



**Employee Benefits Broadcast**  
The Benefits News You Need in 60 Minutes or Less

For audio participation, dial 866.837.9782 and follow the prompt.

**FOLEY**  
FOLEY & LARDNER LLP

1

09.6021



**Employee Benefits Broadcast**

**“The Benefits News You Need  
in 60 Minutes or Less”**

**Tuesday, January 24, 2012  
12:00 p.m. – 1:00 p.m. CST**

**FOLEY**  
FOLEY & LARDNER LLP

2

08.5055



## Employee Benefits Broadcast

### Housekeeping Issues

- Call 866.493.2825 for technology assistance
- Dial \*0 (star/zero) for audio assistance
- To ask questions, use the pull down Q&A menu
- We encourage you to Maximize the PowerPoint to Full Screen Usage:
  - Hit F5 on your keyboard
- To print a copy of this presentation:
  - Click on the printer icon in the lower right hand corner. Convert the presentation to PDF and print as usual.



3

08.5055



## Employee Benefits Broadcast

### Today's Topics

- **The Fine Print:** Contracts With Employee Benefit Vendors — A Lawyer's View
- **Cram Session:** Qualified Retirement and 401(k) Plans — That Pesky Definition of Compensation
- **In The Spotlight:** The Never-Ending Saga of Section 409A — Does (Almost) Every Compensation or Benefits Issue Raise Section 409A Concerns?



4

08.5055



## The Fine Print



### Contracts With Employee Benefit Vendors — A Lawyer's View

Belinda S. Morgan



5

08.5055



## The Fine Print

### Introduction

- Attorney review is often the final step of the process, but still important



6

08.5055



## The Fine Print

### What we'll be discussing:

- Why does it matter?
- What can go wrong?
- How can you avoid contract problems?



## The Fine Print

### Why does it matter?

- Contract protects you if something goes wrong
- Want to “future-proof” the agreement
- May have fiduciary responsibility when contracting with service providers



## The Fine Print

### What can go wrong?

- Scope and cost of services/product provided
- Indemnification provisions
- Ownership of data, intellectual property



## The Fine Print

### What can go wrong? (cont.)

- Fiduciary status of the vendor
- Contract term and automatic renewal provisions
- What happens when the contract terminates?



## The Fine Print

### How can you avoid contract problems?

- Know exactly what you want before beginning negotiations
- Know what your “deal-breakers” are
- Know when to walk away



## The Fine Print

### Conclusion

- Your lawyer reviews vendor contracts with an eye to protecting you from what happens when things go wrong
- With some preparation, however, you can minimize potential issues that may arise



## Cram Session



### Qualified Retirement and 401(k) Plans — That Pesky Definition of Compensation

Isaac J. Morris



13

08.5055



## Cram Session

### What Makes Compensation So Important?

- Because it determines the amount of participant (employee) and company (employer) contributions under the plan's design
  - For instance, your plan may allow you to defer up to 70% of your compensation, and may offer a company match of 50% of the first 6% of your compensation
- Because it is used to apply benefit and deduction limits (imposed by the Internal Revenue Code)
- Because it identifies highly paid individuals who cannot receive excessive (i.e., discriminatory) benefits



14

08.5055



## Cram Session

### What Makes Defining Compensation So Pesky? — Part 1

- Plans often use different definitions of compensation for different purposes
  - Definitions to comply with the limit on annual additions
  - Definitions to comply with the prohibitions against discrimination
  - Definitions to match the needs and preferences of the employer



## Cram Session

### What Makes Defining Compensation So Pesky? — Part 2

- Even with one definition, identifying elements, and putting them in place, can be a challenge
  - It can be difficult to make sure only the correct elements are chosen
  - Payroll systems often have dozens, if not hundreds of pay codes



## Cram Session

### Defining Compensation in a Non-Discriminatory Fashion — Part 1

- Using a safe-harbor definition of compensation
  - The default definition or “long list” definition
  - The “short list” definition
  - Federal wage withholding
  - W-2 wages



## Cram Session

### Defining Compensation in a Non-Discriminatory Fashion — Part 2

- Modifying the safe-harbor definitions
  - By only modifying designated items
  - By still satisfying regulation requirements



