Severance and Retention Plans:
Practical Considerations

By

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SEVERANCE AND RETENTION PLANS: PRACTICAL CONSIDERATIONS

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I. INTRODUCTION

The payment of large severance packages and retention bonuses by public companies in recent years has fueled popular resentment and spurred several legislative and regulatory changes to curb perceived abuses. The executive compensation proxy disclosure rules promulgated by the SEC in 2006 is beginning to have an effect on severance pay practices for executive officers as emerging practices for public companies are tending toward lower severance pay multiples. We are likely to see further changes to severance pay and retention bonus practices as companies adjust to more exacting executive compensation disclosure requirements. It is becoming increasingly important for employers to formulate cogent, rational policies regarding severance pay and retention bonuses and effectively articulate the rationale for providing these benefits.

This paper examines the various considerations that employers should take into account in designing appropriate severance and retention pay policies.

II. REASONS FOR OFFERING SEVERANCE BENEFITS AND RETENTION Bonuses

There are numerous reasons for offering severance benefits and/or retention bonuses. While some of the underlying reasons for granting severance benefits and retention bonuses are similar, there are also some fundamental differences between the two.

A. Severance Benefits. Severance benefits are payable upon the employer’s termination of the employee’s employment or, in some cases, an employee’s voluntary resignation for “good reason.” These benefits are usually paid pursuant to the terms of an employment agreement, hiring letter or a written severance plan or policy agreed to or

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1 Severance pay is usually expressed as a number of weeks of base salary for most rank and file employees or a number of months or even years of base salary (and, in some cases, base salary plus annual bonus) for officers and other executives. While 2- to 3-year severance packages for CEOs and other top executives are still relatively common, the emerging trend over the past several years has been toward significantly lower multiples.

2 A “good reason” termination is a form of contractual constructive discharge in which the severance plan or employment agreement provides that an employee will be entitled to receive severance benefits if he or she quits due to an adverse change in the terms and conditions of employment, such as a demotion, reduction in salary, bonus opportunity or benefits, transfer of employment to new location or similar adverse change described in the severance plan or employment agreement. Typically, only executive officers and other senior executives will be entitled to receive severance benefits upon a good reason termination.
implemented prior to the employee’s termination. It is not uncommon, however, for severance benefits to be paid to a departing employee on an *ad hoc* basis negotiated at termination of employment.

The most commonly cited reasons given for offering severance benefits include:

- **Attracting Key Personnel.** Ironically, one of the most frequently cited reasons for offering severance benefits is to attract key personnel. A severance package offered in connection with the hiring of a new executive can help demonstrate the employer’s confidence in the new executive and its commitment to the executive’s success with the company, while providing the executive with a safety net in case the relationship does not work out.

- **Litigation Avoidance.** Avoidance of litigation is another commonly cited reason for providing severance benefits. In addition to the direct litigation costs, litigation can be disruptive to the employer’s operations and demoralizing for its workforce. By conditioning the payment of severance benefits on a departing employee's execution of a well-designed waiver and release of employment-related claims, an employer can generally avoid most employment-related litigation. See Section V below for a discussion on waivers and releases.

- **Restrictive Covenants.** Severance benefits are often used to aid in the enforcement of restrictive covenants (noncompete, nonsolicitation, nondisparagement and confidentiality). Restrictive covenants can be very difficult to enforce after an employee’s termination. Covenants not to compete are unenforceable in California and their enforceability in several other states is severely constrained. Employers may be able to self-enforce such restrictive covenants by paying severance in installments (such as salary continuation and/or fringe or welfare benefit continuation) and conditioning the payment of severance benefits on the departing employee’s continued compliance with the restrictive covenants. If the employee violates the restrictive covenants, future severance payments can be terminated.

- **Providing a Compassionate Job Transition.** Many companies provide severance benefits under broad-based severance arrangements to treat terminated employees with dignity and compassion. Such policies are not purely altruistic. Companies often provide broad-based severance benefits as part of an effort to cultivate the perception of providing a caring and respectful work environment that can significantly enhance a company’s employee recruitment efforts. Non-cash severance benefits, such as employer-paid COBRA benefits and outplacement services, often does more to enhance an employer’s standing as an employer of choice than cash severance.

**B. Retention Bonuses.** The primary purpose of retention bonuses is to encourage select employees with critical skills or knowledge to remain with the company when other retention incentives fail. Retention bonuses are frequently used in the following circumstances:
Break Down of Long-Term Incentive Compensation. Long-term incentive arrangements are often used as a retention incentive as well as a mechanism for rewarding performance. Most long-term incentive arrangements condition the payout on the employee’s continued employment with the company throughout the performance measurement period providing a retention incentive. The prospect of forfeiting a potentially substantial long-term incentive payout creates a disincentive for the employee to leave. That disincentive disappears, however, if the employee believes that performance is likely to fall short of the minimum performance necessary to generate a long-term incentive payout or the payout is expected to be relatively small. Under these circumstances, a retention bonus may provide key employees with an incentive to remain with the employer.

Underwater Stock Options. Stock options also provide a retention incentive under normal conditions. Stock options typically require the employee to remain in continuous employment for several years before the option becomes fully exercisable. The employee will usually forfeit his or her unvested options at termination of employment. Moreover, the vested stock options will usually remain exercisable for only a short period of time (typically 90 days) following the employee’s termination of employment. The forfeiture of the unvested options coupled with the accelerated expiration of vested options create a significant disincentive for employees to terminate their employment. This retention incentive will disappear, however, if the employee ceases to value the stock options due to a substantial drop in the stock price below the exercise price for the stock option. If the employer is not able to reestablish the retention incentive of the stock options through new option grants and/or a repricing of outstanding options, a retention bonus may be appropriate to incentivize the employee to remain with the company.

Change of Control or Sale or Disposition of a Company or Business Unit. An employer may be at substantial risk of losing key personnel due to personal insecurity arising from uncertainty in connection with a change of control of the employer or its sale or other disposition of a business unit. Employees critical to the operations of the employer or business unit may be tempted to start looking for other employment opportunities rather than face the prospect of working for new owners or a new management team. Retention bonuses are used in these situations to encourage employees who are critical to operations of the employer (or business unit) during this period of transition to remain with the company and keep them focused on enhancing the value of the business. Depending on when the retention period ends, it may also provide the purchaser

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3 Such long-term incentive arrangements often provide for a partial payment in the event of a termination of employment during the performance period due to death, disability, or termination by the employer without cause. In addition, such arrangements may also provide for an accelerated payout in the event of a change of control.
with sufficient time to evaluate personnel and an opportunity to negotiate new employment terms with the employees it wants to retain.

- **Plant or Office Closings.** Retention bonuses are also often used in connection with the closing of a plant, office or division to retain the personnel needed to effect an orderly winding down of the operations.

### III. ERISA COVERAGE

Severance and retention arrangements are offered in a wide array of forms including: unwritten, informal policies; term sheets and written agreements covering individual employees; and more formal written plans or programs covering multiple employees (ranging from a few officers to thousands of rank and file employees). In structuring these arrangements, employers should consider whether ERISA applies to the benefits being offered and how the structure of the arrangement may affect that determination.

