

Negotiating Executive Employment Agreements: Compensation and Benefits

The terms of an executive employment agreement, including the types of compensation and benefits included in the agreement, can have significant tax and securities consequences for the employer. In addition, under certain circumstances, the employer must publicly disclose the employment agreement, which may subject the employer to scrutiny.

The types of compensation and benefits included in the employment agreement, as well as the specificity of these provisions, depends on the negotiation process and the applicable facts and circumstances, such as:

- The employer's business needs.
- The employer's industry.
- Whether the employer is a public company.
- The executive's position.
- The need to attract and retain the executive.

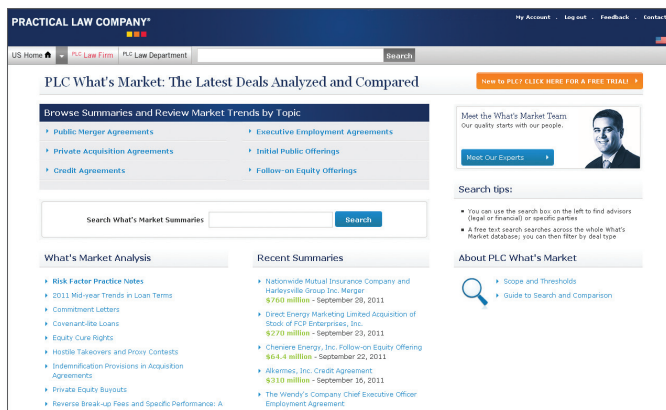
Before negotiating employment agreements, employers should carefully evaluate how particular compensation and benefits terms may be perceived by shareholders and shareholder advisory groups such as Institutional Shareholder Services Inc. (ISS). Terms that were once common, for example, golden parachute excise tax gross-ups, are rare in new public company employment agreements because they are generally disfavored by shareholder advisory groups.

In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) mandates that public companies hold a say on pay shareholder advisory vote on the compensation of the company's "named executive officers" (typically the principal executive officer, principal financial officer and the next three most highly paid executive officers as of the end of the most recently completed fiscal year). Employers should assess the implications of this requirement when reviewing and negotiating their employment agreements (see *Box, An Expert's View*).

>> For more information on the executive compensation provisions of the Dodd-Frank Act, search [Summary of the Dodd-Frank Act: Executive Compensation](#) on our website.

This article examines the issues that employers should consider when drafting and negotiating compensation and benefits provisions of executive employment agreements. The compensation and benefits components that are frequently included are:

- Base salary.
- Annual bonus provisions.
- Signing bonuses.
- Equity awards.
- Perquisites and participation in employee benefit plans.



ABOUT PLCWHAT'S MARKET

PLCWhat's Market provides a continuously maintained database of particular deals and filings, including summaries of recent executive employment agreements, which allows you to analyze and compare terms across multiple agreements. For executive employment agreements, these terms include compensation, severance and provisions addressing emerging issues under the Dodd-Frank Act. Visit PLCWhat's Market at us.practicallaw.com/about/WhatsMarketUS.

>> For a Practice Note that addresses additional provisions of an executive employment agreement, including severance provisions and restrictive covenants, search [Negotiating and Drafting an Executive Employment Agreement](#) on our website.

BASE SALARY

An employment agreement usually specifies an executive's annual base salary, which can be:

- Fixed for the entire term of the employment agreement.
- Subject to discretionary or automatic increases during the term of the employment agreement.

Automatic increases can be made based on a specified amount or cost-of-living increases. However, because of the more stringent regulatory environment, automatic increases have become less common.

ANNUAL BONUS PROVISIONS

Whether an annual bonus provision is included in the employment agreement and the specificity of any annual bonus terms generally depend on the negotiations between the parties. When structuring annual bonus provisions, the employer should consider how much discretion it wants to retain in granting bonuses over the term of the employment agreement. The employer must balance its need for flexibility with the executive's need for certainty in his compensation arrangements.

DISCRETIONARY BONUSES

A purely discretionary annual bonus provision gives the employer the most flexibility. This type of provision allows the employer to determine each year whether to pay an annual bonus and the amount of any annual bonus.

PERFORMANCE-BASED BONUSES

Employment agreements frequently provide that payment of the executive's annual bonus is based on the achievement of

performance goals. This type of provision gives the executive greater certainty in his compensation arrangements. The performance goals can be subjective, objective or a combination of both, and can be based on company-wide or individual performance metrics.

