

StayCurrent

A Client Alert from Paul Hastings

Severance in the Spotlight: New Risks to Executive Contracts

By Mark Poerio, Caroline Bruckner and Lynda Noggle

The pendulum has not stopped swinging against executives when it comes to their compensation. The past few years have seen the SEC clamp down on the disclosure side, and shareholders and attorneys-general react with litigation when abuses have come to light. Late last year, a landmark change in Federal tax laws targeted executives who defer compensation. Section 409A of the Internal Revenue Code (the "Code") now aims a 20% excise tax at certain executive severance arrangements – and that pales compared to two more risks that recently materialized.

First, there was a Federal Circuit Court decision holding that severance pay was an "extraordinary payment" that the SEC could subject to escrow and forfeiture under Section 1103 of the Sarbanes-Oxley Act of 2002 ("SOX"). Then came the new Federal Bankruptcy Law. It basically forbids a Bankruptcy Court from approving executive severance payments, as well as executive retention payments, unless certain standards are met that no current arrangement is likely to meet or to be capable of meeting.

These developments further increase the premium that executives should place on sound, careful design of their compensation packages. Described below are steps by which those who structure executive compensation may respond to the developments described above, as well as recent Treasury Department comments spotlighting Section 409A's application to severance benefits.

New Code Section 409A and Severance

The Law. Shortly after the enactment of corporate tax legislation last November, a senior Treasury Department official referred to its addition of new Code section 409A as a "sea change" in the tax laws that apply to deferred compensation. For a state-of-the-art self-diagnostic Section 409A guide for employers, please contact any Paul Hastings attorney listed at the end of this client alert.¹

The Risks. Executives covered under arrangements that do not conform with Section 409A are vulnerable to immediate taxation, a 20% tax in addition to ordinary income taxes, and

interest. Severance benefits may trigger these penalties under the following circumstances:

- *Six-Month Waiting Period (Public Companies Only)* – The key employees of public companies must wait until at least six months after their employment terminates before collecting any benefits that are subject to Section 409A. This rule becomes a factor, and potential problem, when an executive's severance arrangement calls for payments over a period that extends more than 2-1/2 months after the end of the tax year (of the executive or the employer, whichever ends later) in which the executive's employment terminates. The term "key employee" has the meaning set forth in Code Section 416(i) (except that it does not include key employees' beneficiaries), and generally encompasses officers earning more than \$135,000 per year.
- *Choice between Lump Sum or Installment Payments* – Section 409A penalties are likely to arise from any agreement that permits the executive to choose when and how severance payments are to be paid. IRS Notice 2005-1 establishes a December 31, 2005 deadline for bringing agreements (and plans) into conformity with Section 409A.
- *Good Reason* – Staff attorneys from the Treasury Department and the IRS have been consistently warning that "good reason" provisions are inherently suspect under Section 409A (on the premise that they are capable of manipulation through resignations tied to questionable changes in status). These attorneys have warned as a result that any severance paid due to a good reason resignation could trigger Section 409A penalties even if paid out within 2-1/2 months after the end of the year in which the executive's employment terminates.
- *Taxable Allowances* – Section 409A penalties may arise from agreements that provide for the payment of taxable benefits or allowances following separation.
- *Rabbi Trust Funding* – Employers who establish a rabbi trust as a future source for paying severance benefits

should be aware that a rabbi trust will violate Section 409A if it includes a provision that triggers funding in the event of an event tied to the employer's financial condition.

Precautions. Even though Section 409A is in its infancy, there is no understating the importance of early identification of all potential arrangements – including severance plans, programs, and employment or severance agreements -- that could fall within its broad sweep. Employers have until the end of 2005 to correct problematic arrangements, and perhaps longer if rumors prove correct that the Treasury Department will extend the Section 409A transition period.

Extraordinary Payments and the Gemstar Decision

The Law. If the SEC is investigating a public company's executives (among others) for possible violations of Federal securities laws, Section 1103 of SOX authorizes the SEC to petition a federal district court for a temporary order that prevents the issuer from making "extraordinary payments" to the executives. If the SEC succeeds, the issuer must deposit the extraordinary payments into an interest-bearing escrow account for a period of 45 days. If the investigation results in formal SEC charges of Federal securities law violations, the payments are to remain in escrow until the conclusion of any related legal proceedings.