On balance, there are certain advantages to having ERISA apply to these arrangements, including:

- Preemption of state law (including causes of action based on failure to pay wages, fraud, etc.);
- Access to federal courts;
- ERISA claims administration, which requires exhaustion of administrative claims before the employee can file a lawsuit;
- Arbitrary and capricious standard of review by the courts;
- No right to punitive or extra-contractual damages.

The disadvantages of ERISA coverage include:

- An ERISA plan must comply with ERISA’s reporting (Form 5500) and disclosure (summary plan description) requirements;\(^4\)

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\(^4\) Although the court would review benefit denials under an arbitrary and capricious standard of review, the courts are required to take into account any conflict of interest that arises when the employer acts as the plan administrator and the payor of the benefit claims. *Metropolitan Life Ins. Co. v. Glenn*, 128 S. Ct. 2343 (2008).

\(^5\) Compliance with these requirements should not be difficult. ERISA imposes minimal Form 5500 reporting requirements for unfunded severance plans. Many employers combine the formal plan document and the summary plan description into a single document that they provide to eligible employees.
An ERISA plan must establish a formal claims procedure and provide employees with an opportunity to request a meaningful review of any benefit denial; and

An employee may be awarded attorneys’ fees in a suit for benefits.

In determining whether ERISA applies, there are two questions that must be answered: (1) whether the benefits offered constitute either “welfare” or “pension” benefits, and (2) whether the benefits are provided under a “plan, fund or program.”

A. **“Welfare” or “Pension” Benefits.**

1. **Severance Benefits.** Depending on the terms of the arrangement, severance benefits may qualify either as “pension benefits” or “welfare benefits.” Section 3(2)(A) of ERISA defines the term “pension plan” in part as “any plan, fund, or program . . . to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program provides – (i) retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.” 29 U.S.C. § 1002(3)(2)(A).

Although severance benefits may be viewed as a deferral of income to termination of covered employment, the Department of Labor (“DOL”) has issued regulations providing that a severance arrangement will not be treated as a “pension plan” if the following requirements are met:

✓ Payment under the arrangement is not directly or indirectly contingent upon the employee’s “retirement”;

✓ The total amount of the payments is not greater than twice the employee’s annual compensation for the year immediately prior to the year in which the termination of employment occurs; and

✓ The payments are completed within 24 months of the employee’s termination of employment.

29 C.F.R. §2510.3-2(b).

If the severance pay is not treated as a pension benefit, it should be treated as a welfare benefit. Section 3(1) of ERISA defines the term “welfare plan” as

any plan, fund, or program which . . . was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 302(c) of the Labor Management
Relations Act of 1947 (the “LMRA”) (other than pensions on retirement or death, and insurance to provide such pensions).

Section 302(c)(6) of the LMRA includes “holiday, severance or similar benefits.” See also 29 C.F.R. § 2510.3-1(a)(3) (describing the benefits provided under Section 302(c) of the LMRA that constitute welfare benefits).

2. Retention Benefits. The status of retention benefits under ERISA is much more ambiguous. Retention arrangements will typically provide for a lump sum payment to an employee who remains employed through the date the bonus is earned. While many retention arrangements will also provide for payment if the employer terminates the employee’s employment without cause or if the employee quits for good reason, the payment of a retention bonus is generally not conditioned on the employee’s termination of employment. Accordingly, it would appear that retention bonuses should not be treated as either welfare or pension benefits regulated by ERISA.

The court in Orgeron v. Sea Mar Management, LLC, 2008 U.S. Dist. LEXIS 25953 (W.D. La. Mar. 29, 2009), agreed, stating that the retention bonus payment in that case “is a one-time lump-sum payment to current employees.” The court concluded that the retention bonus arrangement did not provide for a deferral of compensation but did not affirmatively state that the arrangement did not constitute a welfare benefit.7 See also Scott v. American Nat’l Red Cross, 36 EBC 2535 (D. Md. Oct. 11, 2005) (holding that ERISA preempted state law claims relating to severance benefits but not retention benefits).

Unfortunately, many courts appear to focus so much attention on whether the arrangement requires ongoing administration (discussed in Section III.B. below), it often ignores the initial question of whether the benefits provided are welfare or pension benefits. For instance, in France v. Syngenta Crop Protection, Inc., 2002 U.S. Dist. LEXIS 27044 (D. Del. Sep. 30, 2002), the court concluded that a retention bonus arrangement, which provided for payment of a lump sum retention bonus if the employee remained in continuous employment for a definite period of time, was an ERISA plan. The court focused exclusively on whether the arrangement required ongoing administration without ever addressing whether the bonus fell within the definition of welfare benefit or pension benefit.

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6 DOL regulations provide that a “pension plan” does not include “bonuses” unless the bonuses are “systematically deferred to termination of employment or beyond.” 29 C.F.R. § 2510.3-2(c).

7 Although the court in Orgeron quoted the definition of welfare plan from ERISA, it did not expressly state that the retention bonus did not constitute a welfare benefit. Rather, the court ultimately held that the retention bonus arrangement did not require any ongoing administrative scheme and thus did not constitute a “plan” for purposes of ERISA. Id. at *6-7. See the discussion in Section III.B below.
B. Plan, Fund or Program. An employee welfare or pension benefit must be provided under a “plan, fund or program” to be subject to regulation under ERISA. The Supreme Court has held that to come within the ambit of ERISA, a plan must involve an “ongoing administrative scheme.” Fort Halifax Packing Co. v. Coyne, 482 U.S. 1 (1987). In Fort Halifax, the Court concluded that a Maine statute requiring a one-time severance payment upon the closing of a plant was not preempted by ERISA because the statute did not relate to an employee benefit plan. Id. at 12. Although the statute related to an “employee benefit,” it did not relate to an “employee benefit plan” because it did not establish or require an employer to maintain a plan. “The requirement of a one-time, lump-sum payment triggered by a single event requires no administrative scheme whatsoever to meet the employer’s obligations.” Id.

Courts have struggled in determining which types or forms of severance arrangements require an “administrative scheme” and which do not, often with inconclusive or conflicting results. The following is a small sample of some of the recent circuit court decisions.

1. Cases Finding an Ongoing Administrative Scheme

- Severance plan providing detailed formulas for calculating benefits, specifying how benefits would be paid and providing a procedure for handling claims. Wilson v. Kimberly-Clark Corp., 254 Fed. Appx. 280 (5th Cir. 2007).

- Severance plan providing lump sum payment to employees upon involuntary termination of employment within 2 years of a change of control. The plan required the exercise of discretion to determine whether benefits were comparable and to determine the amount of the employee’s seniority for purposes of computing the payment amount. In addition, the plan provided for continuation of medical, dental and life insurance benefits following termination of employment. Kokowski v. Goodrich Corp., 448 F.3d 843 (6th Cir. 2006).

- Severance plan providing medical and dental benefit continuation subject to a dollar cap in addition to severance pay and case-by-case review of benefit eligibility. Petersen v. E.F. Johnson, 366 F.3d 676 (8th Cir. 2004).

