



Executive Compensation Issues Applicable to Tax Exempt Entities

Leslie A. Klein



Overview

- Current trends in executive compensation
- Elements of executive compensation
 - » Salary
 - » Annual Incentives
 - » Long term cash or equity incentives
 - » Retirement/Deferred compensation
 - » Change in control benefits
 - » Severance
- Documenting executive compensation
- Conclusion

Current Trends in Executive Compensation

- Increased attention and criticism of executive compensation
- Increasing shift towards performance based compensation
- Significant reduction of benefits payable on an involuntary termination
- Increased government regulations
- Increased shareholder activism
- Increasing shift from stock options to restricted stock grants

Elements of Executive Compensation: Salary

- Fixed amount v. changing amount
- Changing amount:
 - » Increases based on formula
 - » Discretionary increase or decrease

Elements of Executive Compensation: Annual Incentives

- Generally cash payments paid shortly after the end of the performance period
- Discretionary v. fixed amounts
- Fixed amounts:
 - » Bonus payable if pre-established goals are met with respect to a 12-month performance period
 - May provide for minimum and maximum targets
 - » Performance goals must be reasonable
 - » Challenging in difficult economic conditions

Elements of Executive Compensation: Long Term Cash or Equity Incentives

- Similar to annual incentives but the performance period is generally 3-5 years
- Incentive paid shortly after end of the performance period
- Similar challenges exist in setting performance goals as with annual incentives
- Equity incentive or equity-like incentive
 - » Equity incentives include stock options and restricted stock
 - » Equity-like incentives include restricted stock units, phantom stock, stock appreciation rights and profits interests

Elements of Executive Compensation: Long Term Cash or Equity Incentives

- Special considerations for private companies
 - » Reluctance to provide equity to employees
 - » Lack of liquidity
- Special tax considerations under Section 409A
 - » Must design the long term incentive arrangement to comply with Section 409A or fall within an exception to Section 409A
- Risk of forfeiture for tax exempt entities

Elements of Executive Compensation: Retirement/Deferred Compensation

- Traditional retirement qualified arrangements
 - » Pension, profit sharing, 401(k) and 403(b) plans
- Nonqualified arrangements
 - » Special tax considerations under Section 409A
 - » Risk of forfeiture for tax exempt entities
- Promise by employer to pay compensation to the executive at some time in the future
 - » Employer paid compensation
 - » Earned compensation deferred at employee election

Elements of Executive Compensation: Change in Control Benefits

- Amounts payable upon a change in control in conjunction with an involuntary termination
- Severance/enhanced severance protection in event of a change in control and an involuntary termination

Elements of Executive Compensation: Severance

- Amounts payable upon an involuntary termination
 - » Termination by the employee for “good reason” or by the employer “without cause”
- Key issues:
 - » Amount: lump sum v. installments
 - » Definition of “good reason”
 - » Special tax considerations under Section 409A

Documenting Executive Compensation

- Employment Contracts
 - » Provides for greater incentives and certainty for the executive
 - » Provide for restrictive covenants
- Written Annual and Long-Term Incentive Plans
- Written Equity and Equity-Like Incentive Plans
- Written Nonqualified Deferred Compensation Plans

Conclusion

- The current trends in executive compensation make it more challenging to design arrangements
- Key to use methods to attract, retain, incentivize and reward executives based upon performance
- Many different ways to compensate executives