## Cram Session

### What are Some Common Mistakes?

- Failing to align the plan's definition of compensation with your expectations and operations
- Adopting a prototype plan without considering the definition of compensation
- Lack of recognition of the importance of compensation
- Not fixing or recognizing errors, or letting them pass uncorrected



## Cram Session

### How You Can Avoid Compensation Errors

- Read your plan and your SPD
- Annually review the plan's operations and payroll definitions
- Spot check your plan
- If the definition of compensation is amended, review the amendment carefully to understand its impact on payroll and plan operations
- Make sure relevant parties talk to each other



## In the Spotlight



### The Never-Ending Saga of Section 409A — Does (Almost) Every Compensation or Benefits Issue Raise Section 409A Concerns?

Gregg Dooge



21

08.5055



## In the Spotlight

### The Never Ending Saga of Section 409A

- The “reach” of Section 409A is surprisingly broad.
  - Section 409A applies if a service provider (typically, but not exclusively, the employee) has a right to “deferred compensation”.
  - The legal definition of the term “deferred compensation” is more expansive than the generally understood meaning of that term.
    - This results in arrangements that are subject to Section 409A, even though not typically thought of as deferred compensation arrangements.
    - Today, we want to revisit the core rules of when an arrangement is subject to Section 409A and a few practical illustrations of how (or why) Section 409A applies to certain situations.



22

08.5055



## In the Spotlight

### The Never Ending Saga of Section 409A

- When is a “non-qualified deferred compensation plan” subject to Section 409A?
  - If it provides for a “deferral of compensation”.
  - A plan provides for a “deferral of compensation” if the service provider:
    - obtains a legally binding right during a taxable year to the payment of compensation, and
    - under the plan, the compensation is or may be payable in a later taxable year.
- Exceptions to 409A Coverage (plans or arrangements that are not subject to Section 409A or that are deemed to not provide for the “deferral of compensation”)
  - Qualified retirement plan, e.g., 401(k) or defined benefit pension plans.
  - Section 457(b) plans



## In the Spotlight

### The Never Ending Saga of Section 409A

- A Section 457(b) plan, also known as an “eligible” plan, is a deferred compensation plan maintained by a state or local government or a tax-exempt entity.
- The exception applies only to Section 457(b) plans. A Section 457(f) plan, also known as an “ineligible” plan, may be subject to Section 409A.
- Certain welfare benefits
  - Bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan are excluded from Section 409A coverage.
  - Cautions:
    - Note that medical coverage not included in this list. (There are separate rules in 409A regarding post-termination medical benefits.)



## In the Spotlight

### The Never Ending Saga of Section 409A

- Exceptions to Section 409A coverage (continued)
  - Also, note that although the benefits under the above programs might be excluded from Section 409A, an agreement obligating the service recipient (typically the employer) to pay the premiums for certain coverage, e.g., post-employment life insurance, may be subject to Section 409A. So, the benefit and the arrangements for payment of the cost of the benefit might be two different things.
  - The Short-Term Deferral Rule (a very important but sometimes misunderstood exception)
    - Applicable to payments that are subject to a “substantial risk of forfeiture”.
    - If the arrangement requires that payment to the service provider be made (and, with limited exceptions, payment is made) no later than the last day of the “applicable 2 and ½ month period”, the arrangement is exempt from Section 409A.



## In the Spotlight

### The Never Ending Saga of Section 409A

- Exceptions to Section 409A coverage (continued)
  - Generally, the “applicable 2 and ½ month period” ends on March 15 of the calendar year following the year in which the service provider’s (employee’s) right to receive the compensation is no longer subject to a substantial risk of forfeiture.
  - So, in essence, if amounts are required to be paid by March 15 of the year following the year of vesting, the arrangement is exempt from Section 409A.
  - What is a “substantial risk of forfeiture”?
    - Most typical is a requirement to perform future services, i.e., forfeiture of the award if employment terminates prior to a vesting date.
    - If an award is payable only if prescribed financial metrics are satisfied, there may be a “substantial risk of forfeiture” for 409A purposes until the end of the period over which performance is measured.