- Severance plan providing lump sum payment on involuntary termination where a payout was not triggered by a single event but could be triggered whenever an employee was terminated. The court also noted that the plan required the administrator to exercise discretion in determining whether an employee was terminated “without cause” or quit for “good reason.” Nodworny v. Shaw’s Supermarkets, Inc., 405 F. Supp. 2d 124 (D. Mass. 2005).

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8 See ERISA §§ 3(1) and (2), which are set forth in Section III.A above.
Severance plan providing payment upon termination of employment due to sale of a business unit unless the purchaser offers a job paying at least 85% of the employee’s prior wages at a site not more than 50 miles from the employee’s previous worksite. Way v. Ohio Casualty Ins. Co., 346 F. Supp. 2d 711 (D.N.J. 2004).

2. **Cases Finding No Ongoing Administrative Scheme**


- Employer’s promise made in connection with the sale of a business unit to pay severance benefits if the purchaser terminates an employee’s employment within one year of the sale. Once the employees were terminated, there was nothing for the former employer to do “but write a check.” Eide v. Grey Fox Technical Services Corp., 329 F.3d 600 (8th Cir. 2003).

- Enhanced early retirement benefits offered to terminated employees in connection with the sale of the company and payable at the employee’s election either in a lump sum or a series of periodic payments did not create an administrative scheme. Tinoco v. Voulgarakis, 311 F.3d 617 (5th Cir. 2002).


- E-mail in connection with an offer of employment providing that the employee would be entitled to six months of severance pay if terminated without cause. Emery v. Bay Capital Corp., 354 F. Supp. 2d 589 (D. Md. 2005).

- Suit based on severance pay provided under a release agreement that did not reference the employer’s separate ERISA-regulated severance plan and which exceeded the scope of the release agreement required under the plan. The court concluded that the release agreement constituted a “separate binding contract.” Patel v. Sugen, Inc., 354 F. Supp. 2d 1098 (N.D. Cal. 2005).
IV. TAX ISSUES

A. Internal Revenue Code Section 409A. If not properly structured, severance and retention pay could constitute deferred compensation under Section 409A of the Internal Revenue Code (the “Code”). If an employee has a legally binding right to deferred compensation that fails to meet the requirements of Code Section 409A, the employee will be subject to (i) immediate taxation on the full amount of all vested deferred compensation of a similar type (even if the compensation has not been paid to the employee or is not yet payable to the employee), (ii) a tax penalty equal to 20% of the amount of deferred compensation that is immediately taxable under Code Section 409A, plus (iii) the amount of interest that would be payable due to underpayment of taxes determined as if the deferred compensation was taxable to the employee at the earlier of 2005 or the year the deferred compensation vested.

In general, a payment will be treated as deferred compensation for purposes of Code Section 409A if the employee obtains a legally binding right to the payment in one year and the payment is made in a later year. There are a number of special rules and exceptions that may apply to severance and retention benefits. In general, severance benefits and retention bonuses may qualify as “short-term deferrals” that are exempt from the requirements of Code Section 409A. Alternatively, severance benefits (but not retention payments) may qualify as an exempt “separation pay plan.” If and to the extent that neither of these exemptions apply, the severance and/or retention payments must satisfy the requirements of Code Section 409A to avoid adverse taxation.

If severance is paid in the form of salary continuation, the regulations provide that salary continuation payments may be treated as installment payments with a single commencement date and payment schedule. Installments are treated as a single unitary form of payment commencing on the date the first installment payment is made. Alternatively, the arrangement may provide that each salary continuation payment is a separate payment with its own payment date. Treas. Reg. § 1.409A-2(b)(2)(iii). In general, it is more advantageous to designate each salary continuation payment as a separate payment, because this provides greater flexibility to

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9 Code Section 409A applies broadly to most service providers and not just to employees. Service providers that are taxed on an accrual basis or that perform substantial services for two or more unrelated entities are not subject to Section 409A. For brevity sake, this paper refers only to the consequences of Section 409A on employees.

10 In general, Code Section 409A requires deferred compensation to be paid only upon a specified date (or a fixed schedule of dates) or upon the employee’s death, disability, separation from service, unforeseeable financial hardship or change of control of the employer. Code § 409A(a)(2). In addition, the payment of the deferred compensation may not be accelerated after it is deferred (Code § 409A(a)(3)) and there are restrictions on employee deferral elections and employee elections to change the time and form of distribution of deferred compensation. Code § 409A(a)(4). In addition, deferred compensation that is payable to a “key employee” (within the meaning of Code Section 416(i)) of a corporation that has publicly traded stock due to the employee’s separation from service may not be distributed until 6 months after the employee’s separation from service. Code § 409A(a)(2)(b)(i).
characterize some of the payments as exempt payments or to modify the duration of the salary continuation period in the future.

1. **Short-Term Deferral.** A severance or retention payment will not be treated as deferred compensation if it is required by the terms of the arrangement to be paid to the employee within 2½ months after the end of the taxable year in which the employee vests in the payment and the payment is actually or constructively received by the employee within that time frame (the “short-term deferral period”). For this purpose, the “taxable year” refers to either the taxable year of the employee (generally the calendar year) or the tax year of the employer, whichever ends later. Treas. Reg. § 1.409A-1(b)(4).

A grasp of the following key concepts are needed to understand and apply the short-term deferral exemption.

a) **Substantial Risk of Forfeiture.** An employee will “vest” in a payment when the payment is no longer “subject to a substantial risk of forfeiture.” For purposes of Code Section 409A, a payment will generally be treated as unvested (i.e., subject to a substantial risk of forfeiture) if the compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to the purpose of the compensation and the possibility of forfeiture is substantial.\(^\text{11}\) A payment will also be treated as unvested if it vests as a result of the employee’s “involuntary separation from service”\(^\text{12}\) without cause. Treas. Reg. § 1.409A-1(d)(1).

\(^\text{11}\) Where the employee is a major shareholder of the employer, facts and circumstances will be used to determine whether the possibility of forfeiture is substantial. Among the factors that should be taken into account in determining whether the possibility of forfeiture is substantial are: (i) the relationship of the employee to the other shareholders and their degree of control of the employee, (ii) the position of the employee and the degree to which the employee is subordinate to other employees, (iii) the employee’s relationship to other officers and directors, (iv) the identity of the person who is responsible for deciding whether to discharge the employee, and (v) the past history of enforcing or not enforcing similar forfeiture restrictions. Treas. Reg. 1.409A-1(d)(3).

\(^\text{12}\) Code Section 409A uses the term “separation from service” rather than termination of employment. Although the term “separation from service” as applied to employees generally means a termination of employment with the employer (and all other entities included in the employer’s controlled group by reason of Section 414(b) or (c) of the Code but applying Code Sections 414(b) and (c) as if the standard of control was “more than 50%” rather than “at least 80%”), However, the regulations under Section 409A provide that an employee may have a separation from service earlier than his or her termination of employment if, based on the facts and circumstances, the employee and the employer reasonably anticipate that the level of bona fide services the employee is expected to perform (whether as an employee or as an independent contractor) in the future would substantially and permanently decrease. Treas. Reg. § 1.409A-1(h)(1)(ii). The regulations further provide that if the level of future services is expected to be...
b) **No Legally Binding Right.** In some cases, an employee may not obtain a “legally binding right” to a payment until it is actually paid (or perhaps shortly before it is paid). If the payment is vested on the date the employee obtains a legally binding right to the payment, the short-term deferral rule will be applied by treating the date that the employee obtains a legally binding right to the payment as the vesting date. Treas. Reg. § 1.409A-1(b)(4)(C).