The Risk. On March 22, 2005, the Ninth Circuit Court of Appeals sitting en banc ruled in favor of an SEC petition to establish a SOX 1103 escrow account for approximately \$37.46 million in negotiated severance packages that Gemstar-TV Guide International, Inc. had agreed to pay to its departing CEO and CFO. The decision is reported as *SEC v. Yuen*, 401F.3d 1031(9th Cir. 2005), and is referred to below as the "Gemstar" case.

The SEC acted aggressively in the Gemstar case because the severance payment obligations arose after the SEC's initiation of a formal investigation in October 2002 into Gemstar's reported financial statements as set forth on its Forms 10-K and 10-Q for 1999, 2000, 2001, and 2002. According to the decision, the facts and circumstances provide a "textbook" example of the need to allow the SEC to halt "extraordinary payments" to departing officers once the SEC has initiated an investigation of corporate malpractice.

In a 10-1 decision, the full Ninth Circuit held that the proper inquiry as to whether a payment was "extraordinary" in the context of Section 1103 requires a "fact-based and flexible inquiry" reviewing "context-specific factors such as circumstances under which the payment is contemplated or made, the purpose of the payment and the size of the payment." In Gemstar, the Ninth Circuit seemed to find two factors compelling in favor of the SEC.

(1) *An Extraordinary Process.* It took five months of negotiation, and separate Board approval, before Gemstar's departing CEO

and CFO entered into the termination agreements that gave rise to the proposed \$37.46 million of payments, which were characterized by the opinion as "restructuring payments."

(2) *Extraordinary Amounts.* The combined payments to both executives were at least five times their combined incomes for 2001, and were comprised of cash payments totaling \$29,410,593 in termination fees and \$8,240,437 in full and complete settlement for all unpaid salary, bonuses, and unused vacation days.

Ultimately, the Ninth Circuit's adoption of a flexible, fact-specific standard for finding payments to be "extraordinary" in the context of Section 1103 grants the SEC wide discretion to petition to place a temporary hold on executive severance payments. Although only controlling in Ninth Circuit states (Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington), the Gemstar decision could influence the outcome of similar cases pending in other circuits.

The Precaution. Although the concurring opinion, which was only joined by one other judge, argues that all severance payments are per se extraordinary, the majority decision in Gemstar suggests that "extraordinary" payments result when the process and amounts are extraordinary. Hence, SOX 1103 may not reach severance that is paid –

- pursuant to an arm's length employment agreement,
- in the ordinary course of settling a departing executive's affairs pursuant to the agreement; and
- in amounts that are reasonable when compared to the severance benefits that peer companies provide for similarly-situated executives.

Good independent compensation committee governance should establish all three of these predicates and should insulate reasonable severance arrangements from characterization as extraordinary for purposes of SOX 1103.

Directors of public companies should bear in mind that tightened SEC disclosure rules are likely to require the filing of a Form 8-K to disclose any changes to executive severance plans, contracts, or other arrangements. Further information about these rules appears in our client alert titled "SEC Form 8-K Disclosure Rules For Executive and Director Compensation" (December 2004, copies available on request and on our website).

Bankruptcy Law Changes

The Law. On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"), which is effective for bankruptcy filings after October 17,

2005. The Act severely limits a Chapter 11 debtor's ability to make severance and retention payments to insiders (generally, officers, directors, and others who "control" the debtor). Under revised Section 503, a bankruptcy court may approve a severance payment to an insider of the debtor only if the payment is part of a program that is generally applicable to all full-time employees of the debtor. If the debtor clears this hurdle, the insider's payment is capped at 10 times the amount of the mean severance pay to non-management employees during the calendar year in which the payment is made.