## In the Spotlight

### The Never Ending Saga of Section 409A

- The short-term deferral rule (continued)
  - Payment of regular salary and the provision of regular employee benefit coverage during active employment is exempt from Section 409A because the employee must be employed during the applicable period in order to receive the pay or benefits.
  - Calendar year annual bonus that is paid by March 15 of the following year is exempt from Section 409A unless employee has made an election to defer receipt of the bonus.



27

08.5055



## In the Spotlight

### The Never Ending Saga of Section 409A

- Recurring 409A Trouble Spots
  - Executive incentive arrangements (and subsequent modifications thereto)
  - Misapplication of the short-term deferral rule exemption.
- Executive Incentive Arrangements
  - Section 409A is not limited to plans covering groups of employees. A one-participant arrangement might be a deferred compensation plan for purposes of 409A.
  - Thus, employment contracts or executive incentive programs must be reviewed for 409A compliance.



28

08.5055



## In the Spotlight

### The Never Ending Saga of Section 409A

- Executive Incentive Arrangements
  - Don't be fooled by the terminology. Section 409A might apply even though the arrangement is referred to as a bonus or incentive plan.
  - If (a) an amount or benefit is credited to an employee in one year, (b) the employee is vested in the amount (so that there is not a substantial risk of forfeiture), and (3) the arrangement provides for payment beyond March 15 of the following year, Section 409A applies.
    - This does not mean that Section 409A has been violated.
    - But, if Section 409A applies, it means that making future changes in the arrangement will be more difficult.
    - If the arrangement is exempt from (not covered by) Section 409A, there is greater (but not unlimited) flexibility to make future changes to the arrangement. In contrast, if the arrangement is subject to Section 409A, future changes in the agreement – and in particular, changes in the form and time of payment – are more difficult.



## In the Spotlight

### The Never Ending Saga of Section 409A

- Executive Incentive Arrangements
  - This is a critical point: We see numerous examples in which the parties want to change an agreement without even realizing that it is subject to Section 409A.
    - The practical reality is that the managers of the business frequently discuss the formation and modification of these arrangements.
    - The legal reality is that post-service changes raise 409A considerations.
  - Example:
    - Employer negotiates arrangement with key employee to provide incentive based on growth in key business metric over a three year period.



## In the Spotlight

### The Never Ending Saga of Section 409A

- Executive Incentive Arrangements
  - Employment contract provides for partial payment in year four and the remainder to be paid in installments after the executive's retirement (which is expected to occur at end of the three year period).
  - The initial three year period is a success, the executive does not want to retire, and the parties now want to continue the incentive arrangement, with certain modifications. So, they produce a new employment contract that provides incentive opportunities for years 4, 5 and 6, but also rearranges the payment terms to move some of the amounts that were to be paid in installments following retirement into years 5 and 6 (to cover expected college education costs).



31

08.5055



## In the Spotlight

### The Never Ending Saga of Section 409A

- Executive Incentive Arrangements/Example
  - The modification violates Section 409A.
    - The portion of the original arrangement providing for payments after retirement (separation from service) is subject to Section 409A.
    - The executive was vested in the payment amounts, and the arrangement provided for payment beyond March 15 of the year following the year in which the employee became vested (the date the employee was no longer was subject to a substantial risk of forfeiture).
    - Changing the payment terms of a Section 409A arrangement to accelerate payment is not permitted.
  - We see a steady stream of situations in which there is a desire to amend a previously negotiated employment arrangement.



32

08.5055



## In the Spotlight

### The Never Ending Saga of Section 409A

- Misapplication of the short-term deferral rule (thinking that the exemption applies when it might not)
  - Is your long-term (multi-year) bonus/incentive program really a short-term deferral?
    - A multi-year incentive program might be exempt under the short-term deferral rule.
    - However, need to carefully examine whether a substantial risk of forfeiture exists through-out the entire period. Two common risk of forfeiture provisions:
      - Payment conditioned upon the employee performing substantial future services.
      - Payment conditioned upon the satisfaction of performance metrics, e.g., the financial targets.