An employee will obtain a “legally binding right” to a payment when the employer no longer has a unilateral right to reduce or eliminate the payment. For instance, an employee will generally not have a legally binding right to a discretionary bonus if the employer has reserved an unfettered right to reduce or cancel the bonus. It is quite common for broad-based severance plans to include an express reservation of rights to amend, modify or terminate the plan at any time. Some severance plans provide that the employer may amend, modify or terminate the plan at any time prior to the employee’s termination of employment, prior to the execution of a waiver and release of claims by the employee or prior to a change of control of the employer. In most cases, an employee will not have a legally binding right to severance benefits if the employer has reserved the right to terminate the severance plan and severance benefits payable under the plan without the employee’s consent.

However, the regulations provide that if an employer’s reservation of discretion to reduce or eliminate a payment of compensation “lacks substantive significance,” it will be disregarded. This may occur where the person exercising the discretion is a family member of the employee or is effectively controlled by the employee (for instance, where the employee has effective control over the person who has discretionary authority over the payment (e.g., where the employee is a principal equity holder of the employer)). Treas. Reg. 1.409A-1(b)(1).

c) **Involuntary Separation from Service.** To be an “involuntary separation from service” for purposes of Code Section 409A, an employee’s service must be terminated as a result of the exercise of the employer’s independent, unilateral authority for reasons other than at the employee’s request. Treas. Reg. § 1.409A-1(n)(1). In addition, the employee must be ready, willing and able to continue performing services. Treas. Reg. § 1.409A-1(n)(1). Thus, separation from service due to the employee’s death or disability will not be considered an “involuntary separation from service.” Although severance plans rarely provide for a payout of severance benefits when an employee has a separation from service due to death or disability, individually negotiated employment agreements occasionally do. In addition, it is not uncommon for

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less than or equal to 20% of the average level of services provided over the prior 3-year period, the employee will be rebuttably presumed to have had a separation from service. If the expected level of future services (as an employee or as an independent contractor) is 50% or more, the employee will be rebuttably presumed not to have had a separation from service. Id.
retention plans to provide for payment to an employee who has a separation from service due to the employee’s death or disability. A severance or retention payment should not be treated as “vested” for purposes of the short-term deferral exemption under Code Section 409A merely because it provides that payment will be made if the employee separates from service due to death or disability. However, such a provision will prevent the severance benefits from qualifying for the separation pay exemption described in Section IV.A.2 below.

d) “Good Reason” Separation. Under certain circumstances, an employee’s voluntary separation from service for “good reason” may be treated as an “involuntary separation” for purposes of Code Section 409A. The conditions that will constitute “good reason” must result in a material negative change in the employment relationship and must be specified in the plan or agreement. Other factors that may be taken into account in determining whether a good reason separation under the plan or agreement is “involuntary” include (i) whether the employee is required to give the employer notice of any condition that constitutes good reason and provide the employer an opportunity to cure and (ii) whether the employee would be entitled to receive the same payment (in the same form and at the same time or times) due to a separation for good reason that the employee would receive upon a separation by the employer without cause. Treas. Reg. § 1.409A-1(n)(2)(i).

In addition, if the “good reason” provision in a plan or agreement satisfies the following requirements, a voluntary separation for good reason in accordance with the terms of the plan or agreement will be treated as an involuntary termination on a safe-harbor basis. The conditions for safe-harbor treatment are:

(i) The separation from service must occur during a pre-determined limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the employee:

- A material diminution in the employee’s base compensation.\(^\text{13}\)

- A material diminution in the employee’s authority, duties, or responsibilities.

\(^{13}\) It is unclear under the regulations whether annual bonuses should be included in “base compensation” for this purpose. By using the term “base compensation” rather than “base salary,” it appears that the regulations were intended to encompass material reductions in the amount of compensation payable in forms other than just base salary. However, the regulations do not provide any guidance for distinguishing between “base” forms of compensation and non-base forms of compensation.
A material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee is required to report, including a requirement that an employee report to a corporate officer or another employee instead of reporting directly to the board of directors of the employer.

A material diminution in the budget over which the employee retains authority.

A material change in the geographic location at which the employee works.

Any other action or inaction that constitutes a material breach by the employer of the employee’s employment agreement.

(ii) The amount, time, and form of payment due upon a “good reason” separation must be substantially identical to the amount, time and form of payment payable due upon an actual involuntary separation from service.

(iii) The employee must be required to provide notice to the employer of the existence of the condition that constitutes good reason within a period not exceeding 90 days of the initial existence of the condition, and the employer must be given at least 30 days after receiving notice to remedy the condition. Treas. Reg. 1.409A-1(n)(2)(ii).

e) Extension of Vesting Period/Substitutions. If the vesting period is extended after the beginning of the service period to which the compensation relates, the risk of forfeiture will be disregarded for purposes of Code Section 409A unless the amount payable upon the later vesting date is materially greater (ignoring earnings) than the amount payable on the original vesting date. Treas. Reg. § 1.409A-1(d)(1).

Example 1: An employee is entitled to receive a $5,000 retention bonus if he continues his employment through December 31, 2010. If the retention bonus arrangement is modified to require the employee to continue working through April 30, 2011 to receive the retention bonus, for purposes of determining whether the payment of the retention bonus is a short-term deferral, the retention bonus “vesting date” will still be treated as December 31, 2010. Thus, if the payment is not made until April 30, 2011 when the employee fulfills the condition for the payment, it will no longer be treated as a short-term deferral.

Example 2: If the original retention bonus in Example 1 is modified to require the employee to continue working through April 30, 2011 to receive the retention bonus and the amount of the retention bonus is materially increased by an amount that exceeds reasonable investment income on the $5,000 for the period from the
original vesting date to the new vesting date, the retention bonus will be treated as unvested for purposes of Code Section 409A until the new vesting date of April 30, 2011.

Certain contract renewal or evergreen provisions in employment agreements present a potential trap for the unwary. If an employment agreement provides that the employee may voluntarily separate from service and receive severance benefits upon the expiration of the term of the agreement if the employer fails to renew or extend the contract, the renewal or extension of the contract may be viewed as an extension of the vesting period. Although the regulations provide that the forfeiture of a payment of deferred compensation will not be treated as a payment of deferred compensation, an amount will not be treated as having been forfeited if another payment is made or a legally binding right to a payment is made that acts as a substitution for the compensation that is forfeited. Treas. Reg. § 1.409A-3(f). See also IRS Notice 2007-78 § IV.B. Thus, the short-term deferral exemption may not apply after the expiration of the initial term of an employment agreement that allows the employee to voluntarily separate from service and receive severance benefits when the employer fails to renew or extend the agreement.