A performance-based bonus provision can also include a:

- Target bonus (the amount the executive is entitled to receive if target performance goals are achieved).
- Maximum bonus (the amount the executive is entitled to receive if performance surpasses target performance goals and more difficult goals are achieved).
- Threshold bonus (the amount the executive is entitled to receive if performance does not reach target performance goals but less difficult goals are achieved).

Deductibility of Bonus Payments

Section 162(m) of the Internal Revenue Code (IRC) imposes limits on how much a public company can deduct as a compensation expense for amounts paid to certain executives. IRC Section 162(m) is applicable if both:

- The employer is (or during the term of the employment agreement may become) a public company.
- The executive is:
 - the chief executive officer; or
 - any other officer whose compensation must be disclosed in the company's annual proxy statement (other than the chief financial officer).

Compensation that qualifies as performance-based under IRC Section 162(m) is not subject to these limits. Therefore, if an employer intends for bonus payments to covered executives to be fully deductible, any bonus provisions of the employment agreement should be consistent with the requirements of IRC Section 162(m).

AN EXPERT'S VIEW



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Andrea considers the impact of the Dodd-Frank Act and proxy voting guidelines of shareholder advisory groups on executive employment agreements:

Although the SEC has delayed the implementation of certain executive compensation provisions of the Dodd-Frank Act until 2012, has the Dodd-Frank Act already had an effect on executive employment agreements?

The Dodd-Frank Act's impact on executive compensation has been mixed. The priority for many companies remains evaluating their executive employment agreements and executive compensation practices to account for the company's business demands and the need to attract, retain and incentivize key talent. However, many companies have been analyzing their executive employment agreements and compensation practices in light of certain Dodd-Frank Act requirements, including mandated say on pay, clawbacks of incentive-based compensation and pay-for-performance proxy disclosure.

The 2011 proxy season was the first year of a mandated say on pay shareholder advisory vote on the compensation of named executive officers. The say on pay requirement encouraged public companies and their compensation committees to take a fresh look at their compensation arrangements. In certain cases, even if companies did not change their executive employment agreements, they nonetheless revisited their proxy disclosures and, in certain cases, revised them to better explain the rationale

behind their agreements. Ultimately, because virtually all say on pay proposals were approved by shareholders, it is difficult to determine whether the Dodd-Frank Act's say on pay requirement has had a meaningful impact on executive employment agreements.

Under the Dodd-Frank Act, public companies are required to adopt a policy that provides for the recovery of executive incentive-based compensation if an accounting restatement is required due to material noncompliance with financial reporting requirements. However, there are many open issues that will need to be addressed by SEC interpretive guidance. In the meantime, companies are taking different approaches regarding clawbacks of incentive-based compensation. For example, some companies are including acknowledgments from executives in recently negotiated agreements that incentive-based compensation will be subject to any clawback policy that is adopted or implemented to comply with the Dodd-Frank Act. Other companies are adopting incentive-based compensation clawback policies and affirmatively subjecting incentive-based compensation to clawback. Finally, some companies are taking a wait and see approach pending release of additional guidance.

The Dodd-Frank Act also requires additional proxy disclosure showing the relationship between compensation paid to a company's named executive officers and the company's financial performance. This requirement has not directly impacted

>> For more information on performance-based compensation under IRC Section 162(m), search [Section 162\(m\): Limit on Compensation](#) on our website.

Short-term Deferral Exception

Performance-based bonus provisions should specify when the bonus will be paid. When drafting the payment date provision, the parties should consider whether the bonus is intended to be a short-term deferral under IRC Section 409A.

>> For more information on short-term deferrals under IRC Section 409A, search [Section 409A: Deferred Compensation Tax Rules](#) on our website.

Termination of Employment

The employment agreement should specify how the executive's eligibility for a performance-based bonus is affected by termination of employment. The employer must decide whether the executive is required to be employed on the last day of the performance period or on the payment date to be eligible to receive the bonus.

In addition, the employer should decide whether the executive will be eligible to receive a bonus for the year in which the executive terminates employment. For example, the employment agreement can provide that if the executive's employment is terminated without cause or for good reason during the performance period, and the performance goals are satisfied, the executive is entitled to a pro-rated portion of the bonus that

executive employment agreements pending SEC proposed rulemaking. However, this requirement, together with certain shareholder advisory groups' focus on performance-based vesting, has likely contributed to the growing trend of granting performance-based equity awards, such as restricted stock units or performance shares that vest upon achievement of specified performance metrics.

