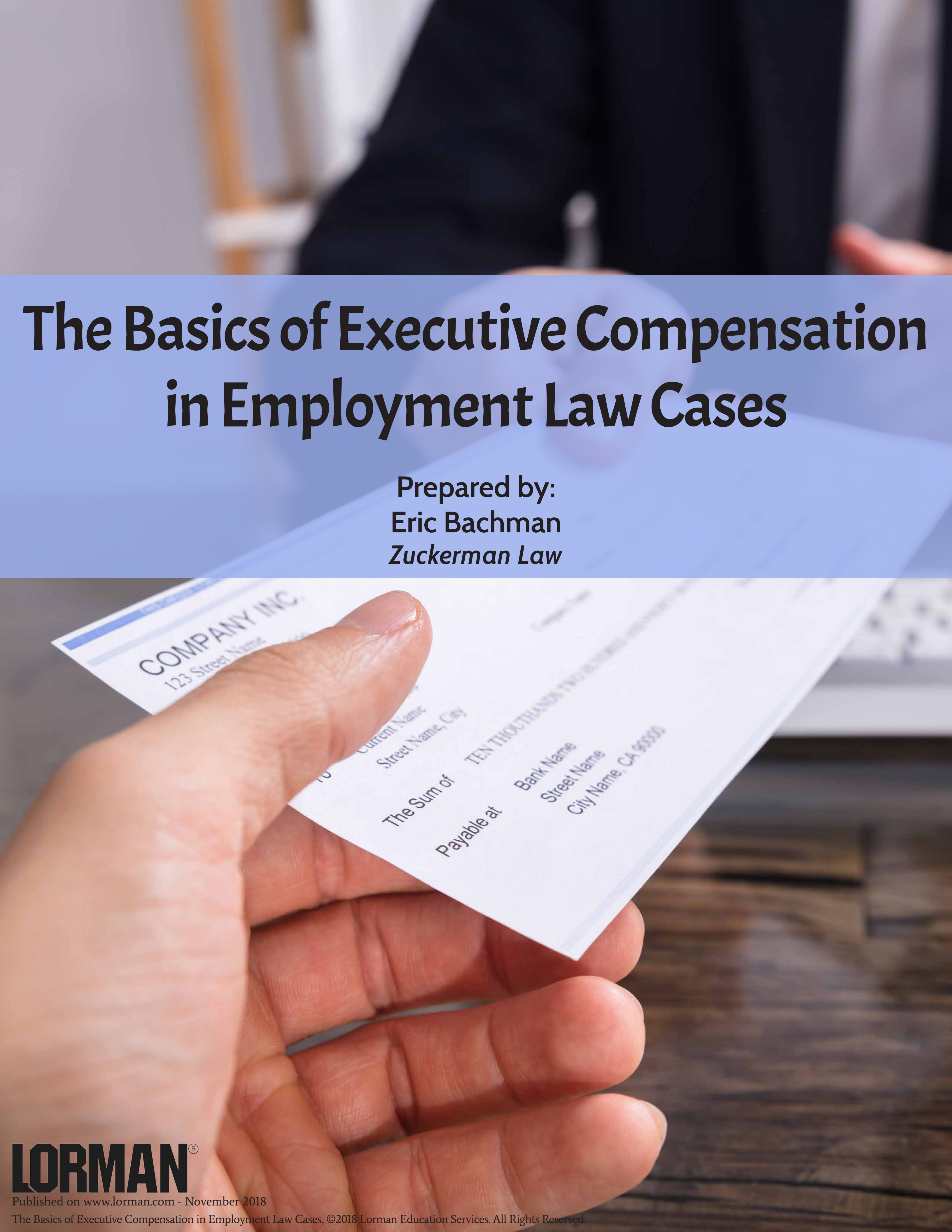

The Basics of Executive Compensation in Employment Law Cases

Prepared by:
Eric Bachman
Zuckerman Law

LORMAN®

Published on www.lorman.com - November 2018

The Basics of Executive Compensation in Employment Law Cases

Written by Eric Bachman – 4/6/18

When joining or exiting a company, executives face unique challenges to ensure their rights are protected given the variety of compensation they receive beyond a salary.

Knowing precisely what your compensation consists of and how to maximize its value during negotiations is essential.

Below is a high-level review of the key concepts, and more detail will be provided on each subject in future posts.

Base salary

An executive's base salary is the most straight-forward type of compensation. It is usually characterized as an annual salary and often paid in the same intervals as other salaried employees (for example, monthly or bi-weekly).

Salaries among executives vary greatly based in part on the industry and potential value of the other forms of compensation offered.

Bonuses (short-term incentives)

Many different types of bonuses exist, including a signing bonus and different forms of annual incentives. Companies use bonuses to incentivize executives to achieve the company's short-term business goals. The bonus itself is commonly paid as a percentage of the base salary.

Various targets are usually set to encourage superior performance and may include criteria like: development of a new product; achieving a certain level of sales; and other performance goals within the executive's division or department.

Long-term incentives

Long-term incentives routinely comprise the biggest portion of an executive's compensation. Companies offer long-term incentives to retain talent and encourage executives to realize the company's strategic goals and objectives.

Long-term incentives are normally granted as some form of equity compensation, such as:

- stock options (the executive can buy or sell the company's stock at an agreed (exercise) price within a set period of time)
- restricted stock shares/units (an award of stock with restrictions usually contingent upon working for the company a particular length of time)
- performance shares/units (an award of stock with restrictions often related to achieving company performance goals)

Typically, the equity grants will vest over a specific period of time, essentially making the executive an investor in the company's performance. The vesting period varies by company but usually covers a period of 3 to 5 years. Long-term incentives that have not vested are typically forfeited once the executive departs the company.

Termination issues

The manner in which a company characterizes an executive's termination of employment is extremely important. For example, if the employer terminates the executive for "cause," then s/he will often lose most rights to unvested long-term incentives and other future compensation. If the executive resigns with "good reason" or is terminated without case, however, then the executive is routinely able to secure significant severance benefits.

Thus, how an employment agreement defines a termination for "cause" and a resignation with "good reason" is vital to know if considering a departure. And when negotiating an employment agreement, it is essential to define this terms to give the executive adequate protection.

Tax consequences

Several provisions of the Internal Revenue Code (I.R.C.) may impact an executive's compensation and exit from the company. Chief among them is Section 409A of the I.R.C., which, per the IRS:

applies to compensation that workers earn in one year, but that is paid in a future year. This is referred to as nonqualified deferred compensation. This is different from deferred compensation in the form of elective deferrals to qualified plans (such as a 401(k) plan) . . .

"If deferred compensation meets the requirements of Section 409A," according to the IRS, "then there is no effect on the employee's taxes." That is, the compensation is taxed the same way it would be taxed if it were not covered by Section 409A. However, if the compensation arrangement does not meet the requirements of Section

409A, then “the compensation is subject to certain additional taxes, including a 20% additional income tax.”