

**WESTERN PENSION AND BENEFITS CONFERENCE
SPRING SUMMIT
APRIL 30, 2008**

Linda Griffey
Partner
O'Melveny & Myers LLP
Los Angeles, CA

Kurt Hallock
Assistant General Counsel
Computer Sciences Corporation
El Segundo, CA

SECTION 409A QUESTIONS

Additional Guidance

1. IRS is working on income inclusion guidance.
 - Calculation of interest tax
 - Whether losses on discounted options would be taken into account
2. Code Y reporting
 - Notice 2007-89 applied in 2007
 - Moratorium may be extended for 2008
3. Permanent correction program
4. IRS is studying whether it has the authority to require withholding for the 20% penalty

Legally Binding Right and Substantial Risk of Forfeiture

An employer has an annual incentive plan designed to qualify as a performance-based bonus plan under Section 162(m) and therefore requires the compensation committee to certify that the performance goals have been made before bonuses can be paid. The compensation committee has the discretion to reduce the amount of the bonuses payable. Do the participants have a legally binding right to bonuses before the compensation committee determines the amounts of the bonuses that are payable? If the participants do not have to work beyond December 31 of the performance year, are their bonuses subject to a substantial risk of forfeiture until the compensation committee determines the amounts of bonuses that are payable?

Substantial Risk of Forfeiture

Assume a private equity firm is in the business of buying and selling portfolio companies. The firm enters into an agreement that it will pay one of the firm's executives 5% of the sales price of Portfolio Company X and that such payment will be made within 60 days of the sale of Portfolio Company X. Does the requirement for the sale of Portfolio Company X constitute a substantial risk of forfeiture so that the compensation qualifies as a short-term deferral?

Definition of Good Reason

1. An executive's employment agreement provides that he will be paid a severance payment within 60 days if he terminates employment for "good reason" within 12 months following a change of control of the company. Good reason is defined in a manner that does not satisfy the safe harbor under Section 409A (assume, for example, that good reason includes any reduction in salary rather than a "material diminution"). There has not been a change of control of the company. Can that definition of good reason be amended now to conform the definition of good reason to the safe harbor definition?
2. Same facts as above except that the executive is entitled to severance for a termination for good reason even if there has not been a change of control. There has been no reduction in the executive's salary. Can the definition be amended now to conform to the safe harbor definition?

Stock Rights/Dividend Equivalents

1. Is it correct that it is problematic to have stock options that provide for payment of dividend equivalents prior to exercise regardless of whether the option is exercised if no dividend equivalents are paid after the earlier of the exercise or the expiration of the option? If so, what is the Section 409A violation and can it be fixed?
2. How do you analyze a right to receive dividend equivalents with respect to an equity award under Section 409A? Are they short-term deferrals because there is no guarantee that dividends will be paid? Or do they qualify as fixed payments even though there is no "objectively determinable amount" for each dividend?
3. Does the fact that directors hold dividend equivalent rights and decide the payment dates pose a problem?

In-Kind Benefits

Employment contracts often provide for the continuation of welfare benefits as part of a severance package. Sometimes such continued welfare benefits include taxable disability insurance. Generally insurance companies will not provide disability insurance to executives who are not employed. Is it permissible for a company to satisfy its obligations to provide disability insurance by paying the executive the cash value of the disability coverage (measured by the amount of premiums that were payable prior to termination or some other valuation method) on an annual or monthly basis? Does this arrangement run afoul of the rule in Treasury Regulations Section 1.409A-3(i)(iv)(5) that the rights to in-kind benefits cannot be subject to liquidation or exchange for another benefit?

Deferral Elections

1. If a participant is demoted during a plan year and ceases to be eligible to participate in deferred compensation plans because he is no longer part of the top hat group, can the employer cancel his deferral election?
2. Treasury Regulations Section 1.409A-2(a)(5) allows a deferral election to be made within the first 30 days following the date the employee obtains a legally binding right to a payment if the payment is subject to a substantial risk of forfeiture for a period of at least 12 months. It further provides that you can still use this rule even if the payment would vest upon death, disability or a change of control.
 - a. What if an employee has an employment agreement that provides that all unvested awards and payments will vest if he is fired without cause? Does that provision in his employment agreement prevent him from electing to defer the payment under the 30-day rule?
3. Assume an employee elected to defer 10% of his 2008 salary under the deferred compensation plan of his employer, which is Subsidiary A of Company X. In the middle of 2008, he is transferred to Subsidiary B of Company X, which does not maintain a deferred compensation plan. Will it violate Section 409A if his salary deferrals cease upon his transfer to Subsidiary B? What effect will other benefit changes have under Section 409A? For example, what if severance benefits are different in amount and form at the two subsidiaries? What if the employee elected to defer 100% of his bonus, and the subsidiary has a separate bonus program?
4. What is the deadline for electing to defer a bonus to be earned in 2008 and paid in 2009, assuming the bonus does not qualify as performance based and the participant has to be employed on the date in 2009 that bonuses are paid in order to qualify for the bonus? It appears that the deferral election can be made late in 2008 (subject to constructive receipt issues) because (a) the bonus would be a short-term deferral and (b) Section 3.02 of

Notice 2007-86 provides that a deferral election may be made with respect to an amount that is a short-term deferral provided that the election is made before January 1, 2009 and before the year in which the amount would otherwise be paid. Is that correct?