On the other hand, if the employment agreement provides that the employee will be entitled to receive severance benefits only if he or she has an involuntary separation from service (including a Section 409A compliant “good reason” separation) during the term of the contract (i.e., the severance benefits are forfeited if the contract expires for any reason prior to the employee’s involuntary separation from service), the extension or renewal of the employee agreement will not, in and of itself, cause the severance benefits to fall outside the scope of the short-term deferral exemption or to be treated as a substitution for purpose of Code Section 409A.

2. **Separation Pay Plan Exception.** Severance benefits that fail to meet the short-term deferral exemption\(^\text{14}\) may qualify for exemption from Code Section 409A as

\(^{14}\) Separation pay may fail to qualify for the short-term deferral exemption and still qualify under one of the separation pay exemptions for any of the following reasons. First, the short-term deferral exemption may not apply to separation pay paid in the form of salary continuation payments if it is possible for any of the payments to be paid more than 2½ months after the end of the year in which the employee has a separation from service. This may also occur if the employer adopts a window program (see footnote 15 below) that closes more than 2½ months after the end of the year in which it opens (e.g., where the window program provides severance benefits to any employee who voluntarily terminates employment between November 1, 2009 and June 30, 2010). Second, the short-term deferral may not apply where the severance benefits are provided pursuant to an employment agreement that provides for the payment of severance in the event that the employer fails to extend or renew the agreement upon expiration of the contract, in which case, the short-term deferral exemption will cease to apply at the expiration of the initial term of the agreement.
an exempt “separation pay plan.” Retention bonus arrangements generally are not eligible for the separation pay plan exception. There are several different separation pay plan exemptions that may apply depending on the types of severance benefits being provided and the employees to whom they are provided.

a) **Collectively bargained plans.** Collectively bargained separation pay plans are completely exempt from Section 409A to the extent they meet the following criteria:

- The plan is contained in a collective bargaining agreement determined by the Secretary of Labor to be a collective bargaining agreement,
- The separation pay was the subject of arm’s length negotiations between the employer and the bargaining unit, and
- The circumstances surrounding the agreement evidence good faith bargaining about separation pay (i.e., no collusion).

Only separation pay available on an involuntary separation from service (as defined in Section IV.B.3 above) or pursuant to a window program\(^{15}\) qualifies for this exemption. Treas. Reg. 1.409A-1(b)(9)(ii). Additionally, if the separation pay plan covers members of the bargaining unit and also other employees, only the portion covering the members of the bargaining unit is eligible for the collective bargaining exemption. Id.

b) **The “Two Times” Exception.** All or part of the payments under a non-collectively bargained separation pay plan can also be exempt from Code Section 409A under the so-called “Two Times Exception”. Treas. Reg. §409A-1(b)(9)(iii). This exemption only applies to involuntary separations from service or separations from service pursuant to a window plan, and it only applies to the extent that the pay under the plan meets the following requirements:

(i) payments (other than payments under foreign plans and certain reimbursements described below) must not exceed *two times* the lesser of:

\(^{15}\) A “window program” is a program established by the employer to provide separation pay to employees who separate from service within a limited period of time not to exceed 12 months. Separation pay received in connection with a window program does not need to be on account of an “involuntary” separation from service to qualify for this exemption. Treas. Reg. § 1.409A-1(b)(9)(vi).
the employee’s annualized compensation. This is based on the employee’s annual rate of pay for the year prior to the year of separation, adjusted for any increase during that year that was expected to continue indefinitely if the employee had remained employed,\textsuperscript{16} or

the limit on compensation for qualified plans under Section 401(a)(17) for the year of the separation;\textsuperscript{17} and

(ii) the plan provides that the separation pay described above must be paid by no later than the last day of the second taxable year after the year in which the separation occurs. Thus, for separations occurring in 2009, the separation pay may be paid no later than December 31, 2011 to qualify for this exception.

The Two Times Exception is a very helpful exception because it applies to separation pay payments “to the extent” they fit within the exception. Thus, for example, if an employee with annualized compensation in the prior year of $500,000 and a current year salary of $540,000 is entitled to a severance payment of two years’ salary continuation (24 monthly payments of $45,000 each), the following analysis would apply: The applicable limit for the Two Times Exception is $450,000. The separation pay fits the Two Times Exception to the extent of the first 10 payments $450,000/45,000 = 10). The remaining 14 monthly payments are deferred compensation subject to Section 409A.

The fact that the first 10 payments are completely exempt from Section 409A means (a) they can be accelerated and paid in a lump sum (or other form) if desired, and (b) they are not subject to the 6-month delay rule for “specified employees” of public companies, so there need be no delay in payment.

\textsuperscript{16} The phrase “that year” is ambiguous. If the limit on the exception for separation pay is based on the annual rate of pay in the prior year, presumably it will already have been adjusted for salary increases in such prior year and so the reference is meaningless. On the other hand, if “that year” refers to the year of separation, why would the primary reference be to the prior year? The most logical argument is that the reference to salary increases is meant to clarify that “annualized compensation” means the rate of compensation in effect after any salary increases, in the year prior to the year of separation, and not the actual pay received in such prior year.

\textsuperscript{17} The compensation limit in effect under Code Section 401(a)(17) for 2009 is $245,000. Thus, the Two Times Exception may exempt up to a maximum of $490,000 from Code Section 409A for separations from service occurring in 2009.
c) **Reimbursements and In-Kind Benefits.** Code Section 409A does not apply to:

- Reimbursable expenses that are deductible under Code Section 162 (expenses incurred in a trade or business) or Code Section 167 (depreciation in respect to property used in a trade or business determined without regard to any limitations based on adjusted gross income), reasonable outplacement services or reasonable moving expenses actually incurred (including reimbursement of all or part of the loss on the sale of the employee’s primary residence). To qualify for this exemption, the reimbursable expenses must be incurred no later than the last day of the second taxable year following the taxable year in which the employee has a separation from service. Treas. Reg. § 1.409A-1(b)(9)(v)(A) and (E).

- Medical benefits that are deductible under Section 213 of the Code (determined without regard to the requirement that such expenses exceed 7.5% of adjusted gross income) to the extent that the medical benefits are provided during the period of time the employee is eligible for continuation coverage under COBRA. Treas. Reg. § 1.409A-1(b)(9)(v)(B).

The reimbursements and in-kind benefits exemption applies to both voluntary and involuntary separations from service. Treas. Reg. § 1.409A-1(b)(9)(v).

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d) **Foreign Plans.** Certain foreign separation plans are also exempt from Section 409A. These plans are exempt to the extent they provide separation pay required under the law of the foreign jurisdiction and are generally exempt only with respect to foreign earned income. See Treas. Reg. § 409A-1(b)(9)(iv).

e) **Only Separation Pay Falling Outside the Scope of the Exemptions will be Considered Deferred Compensation.** It is important to be sure which payments on separation from service are paid from an exempt separation pay plan and which are not exempt. In addition, it is also important not to confuse other types of deferred compensation as separation pay. Here are some examples that illustrate these points:

**Example 1:** An employer has a change-in-control (“CIC”) severance plan that pays three times salary in a lump sum within 10 days following an involuntary termination occurring within 12 months following a CIC. If the employer does not offer any pre-CIC severance benefits, the entire lump sum payment should be exempt from Section 409A under the short-term deferral exception because it is subject to a substantial risk of forfeiture until the involuntary termination occurs.
Example 2: Assume a company has a general severance plan that provides for 2 years salary continuation upon an involuntary separation from service. For most employees, payments will be exempt from Code Section 409A under the Two Times Exception. However, if the employee’s annual compensation exceeds two times the compensation limit under Code Section 401(a)(17), a portion of the payments will fall outside the Two Times Exception and will be treated as deferred compensation subject to Code Section 409A. Assume the company adds a special CIC severance plan covering executive officers, which provides for a lump sum payment equal to three times salary upon an involuntary termination within two years following a CIC. The CIC definition is not Section 409A-compliant. At the same time as it adopts the CIC severance plan, it amends the regular severance plan to provide that it does not apply to executive officers after a CIC (using the same non-compliant definition).