The Act's retention payment provision is even more restrictive than its severance payment provision. A bankruptcy court may approve a retention bonus to an insider of a debtor only if the following 3-part test is met: (1) the insider has a bona fide job offer from another business at the same or greater rate of compensation; (2) the insider's services to the debtor are essential to the survival of the business; and (3) the payment is capped at either –

- (a) 10 times the amount of the mean retention payment made to non-management employees during the calendar year in which the payment is made, or
- (b) if the debtor did not make any similar payments to non-management employees during the calendar year in which the payment is made, an amount equal to 25% of any similar payment made to the insider for any purpose during the calendar year prior to the year in which the retention payment is made.

The Risk. The new Bankruptcy Law imposes unprecedented standards for the severance and retention programs that troubled companies typically adopt. As a result, after October 17, 2005, it will be practically impossible for Chapter 11 debtors to receive Bankruptcy Court approval for executive-only severance plans. In addition, it is possible that severance payments that would otherwise be payable to key employees of public company debtors within six months prior to a Chapter 11 bankruptcy filing will be subject to this post-petition rule to the extent that, because of new Code Section 409A, such payments are delayed for six months.

The Precaution. It takes a pre-bankruptcy termination of employment to vest an executive in any claim for severance benefits. As a practical matter, this means that executives who remain employed through the filing date of their employer's Chapter 11 petition run the risk of collecting a fraction, if any, of the severance benefits promised under their pre-bankruptcy severance plans and employment agreements.

Pre-bankruptcy planning may, however, enable executives to avoid forfeiting all of their pay-to-stay or retention benefits in the event their employer files a Chapter 11 bankruptcy petition. Employers with these types of plans may want to consider revising their vesting terms in order to provide executives with the opportunity to earn vested benefits on a pre-petition basis.

This is because if a plan or agreement provides for no vesting until a future corporate transaction (such as a sale or other liquidity event), an executive will be entirely at the mercy of a bankruptcy court if a Chapter 11 filing occurs before the executive collects benefits. On the other hand, if the executive is able to become partially (or fully) vested before a Chapter 11 filing, the executive would be able to establish some pre-petition vested benefit that will result in an unsecured claim – rather than nothing – if a Chapter 11 filing occurs.

Conclusion

Whether in the form of plans or individual agreements, executive severance arrangements are in the crosshairs of shareholders, the SEC, the Treasury Department, and Congress. This is not the time for executives or their employers to be complacent or passive. Careful attention now should significantly reduce the risk that executive severance arrangements will be criticized, trigger 409A penalties, be considered "extraordinary" for purposes of SOX, or be invalidated entirely in a Chapter 11 bankruptcy.

Notes

1. For general information about Section 409A, see our client alerts titled "Congress Tightens Deferred Compensation Tax Laws" (November 2004) and "Deferred Compensation Tax Guidance Delivers Relief: Employers Need to Respond in 2005" (January 2005) (copies available on request and at www.paulhastings.com).

Please feel welcome to contact any of the following with any questions about these, and any other, executive compensation matters:

Ethan Lipsig (LA) 213 683 6304
ethanlipsig@paulhastings.com

Mark Poerio (DC) 202 551 1780
markpoerio@paulhastings.com

Steve Harris (LA) 213 683 6217
steveharris@paulhastings.com

Eric Keller (DC) 202 551 1770
erickeller@paulhastings.com

Julie Kwok (LA) 213 683 6233
juliekwok@paulhastings.com

Jocelyn Sturdivant (DC) 202 551 1808
jocelynsturdivant@paulhastings.com

KC Choi (LA) 213 683 6303
kcchoi@paulhastings.com

Lynda Noggle (DC) 202 551 1777
lyndanoggle@paulhastings.com

Caroline Bruckner (DC) 202 551 1815
carolinebruckner@paulhastings.com

Caroline Lee (LA) 213 683 6204
carolinelee@paulhastings.com

Lisa Brown (DC) 202 551 1764
lisabrown@paulhastings.com

StayCurrent is published solely for the interests of friends and clients of Paul, Hastings, Janofsky & Walker LLP and should in no way be relied upon or construed as legal advice. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. Paul Hastings is a limited liability partnership. Copyright © 2005 Paul, Hastings, Janofsky & Walker LLP.