typically paid shortly after termination of employment or when the organization pays bonuses to its other employees and executives. However, whether the executive is entitled to a pro rata share of a bonus for the year in which he terminates employment is prone to dispute. In addition, if the business organization maintains the arrangement on an informal basis, there may be no document to provide the answer. To complicate the issue further, in certain states, employees may have a legal right to a pro rata bonus despite the terms of any bonus policy or past practice. The organization should take care to review the terms of any bonus policy, the applicable wage payment laws and any interpretive authority before concluding whether a payment is due.

Nonqualified Deferred Compensation Arrangements

Nonqualified deferred compensation arrangements generally raise the same issues that arise for bonuses (for example, to what extent is the executive entitled to a distribution?) but with the added layer of complexity that accompanies application of IRC § 409A (the rules governing



distributions from nonqualified deferred compensation arrangements). To determine whether the terminating executive is entitled to a payment under the nonqualified deferred compensation plan consistent with IRC § 409A, an organization must confirm the following:

- Does the termination meet the definition of "separation from service" under Treas. Reg. 1.409A-1(h)? A separation from service means the executive dies, retires or otherwise has a termination of employment with the employer.
- Does IRC § 409A require the organization to delay for six months payment to the executive as a "specified employee" under IRC § 409A(a)(2)(B)? A "specified employee" is an employee of a publicly traded company who is:
 - an officer of the company with annual compensation greater than \$160,000 (the indexed threshold for 2009);
 - a 5% owner of the company; or
 - a 1% owner of the company with annual compensation greater than \$150,000.
- If the plan permits subsequent deferrals, has any election to further defer the income met the requirements of IRC § 409A(a)(4)(C)? This generally requires that:
 - the election is made at least one year before distribution would ordinarily have occurred; and
 - the distribution is delayed to a date no sooner than five years after distribution would ordinarily have occurred.

Equity Compensation Arrangements

Identifying a terminating executive's rights to equity compensation in connection with a termination of employment can be one of the most complicated steps in this process, given:

- The different forms of equity compensation that an organization can award (for example, restricted stock, stock options, stock appreciation rights and stock grants).
- The variety of documents that can govern the terms and conditions of the award (for example, the employment agreement, multiple grant agreements and the equity compensation plan document).

- The many variables present in each form of equity compensation (for example, rights to accelerated vesting, timing deadlines to exercise certain rights and forfeiture provisions).

The following questions should allow an organization to isolate the primary and material issues that determine the executive's rights to equity compensation on termination of employment:

- Do the circumstances of the executive's termination of employment require any unvested equity grants to become vested? For example, some equity compensation grants provide for accelerated vesting for "favorable" terminations of employees (involuntary terminations without "cause" or voluntary terminations for "good reason").
- Do the circumstances of the executive's termination of employment require the executive to forfeit any equity compensation? For example, some equity compensation grants require the grantee to forfeit grants if the business organization terminates the executive for "cause".
- What are the deadlines on which the parties to the award must exercise any applicable rights? For example, incentive stock options generally must be exercised within three months of an executive's termination of employment to retain the tax benefits that apply to incentive stock options.

STEP 3: CONSIDERING ALTERNATIVE BENEFITS

Once the organization has determined the compensation and benefits to which the terminating executive is legally entitled under the existing benefit and compensation arrangements, the organization must then determine whether it wishes to provide the executive with something less (for example, exercise any forfeiture rights that may exist) or provide something more. Various issues affect an organization's decision on this point, including:

- **The reasons for terminating employment.** For example, if the executive was terminated for cause or for other performance reasons, the organization may wish to exercise benefit and pay forfeiture provisions and not provide anything additional to the executive, regardless of any other issue. However, if the organization wishes to obtain a waiver and release from the executive, it must



provide the executive with some form of consideration above and beyond what he is then entitled to receive.

- **The value of pay and benefits received on termination.** If the overall economic value of the pay and benefits the executive will receive at termination (including vested equity and other pay and benefits provided to the executive before termination) is high enough, there may be little reason to provide any additional severance pay if the organization views severance pay as a form of "income replacement", as most organizations do.
- **Shareholder and outside reaction to the separation package.** Recently, organizations have come under fire for the size of severance packages provided to executives (see, for example, Andrew Ross Sorking, *Golden Coffins and Parachutes Should Go, Report Says*, N.Y. Times, September 21, 2009). This has caused some organizations to reconsider their past practices when providing severance.
- **The legal requirements to modify an existing award.** For example, if the organization intends to:
 - modify an equity grant, it must determine whether it can, in fact, modify the award, taking into consideration the terms of the plan and the grant agreement, and which person or entity must approve the modification (for example, officer or a committee of the board); or
 - modify a nonqualified deferred compensation plan award, it must comply with IRC § 409A, which prohibits the acceleration of the time or schedule for any payment under the plan. Elections to further defer income must be completed at least one year before the payment was otherwise to be made and the income must be deferred for at least five years after the date payment was otherwise to be made.
- **Accounting implications.** The organization should consider the accounting implications of modifying an existing award.
- **The organization's philosophy.** The changes to the executive's severance package should be consistent with the business organization's philosophy on providing severance (for example, severance as income replacement as opposed to a reward for prior accomplishments).
- **The executive's position.** For example, the likelihood

of the executive finding new employment relative to the amount of compensation and benefits payable to him on termination.

- **Legal claims.** Consider the risk of the executive bringing legal claims related to employment or termination of employment and the likelihood that providing additional compensation and benefits would induce the executive to sign a waiver and release of claims.
- **The organization's practice.** The organization should take into account its past practices and how it has treated similarly-situated executives.

STEP 4: PRESENTING, NEGOTIATING AND DOCUMENTING THE AGREEMENT

After the business organization completes Step 3, it should strongly consider documenting the rights and responsibilities of the separating parties in a formal separation agreement. The advantages to preparing a separation agreement include:

- Obtaining from the executive a waiver of rights and release of claims. Note that a release of claims under the Age Discrimination in Employment Act and the Older Workers Benefit Protection Act must comply with certain rules to be valid. For more information about these rules see *Layoffs and Reductions in Force Checklist* (www.practicallaw.com/3-500-4341).
- Setting out, in a single document, the entire menu of compensation and benefits the executive will receive on termination, reducing the risk of any later dispute or claim by the executive for other pay or benefits.
- Allowing the business organization to modify rights and responsibilities that exist immediately before the termination of employment to reflect the negotiated separation package.

STEP 5: REVIEWING AND RESPONDING TO POST-TERMINATION ISSUES

An important step, which organizations often neglect, is to track and respond to post-termination issues. The organization should review what, if any, ongoing responsibilities the executive may have to the organization and monitor and confirm that he is meeting those responsibilities.



For example, the organization should confirm that the former executive complies with any applicable restrictive covenants that apply to him, including non-compete, non-disparagement, non-solicitation and confidentiality requirements.

If the organization determines that the executive breached any such responsibility, it should then explore its available remedies, including its right to cease paying benefits and/or any forfeiture right that may exist. It should also consider whether legal action is necessary to prevent the executive from further breach.