Because the executive officers at one time had a legally binding right to post CIC-payments under the general severance plan, the new CIC severance plan should be treated, for Code Section 409A purposes, either as an amendment to the general separation pay plan or as a separation pay plan that must be aggregated with the general severance plan. See Treas. Reg. §1.409A-1(c)(2)(D). The provision for a lump sum payment on an involuntary separation after a CIC would violate the requirement that a plan can only designate one time and form of payment upon the occurrence of any Section 409A payment event (other than specified date). Treas. Reg. §1.409A-3(c). Because the CIC severance plan and the general severance plan are aggregated, the CIC severance payment would not be eligible for the short-term deferral exemption. Therefore, only a portion of the payments under the CIC severance may be distributed in a lump sum. The amount that may be paid in a lump sum will equal the sum of (i) the portion of the severance benefits payable under the CIC severance plan that exceeds the amounts payable under the general severance plan plus (ii) the portion of the salary continuation payments under the general severance plan that are exempt under either the short-term deferral exemption or the Two Times Exception.

3. Tax-Exempt Employers (Code Section 457). Deferred compensation payable by tax exempt and state and local governmental employers is generally taxable to the employee when the deferred compensation is no longer subject to a substantial risk of forfeiture. Code Section 457(f) does not apply, however, to bona fide severance pay. In August of 2007, the IRS and the Treasury Department issued guidance relating to the application of Code Section 457(f) to severance plans. In general, Notice 2007-62 provides that pending further guidance, the short-term deferral exemption and the Two Times Exception under Code Section 409A would also apply to tax exempt and governmental employers under Code Section 457(f).

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18 An exception to this requirement applies to compensation deferred under an “eligible deferred compensation plan” described in Code Section 457(b), which is largely inapplicable to severance and retention plans.
Notice 2007-62 raises some difficult issues for tax-exempt employers. To the extent that the severance benefits meet either the short-term deferral exemption under Code Section 409A or the Two Times Exception, the severance benefits should escape taxation under Code Section 457(f). However, the portion of the salary continuation payments that do not qualify under either exemption will be treated as taxable deferred compensation when the payment is no longer subject to a substantial risk of forfeiture.

The impact of these restrictions may be demonstrated in the following examples:

**Example 1:** The CEO of a tax-exempt hospital system has an employment agreement providing that immediately upon his involuntary separation from service during the term of his agreement, he will receive a lump sum severance payment of $720,000. This severance payment would be exempt from Code Section 457(f) as a short-term deferral.

**Example 2:** Same facts as in Example 1, except that the severance pay is paid in the form of one year of salary continuation. The first 2½ months of salary continuation payments ($150,000 [$720,000 times (2½ / 12)]) should be exempt as a short-term deferral. An additional $490,000 would be exempt under the Two Times Exception. The remaining $80,000 in severance would be taxable to the CEO when it is no longer subject to a substantial risk of forfeiture (i.e., upon his involuntary separation from service) even though it may not be immediately payable to him.

**Example 3:** Same facts as in Example 1, except that the CEO’s employment agreement provides that if his employer does not renew or extend his agreement at the expiration of the initial term of the agreement, the CEO may voluntarily separate from service and receive the severance pay. The employer renews the employment agreement at the end of its initial term in 2009. The severance payments cease to be subject to a substantial risk of forfeiture for purposes of Code Section 457(f) as of the end of the initial term of the employment agreement. The Two Times Exception, however, should continue to exempt the first $490,000 of the severance pay (2 times the $245,000 annual compensation limit under Code Section 401(a)(17)) but the remaining $230,000 in potential severance pay would not meet either the short-term deferral exemption or the Two Times Exception and thus would be taxable to the CEO in 2009 when the payment is treated as no longer being subject to a substantial risk of forfeiture.

**4. Severance Benefits Conditioned on Execution of a Waiver and Release.** Severance benefits are often conditioned on the employee’s execution of a waiver and release of employment-based claims. See Section V below. Delays in the payment of severance benefits pending the employee’s execution of the release and the expiration of the applicable rescission period can cause severance benefit payments to fall outside the scope of the short-term deferral exemption if the agreement or severance plan does not require the employee to execute the release in time to allow the severance payment(s) intended to qualify for the short-term deferral exemption to be paid before the end of the short-term deferral period. In the case of year-end terminations, the timing can be quite tight. For instance, if an employee is terminated on the last day of the year, the severance must be paid within 74 days after the termination to qualify as a short-term deferral. If the employee is terminated in a reduction in force or other termination
program, the employee must be given at least 45 days to consider a waiver of any age discrimination claims and must have 7 days after executing the release to revoke the release. (See Section V.B.3 below.)

To the extent that the severance pay is treated as deferred compensation subject to Code Section 409A, the severance plan or agreement may provide that the severance payment will be made within a designated period after the payment event occurs but only if the designated period either begins and ends within the same year or does not exceed 90 days and the employee cannot choose which taxable year the payment will be made. Treas. Reg. § 1.409A-3(b). Since the employee can control when he or she signs the release, the employee can indirectly control the timing of the payment. In order to avoid a violation of Section 409A, the plan or agreement should provide that no severance payment(s) will be paid until a specified number of days (e.g., 60 days) has elapsed following the employee’s separation from service regardless of when the employee signs the release. The number of days specified should be sufficient to allow the rescission period to expire if the employee does not execute the release until the end of the applicable period of time he or she has to consider the release.

B. Golden Parachute Taxes (Code Section 280G). Severance and retention payments that are paid in the context of a change of control of a corporation may be subject to the “golden parachute” tax rules. In general, under the “golden parachute” tax rules, certain employees who receive “excess parachute payments” will be subject to 20% non-deductible excise tax on such payments and the corporation will be denied a tax deduction for such payments. See generally Code §§ 280G and 4999.

The golden parachute tax rules generally work as follows:

- If a “disqualified individual,” (which generally includes certain officers, shareholders and other highly compensated individuals) receives

- “parachute payments,” which are defined generally as any payments in the nature of compensation for services, that

  ✓ are, by their terms or in operation, “contingent” upon a change of ownership or control of a corporate employer, and

  ✓ have an aggregate present value which equals or exceeds three (3) times the disqualified individual’s base amount (i.e., his or her average annual taxable compensation from the employer for the five (5) taxable years prior to the change of ownership or control), then

19 This can happen when severance benefits are payable under the severance plan or agreement upon the employee’s voluntary separation for “good reason,” and the definition of “good reason” in the plan or agreement is non-Section 409A compliant.
the disqualified individual is subject to a 20% excise tax penalty on the amount of his “excess parachute payments” (i.e., an amount by which the disqualified individual’s parachute payments exceed the base amount). Code § 4999(a). In addition to the tax penalty, the employer is denied a tax deduction on excess parachute payments. Code § 280G(a).