Have the proxy voting guidelines of shareholder advisory groups, such as Institutional Shareholder Services Inc. (ISS), become more important as a result of the requirement that companies submit their executive compensation programs to a say on pay vote? What impact have these guidelines had on executive employment agreements?

Even before the enactment of the Dodd-Frank Act, companies considered proxy voting guidelines, largely in an effort to avoid a failed re-election of a director serving on the compensation committee. Now, companies are even more reluctant to ignore shareholder advisory groups' executive compensation guidelines because a failed say on pay vote may be embarrassing to boards (particularly compensation committee members) and may increase exposure to shareholder derivative suits (even though the Dodd-Frank Act clearly provides that a negative say on pay vote should not be construed as creating or implying any change to the board's fiduciary duties or any additional fiduciary duties).

However, some companies believe that certain shareholder advisory groups take a formulaic approach to executive compensation without fully considering all relevant facts and circumstances that apply to a company's executive compensation needs. For example, although the guidelines may indicate that the shareholder advisory group will consider the specific context when evaluating executive compensation arrangements, it is unclear how and to what extent this is done in practice. Therefore, when deciding whether to modify their executive employment agreements, many companies balance their individual situations against the shareholder advisory

groups' proxy voting guidelines (such as ISS's "hot button" list of problematic pay practices).

In light of these guidelines, many companies are considering certain modifications to their executive employment agreements, such as:

- Eliminating golden parachute tax gross-up provisions.
- Eliminating tax gross-up provisions on perquisites and other benefits (sometimes along with a general reduction or elimination of perquisites and other benefits).
- Reducing golden parachute payments to three times (or less than three times) the sum of base salary and bonus.
- Replacing single-trigger provisions that call for immediate payment upon a change in control with double-trigger provisions (provisions that require an involuntary termination on or after a change in control to trigger payment).
- Adopting stock ownership guidelines for the CEO (which is not typically included in the employment agreement).
- Eliminating automatic-renewal provisions and replacing them with fixed terms.
- Eliminating multi-year guarantees for salary increases and incentive awards.
- Adopting performance-based vesting for restricted stock, restricted stock units and similar awards.

Companies are not required to implement these modifications. Rather, companies should evaluate these approaches, taking into account their individual business needs and circumstances.

would have been paid had the executive remained employed for the entire performance period.

If the employer intends for the executive's bonus to constitute performance-based compensation under IRC Section 162(m), the employer should confirm that treatment of the bonus upon the executive's termination is consistent with the requirements of IRC Section 162(m) (see above *Deductibility of Bonus Payments*). For example, an employment agreement may provide that upon the executive's termination of employment without cause, the executive will receive his target bonus regardless of whether performance goals are achieved. However, this provision is inconsistent with the requirements of IRC Section 162(m). As a result, bonus payments to the executive for each year of the employment agreement, even for years before the executive's

termination of employment, would not be performance-based compensation under IRC Section 162(m).

In certain states, a bonus may be considered wages, depending on the terms and conditions of the compensation arrangement. When negotiating the circumstances under which the executive forfeits the bonus in connection with his termination of employment, the employer should confirm that the forfeiture is permitted under the applicable state's wage payment laws.

GUARANTEED BONUSES

Guaranteed bonus provisions provide the executive with a guaranteed minimum bonus for each year during a specified period. These provisions are more commonly included when the employer is a new entity or has recently undergone significant

changes. For example, a guaranteed bonus may be provided when an executive is hired by a recently acquired entity.

SIGNING BONUSES

Signing bonuses are generally provided only under unique circumstances. For example, a signing bonus may be provided if the executive:

- Forfeited a significant amount of unvested compensation from his former employer because he voluntarily terminated his employment to take the position.
- Is receiving base salary that is less than what the former employer provided.
- Relocated to take the position.

The employer should decide whether it will require the executive to forfeit the signing bonus if the executive does not remain employed for a specified period. For example, the employment agreement can provide that the executive forfeits the signing bonus if the executive does not remain continuously employed by the employer for at least one year.

EQUITY AWARDS

Equity-based awards that are typically provided to executives include:

- Stock options.
- Stock appreciation rights.
- Restricted stock.
- Restricted stock units.
- Performance awards.

>> For more information on equity awards, search [Stock Options and Other Equity Compensation](#) on our website.