1 Year/5 Year Rule for Changes to Payment Elections

A deferred compensation plan provides for payment upon a separation from service. Payment will be in a lump sum if a participant terminates prior to age 60; however, each new participant may elect to receive benefits in the form of a lump sum, 5-year installments or 10-year installments at retirement, which is defined as a separation from service that occurs at or after age 60, and to make a change to that election subject to the 1 year/5 year rule. Assume a participant originally elects 5-year installments as his retirement form of benefit and later changes his election to a lump sum, which will delay the retirement benefit payment date until 5 years after his separation from service at age 60 or later. Then assume he actually separates from service at age 50. Since he never had any election as to form of benefit for a pre-retirement separation from service, is the benefit at age 50 payable immediately or does it have to be delayed for five years?

Discounted Stock Options

1. Assume a Section 16 officer has a discounted stock option that did not get repriced before 2007. Is it correct that if he still held the option at December 31, 2007, he was taxed on the spread as of December 31, 2007 regardless of the amount of spread at any other date in 2007? What if he still holds the option at the end of 2008? Is he taxed again on any additional spread? What happens if the stock has gone down in value as of the end of 2008?
2. If a company wishes to make discounted stock options compliant with Section 409A by having optionees elect an exercise date before January 1, 2009, can the optionees elect a year and then exercise at any time during that year?

Payment on Fixed Dates Following Vesting

A class-year deferred compensation plan provides that the amount credited to a participant's account for any plan year will vest in 3 annual installments on December 31 of each of the 3 years following crediting. Each vested installment will be paid as soon as practicable following its vesting date but in no event later than the end of the following year. Thus, these payments do not qualify as short-term deferrals. Vesting will be accelerated upon death, disability, attainment of age 65, termination without cause or a change of control. The definitions of change of control and disability do not satisfy the definitions for those terms under Section 409A. Could payment

be accelerated in the event of the accelerated vesting under these provisions? Or could payment only be accelerated on account of vesting upon death, termination without cause or attainment of age 65 because (1) disability and change of control would not independently qualify as payment triggers and (2) even if the payments were made within 2-1/2 months following the end of the year in which vesting occurs due to disability or change of control, the payments could not qualify as short-term deferrals because the normal in-service payments do not qualify as short-term deferrals?

Short-Term Deferrals

1. A bonus plan provides that participants will be paid bonuses based on the appreciation in the value of the company's stock from the effective date of the plan until the "valuation date." The "valuation date" is the earliest of (i) September 30, 2009, (ii) the date on which a change of control occurs or (iii) such earlier date determined by the Administrator. Benefits will be paid in installments beginning within 30 days following the "valuation date" and quarterly thereafter. However, continued employment is required until each installment payment date in order to be eligible to receive the applicable installment. Since no participant is entitled to a payment unless he is employed on the payment date, each payment will qualify as a short-term deferral and not be subject to Section 409A. Therefore, the discretion of the Administrator to accelerate the "valuation date," which in turn accelerates vesting and payout, should not create a prohibited acceleration of deferred compensation under Section 409A. Is that a correct interpretation?
2. A specified employee of a public company is entitled to installment payments for a period of three years following his involuntary termination of employment. Is it correct that all payments made on or before March 15 of the year following his involuntary termination of employment can qualify as short-term deferrals -- and therefore will not be subject to the six-month delay rule -- if the plan provides that each installment is to be treated as a separate payment for purposes of Section 409A? Can the plan be amended before January 1, 2009, to provide that each payment is to be treated as a separate payment even if the specified employee separates from service before the amendment is adopted?
3. An executive has a severance agreement that provides that if the executive is involuntarily terminated, the company is obligated to pay him severance benefits. The agreement also states that the severance is payable upon the following events: (i) death, (ii) disability, and (iii) termination of employment for any reason within 12 months following a change in control. If the Executive voluntarily terminates employment prior to death, disability or a change in control of the company the executive is not entitled to the severance. The company is publicly traded and the executive qualifies as a "specified employee." In January of 2008, the executive is involuntarily terminated by the Company.

- a. Will the payment of severance due to Executive's involuntary termination of employment qualify as a short-term deferral if it is paid before March 15, 2009?

Six-Month Delay Rule

A specified employee separated from service on June 28, and is entitled to a lump sum payment under a deferred compensation plan on December 29 of that year. The employer has received notice that the specified employer is in a divorce proceeding and that QDROs will be forthcoming with respect to amounts due to the employee under the employer's qualified plans and the deferred compensation plan. If the employer delays payment under the deferred compensation plan in anticipation of the QDRO, does the delay violate Section 409A? To what extent can the employer and specified employee rely on Treasury Regulation Section 1.409A-3(g) (disputed payments and refusals to pay) and/or 1.409A-2(b)(7)(ii) (payments that would violate Federal securities laws or other applicable laws)?

Renewed Employment Agreements

An executive has a three year employment contract that runs from February 1, 2006 to January 31, 2009. It provides for \$1 million paid out over 12 months if he is fired without cause. It also provides for \$1 million paid out over 12 months if, at the end of the term of the contract, the executive is willing to perform services but the employer declines to renew the contract. The contract is renewed at the end of the term, effective February 1, 2009.

- a. Does the renewal of the contract with the same severance provisions provide for an impermissible further deferral of deferred compensation?
- b. What is the result if, in renegotiating the contract, the parties agree to increase the severance amount to \$2 million?
- c. What is the result if, in renegotiating the contract, the parties agree to a different form of payout such as a lump sum or payable over 24 months?

Change of Control Payments

An executive's employment agreement provides for a number of benefits in the event he is terminated without cause following a change of control, such as vesting of options, salary continuation, pro rata bonus payment, continued welfare benefits, etc. However, the benefits are capped at 2.99 times his base amount to avoid the excise tax. The employment agreement allows the executive to designate which benefits will be forfeited in order to meet the cap. Is this provision allowable under Section 409A?