Code § 280G(b)(2).

1. **Contingent Payments.**

   a) **Payments that Would Not be Made if a Change of Control had not Occurred.** Generally, a payment is considered “contingent” on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event (such as an involuntary termination of employment). However, a payment will not be treated as contingent on a change of ownership or control if it is substantially certain, at the time of the change of ownership or control, that the payment would have been made whether or not the change in ownership or control occurred. Treas. Reg. § 1.280G-1, Q&A-22(a).

   b) **Payments Closely Associated with a Change of Control.** A payment will be treated as contingent on a change in ownership or control if the payment is contingent on an event that is “closely associated” with a change in ownership or control, a change in ownership or control actually occurs, and the event is “materially related” to the change in ownership or control. Treas. Reg. § 1.280G-1, Q&A-22(b)(1). A disqualified person’s termination of employment (whether voluntary or involuntary) is generally considered an event that is “closely associated” with a change of control. Treas. Reg. § 1.280G-1, Q&A-22(b)(2). Although termination of employment is considered closely associated with a change in ownership or control, retention bonus payments are contingent on an employee’s remaining in continued employment rather than a termination of employment.

   An event will be presumed to be “materially related” to a change in ownership or control if the event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If an event occurs outside of this time period, the event will be presumed not to be materially related to the change in ownership or control. Treas. Reg. § 1.280G-1, Q&A-22(b)(3).

   **Example 1:** An employee and employer executed an employment agreement in 2007. The employment agreement provides that the employee will receive severance pay equal to one year of base salary if the employer terminates the employee’s employment without cause during the term of his agreement. A change of control of the employer occurs in 2009 and six months later the employer terminates the employee’s employment without cause. The severance pay will be presumed to be contingent on the change of ownership or control of
the employer because the termination occurred within one year of the change in control. It does not matter that the employee would have received the same severance pay on termination without cause if the change of control had never occurred. Treas. Reg. § 1.280G-1, Q&A-22(e) (Example 3).

Example 2: Assume the same facts as Example 1, except that the termination of employment occurs 18 months after the change of control. The termination is not closely affiliated with the change of control. Since the employee would have received the same severance payment on his termination of employment had the change of control not occurred, the severance payment is not considered contingent on a change of ownership or control.

Example 3: Same facts as Example 2, except that the employment agreement provides that the employee will receive severance pay equal to two years of base salary if the termination of employment occurs during the two-year period following a change of control. Although the termination is not considered materially related to the change of control, a portion of the severance pay (one year of base salary) would not have been paid if the change of control had not occurred. Accordingly, half of the severance pay (one year of base salary) would be treated as contingent on a change of control. See Treas. Reg. § 1.280G-1, Q&A-22(e) (Example 2).

c) Contracts Entered into Within One Year of a Change of Control.

If a payment is made under an agreement (or a significant amendment to an existing agreement) entered into within one year prior to the date of the change, the payment is presumed to be contingent on a change in ownership or control Treas. Reg. § 1.280G-1, Q&A-25. The amount subject to this presumption is limited to the amount by which the payment exceeds the amount of the payment that would have been made absent the agreement or amendment. Treas. Reg. § 1.280G-1, Q&A-25(b).

This presumption may be rebutted by “clear and convincing evidence” that the payment is not contingent on the change in ownership or control. Treas. Reg. § 1.280G-1, Q&A-26(a). The presumption may be rebutted based on the relevant facts and circumstances, including the content of the agreement or amendment and the circumstances surrounding its execution, such as whether it was entered into when a takeover attempt was underway and the degree of likelihood that a change in ownership or control actually would occur. Treas. Reg. § 1.280G-1, Q&A-26(a). Even if the presumption is rebutted, some or all of the severance benefits under the plan or agreement may still be contingent on the change in ownership or control under the general rules described in Section IV.B.1 (above). Treas. Reg. § 1.280G-1, Q&A-26(a).

Example 1: Six months prior to a change of control of the employer, the employer and employee amend the employee’s employment agreement to increase the amount of severance pay the employee is entitled to receive upon termination without cause from one year of base salary to two years of base...
salary. The employee’s employment is terminated without cause 18 months after the change of control. Because the employment agreement was entered into within one year of the change of control, the amount by which the amendment increased the severance pay would be presumed to be conditioned on a change of control, unless the employee and employer can present clear and convincing evidence that the increased severance payment was not contingent on a change of ownership or control. The amount of severance pay payable under the terms of the employment agreement in effect before it was amended (one year of base salary), would not be contingent on a change of ownership or control because the termination of employment occurred more than one year after the change of control and the employee would have received one year of base salary in severance pay even if the change of control had not occurred.

Example 2: On March 1, 2009, an employer adopted a retention bonus plan providing a retention bonus to eligible employees who continue in employment with the employer through June 1, 2009. A change of control occurs on January 15, 2010. Although the retention bonus payments were all paid prior to the change of control, the retention bonus payments will be presumed to be contingent on a change of control because the plan was adopted within one year prior to the change of control unless the employer can establish by clear and convincing evidence that the retention bonus was not contingent on a change of ownership or control.

2. **Disqualified Individual.** A “disqualified individual” with respect to a corporation is an individual who, at any time during the twelve-month period prior to and ending on the date of the corporation’s change in ownership or control (the “disqualified individual determination period”), is an employee, independent contractor or director of the corporation, who is

- a more than 1% shareholder of the corporation,
- an officer of the corporation (but not more than is the lesser of (i) 50 officers or (ii) the greater of 3 officers or 10 percent of the corporation’s workforce will be considered disqualified individuals by reason of their status as officers), or
- a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation, or the highest paid 250 employees of the corporation, when ranked on the basis of compensation earned during the 12-month period ending prior to the change of control.


3. **Payors Subject to the Golden Parachute Tax Rules.** To be subject to the golden parachute tax rules, a payment must be contingent on a change of ownership or control of a corporation. Thus, payments that are contingent on a change of
ownership or control of a non-corporate entity, such as a partnership or association that is not taxed as a corporation, generally are not subject to the golden parachute tax rules. However, for purposes of determining whether a corporation has had a change of ownership or control, all members of an affiliated group (defined in Code Section 1504 without regard to Code Section 1504(b)) are treated as a single corporation. Treas. Reg. § 1.280G-1, Q&A-46.

a) Excluded Entities. The Treasury Regulations under Section 280G describe several types of organizations (in addition to partnerships and associations not taxed as corporations) that are not subject to the golden parachute tax rules.

(i) Small Business Corporation Exemption. Payments with respect to a change of control of a “small business corporation” are exempt from the golden parachute tax rules. Treas. Reg. § 1.280G-1, Q&A-5(a)(1). A corporation will qualify for this exemption if immediately prior to the change in ownership or control, the corporation is an S-corporation or would be eligible to elect to be taxed as an S-corporation if the requirement in Code Section 1361(b)(1)(C) that precludes a non-resident alien from being a stockholder did not apply. Treas. Reg. § 1.280G-1, Q&A-6(a)(1). Members of an affiliated group are not treated as a single corporation for purposes of this exemption. Treas. Reg. 1.280G-1, Q&A-6(b).