Before negotiating the employment agreement, the employer should consider whether it intends to provide the executive with equity-based compensation awards and, if so, the degree to which the terms of the awards will be included in the employment agreement.

If the executive will be receiving an award in connection with his execution of the employment agreement, the employer may want to address only that award and reserve discretion regarding the terms and conditions of awards to be granted in the future. However, the executive may want assurance that he will be granted a specific amount or type of equity awards annually. The executive may also want certain terms of the awards to be specified in the employment agreement. For example, the executive may request that all equity awards granted to him during the term of the employment agreement vest if he is terminated without cause.

PERQUISITES AND EMPLOYEE BENEFIT PLANS

The employment agreement usually addresses any perquisites the executive is entitled to during the term of the agreement and the employee benefit plans in which the executive will participate. Executive perquisites may include:

- Personal use of a company car or airplane.
- Country club dues.
- Financial planning or tax advice services.
- Special life insurance coverage.

To preserve flexibility for the employer, the employment agreement can describe these benefits generally. This can be done by stating that the executive will be eligible to participate in employee benefit plans and receive perquisites that are provided to similarly situated employees of the employer. However, if there are certain perquisites or employee benefits that are important to the executive, he may want them set out in the employment agreement.

The parties should also assess the tax consequences of any perquisites or benefits, including:

- Whether the perquisite or benefit is taxable.
- How the employer intends to satisfy any tax withholding obligations.

In addition, the parties should decide how the perquisites and benefits will be treated upon the executive's termination of employment.

RECENT EXECUTIVE EMPLOYMENT AGREEMENTS

The following is a sampling of recent executive employment agreements contained in ^{PLC}What's Market with summaries of some of their respective compensation and benefits provisions. To view additional summaries, visit ^{PLC}What's Market at us.practicallaw.com/about/WhatsMarketUS.

EMPLOYMENT AGREEMENT	Expedia, Inc. Executive Vice President and Chief Financial Officer October 20, 2011	Public Storage Senior Vice President, Chief Operating Officer August 29, 2011	The Men's Wearhouse, Inc. Chief Financial Officer and Executive Vice President April 15, 2011
ANNUAL RATE OF BASE SALARY	\$425,000. Section 3A(a)	\$500,000. Compensation	\$450,000, subject to review from time to time for increase, but not decrease. Section 4(a)
ANNUAL BONUS AND CASH INCENTIVES	Discretionary annual bonus with a target of 75% of annual base salary. The executive is also entitled to participate in any incentive programs on the same basis as provided to similarly situated executives. Section 3A(b), 3A(c)	For calendar year 2011, the executive receives an annual bonus in an amount equal to \$365,000. The executive is not eligible to receive the 2011 bonus if he is terminated for cause during the first year of employment. For calendar year 2012, the executive's bonus potential is \$500,000, subject to the employer's regular bonus plan provisions. Typical bonus payouts generally range from 70% to 80% of target. The executive must be employed continuously during the year and at the time of payment to receive the 2012 annual bonus. Compensation	Annual target bonus is at least \$350,000, payable based on performance in accordance with the terms of the employer's annual cash bonus program for executive officers. The employment agreement provides for payment above and below target. The executive must be employed on the bonus payment date to receive the annual bonus. The executive is also entitled to participate in all incentive compensation plans on the same basis as senior management executives. Section 4(b), 4(c)
SIGN-ON EQUITY GRANTS	None specified.	Stock options to purchase 100,000 shares of common stock, subject to time vesting in five equal annual installments. 5,000 shares of restricted stock, subject to time vesting in eight equal annual installments. Employee retention and rewards	None specified.
ONGOING EQUITY GRANTS	None specified.	Eligible to receive periodic restricted stock awards. Employee retention and rewards	Annual grants of restricted stock, deferred stock units or stock options, or a combination thereof, having a fair market value equal to \$800,000. Any restricted stock or deferred stock units will have a vesting period of no longer than three years and any stock options will have a vesting period of no longer than five years. Section 4(d)
BENEFITS AND PERQUISITES	Health, welfare and retirement benefits (including annual paid vacation) on the same basis as provided to similarly situated executives. Section 3A(c)	Three weeks' paid vacation per year. Comprehensive benefits provided by the employer. Vacation, Other benefits	Health, welfare and retirement benefits on the same basis as provided to senior management executives. 20 days' paid vacation per year. Section 4(c), 4(e)