## In the Spotlight

### The Never Ending Saga of Section 409A

- Payment contingent upon the performance of substantial future services
  - Many arrangements contain a general rule that the employee must remain employed for the entire performance period.
  - However, many arrangements also provide an exception for “retirement”, e.g., an employee who retires during the performance period on or after age 55 with at least 10 years of service is eligible for a pay-out.
    - Thus, if a three-year incentive award provides for pay-out by March 15 of year 4, the employment condition does not satisfy the short-term deferral requirements with respect to an employee who is eligible for retirement at the time of grant or who becomes eligible for retirement in years 1 or 2.
    - This is because unless there is another condition, e.g., the performance metrics, that constitutes a substantial risk of forfeiture, the employee can terminate employment in years 1 and 2 and have a vested right to a payment that will not be made until year 4. So, unless another risk of forfeiture exists, the short-term deferral exemption is not satisfied.



## In the Spotlight

### The Never Ending Saga of Section 409A

- Performance Metrics as a Substantial Risk of Forfeiture
  - For an award that is conditioned upon the satisfaction of pre-defined performance metrics, satisfaction of the performance metrics might itself be a substantial risk of forfeiture for purposes of the short-term deferral rule.
  - However:
    - If an employee who “retires” receives, e.g., a prorated portion of the target award, without regard to actual performance, then the performance metrics are not a substantial risk of forfeiture.
    - Be certain that there really is a single performance period rather than multiple separate performance periods.
      - If there is a single performance period, there is a risk of forfeiture until the last day of the performance period because negative performance in a later year (for example, year three) might operate to reduce or eliminate the award that is payable with respect to performance in an earlier year (for example, year one).



## In the Spotlight

### The Never Ending Saga of Section 409A

- Not all employers have a single performance period structure, even though they refer to the incentive as a 3 year award. For example, some employees provide for an incentive payable by March 15 of year 4, but the amount payable is the sum of a payment amount separately calculated for years 1, 2 and 3, such that each calculation is independent and negative performance in a later year does not impact the amount payable with respect to an earlier year. For example, if the amount payable with respect to year 1 is not paid by March 15 of year 2, but is instead to be paid by March 15 of year 4, the financial metrics do not produce a substantial risk of forfeiture beyond the end of year 1 for the amount “earned” in year 1. For this type of award to be subject to a substantial risk of forfeiture, there has to be an independent risk of forfeiture, e.g., a requirement of continued employment. However, as we have seen, the employment condition might itself have problematic exceptions.



## In the Spotlight

### The Never Ending Saga of Section 409A

- Summary
  - Executive incentive programs frequently are subject to Section 409A.
    - Modification of an existing arrangement may be problematic.
  - Tread carefully with the short-term deferral rule.
    - Many arrangements that look like short-term deferrals exempt from 409A are not in fact exempt.
    - This may impact the parties' ability to make subsequent changes in the arrangement and may be important in determining when and how an employee may make an election to defer payment of the award.
  - These are “every day” Section 409A issues.



## Employee Benefits Broadcast

### Questions & Answers



## Employee Benefits Broadcast

### Contact Information

- **Belinda S. Morgan**  
312.832.4562  
[bmorgan@foley.com](mailto:bmorgan@foley.com)
- **Gregg H. Dooge**  
414.297.5805  
[gdooge@foley.com](mailto:gdooge@foley.com)
- **Isaac J. Morris**  
414.297.4973  
[imorris@foley.com](mailto:imorris@foley.com)



39

08.5055



## Employee Benefits Broadcast

### Mark Your Calendar

- The remaining sessions of the 2012 Employee Benefits Broadcast Series will take place on the following dates:
  - April 24, 2012
  - July 24, 2012
  - October 23, 2012



40

08.5055



## Employee Benefits Broadcast

### Thank You

- A copy of the PowerPoint presentation and a multimedia recording will be available on Foley's website within 24 to 48 hours:  
[http://www.foley.com/news/event\\_detail.aspx?eventid=3993](http://www.foley.com/news/event_detail.aspx?eventid=3993)
- We welcome your feedback. Please take a few moments before you leave the web conference today to provide us with your feedback:

<http://www.zoomerang.com/Survey/WEB22EJBYH66NY>



41

08.5055