(ii) Exemption for Certain Privately Held Corporations. Payments contingent on a change of ownership or control of a privately-held corporation will be exempt from the golden parachute rules if the following conditions are met:

- immediately prior to the change in ownership or control, no stock in such corporation was readily tradable on an established securities market (or otherwise), and
- shareholders possessing at least 75% of the voting power of the corporation immediately prior to the change of control vote to approve the payment.

Treas. Reg. § 1.280G-1, Q&A-6(a)(2). For administrative convenience, the Treasury Regulations allow the corporation to determine the owners of its voting stock as of any date within the six-month period ending on the date a change of ownership or control occurs. Treas. Reg. § 1.280G-1, Q&A-7(b)(2). The corporation must provide all shareholders who are entitled to vote with adequate disclosure of all material facts concerning all material payments to the disqualified individual that would qualify as parachute payments if this exemption did not apply. Treas. Reg. § 1.280G-1, Q&A-7(a). The shareholder vote must determine the right of the disqualified individual to receive the payment (or to
4. **Caps and Tax Gross Ups.** The punitive impact of the golden parachute tax rules has caused many public corporations and their executives to contractually limit the adverse tax consequences through one or more of the following approaches.

- **Hard Cap.** Limit the aggregate present value of the payments contingent on a change of ownership or control to an amount that does not exceed three times the bases amount (the “safe-harbor amount”).

- **Greater of Capped or Net Uncapped.** Limit the aggregate present value of the payments contingent on a change of ownership or control to the safe-harbor amount unless the amount the disqualified individual would receive without the cap and after paying the excise tax would exceed the capped payment. Some contracts provide that if the payments are not capped, the corporation will provide a tax gross up (described below).

- **Tax Gross Up.** The disqualified individual is “grossed up” fully or partially for the effect of the excise tax.

Although it is not uncommon to see change of control severance agreements that provide severance benefits equal to three times salary (or three times salary and bonus) along with tax gross ups, recent trends suggest that corporations are reducing the severance multiples and are less willing to provide excise tax gross ups. Recent changes in executive compensation disclosure requirements and proposed legislative and regulatory changes in executive compensation and corporate governance are likely to make compensation committees even less willing to approve tax gross ups and large severance multiples in the future.

a) **Caps.** The most basic form of cap is a provision that provides that if any payments constitute excess parachute payments, such amounts will not be paid (or if previously paid to the disqualified individual, must be repaid to the corporation).

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20 Privately-held corporations will usually (but not always) rely on the shareholder approval exemption. In some instances, however, the shareholder approval exemption may not be feasible. This may occur where there is a sizable group of dissident shareholders. It may also occur in a fire sale situation where the common stockholders (and perhaps even one or more classes of preferred stockholders) will receive little or no consideration for their shares in the change of control transaction. In these situations, the corporation and disqualified individual remedial may use one of the approaches described below.
Other agreements provide for a cap which applies only if the amount payable to the executive after applying the cap would exceed the net amount the executive would receive after payment of the excise taxes if the cap were not applied. A variant on this formulation is to provide that the parachute cap will apply unless the net uncapped amount (without a tax gross up) would exceed the capped amount by a certain percentage (e.g., 20%).

b) **Tax Gross Up.** An employment or severance agreement may provide a tax gross up in lieu of capping the parachute payments to the executive. The purpose of a tax gross up is to provide an executive with an additional payment equal to the amount needed to pay the golden parachute excise tax on the excess parachute payments to which he is entitled without the gross up and the amount needed to pay both the golden parachute excise tax and income taxes on the tax gross up payment, so that the executive is in the same economic position as he would have been if the golden parachute penalty excise tax did not apply.

The cost to the corporation of a tax gross up payment is very substantial relative to the benefits provided to the executive, as reflected in the Examples below. Corporate compensation committees are increasingly more reluctant to approve such gross up provisions because of the excessive cost to the corporation and fear of negative publicity.

The following examples illustrate the effect of a parachute cap and tax gross at different payment levels. These examples use the following assumptions:

<table>
<thead>
<tr>
<th>Executive</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncapped Payments</td>
<td>$800,000</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Base amount</td>
<td>$255,000</td>
<td>$255,000</td>
</tr>
<tr>
<td>3x base amount</td>
<td>$765,000</td>
<td>$765,000</td>
</tr>
<tr>
<td>Capped payment</td>
<td>$765,000</td>
<td>$765,000</td>
</tr>
<tr>
<td>Net after tax to Executive</td>
<td>$459,000</td>
<td>$459,000</td>
</tr>
<tr>
<td>Marginal tax rate</td>
<td>40%</td>
<td>40%</td>
</tr>
</tbody>
</table>

**Example 1:**

**If the Golden Parachute Tax Rules Did Not Apply**

- Executive A would net $480,000 (60% of $800,000)
- Company could deduct entire $1,900,000 ($800,000 plus $1,100,000)
- Executive B would net $660,000 (60% of $1,200,000)
- After-tax cost to Company would be $480,000 for Executive A, and
- $660,000 for Executive B
Example 2:  

**Without any Cap or Tax Gross Up**

- Executive A would pay $109,000 in excise tax (20% of excess of $800,000 over $255,000)
- Executive B would pay $169,000 in excise tax (20% of excess of $1,100,000 over $255,000)

- Payment to A net of all taxes would be $371,000 ($800,000 less $320,000 income tax and $109,000 excise tax)
- Payment to B net of all taxes would be $491,000 ($1,100,000 less $440,000 income tax and $169,000 excise tax)

- Company could deduct only $510,000 of $1,900,000 ($255,000 for each Executive)
- After-tax cost to Company would be $698,000 for Executive A, and $998,000 for Executive B

Example 3:  

**“Best Net” Parachute Tax Cap – No Tax Gross Up**

<table>
<thead>
<tr>
<th>Executive</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncapped Payment</td>
<td>$800,000</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Base amount</td>
<td>$255,000</td>
<td>$255,000</td>
</tr>
<tr>
<td>3x base amount</td>
<td>$765,000</td>
<td>$765,000</td>
</tr>
<tr>
<td>Capped payment</td>
<td>$765,000</td>
<td>$765,000</td>
</tr>
<tr>
<td>Net after-tax with cap</td>
<td>$459,000</td>
<td>$459,000</td>
</tr>
<tr>
<td>Net after-tax without cap</td>
<td>$371,000</td>
<td>$491,000</td>
</tr>
<tr>
<td>Cost to Company</td>
<td>$459,000</td>
<td>$998,000</td>
</tr>
</tbody>
</table>

Executive A is better off with a capped payment whereas Executive B is better off with out any cap. The Company’s after-tax cost of providing the payment to Executive A is the same as the after-tax net benefit to Executive A. However, it costs the Company an additional $539,000 ($998,000 - $459,000 = $539,000) to provide Executive B with an additional $32,000 ($491,000 - $459,000 = $32,000).
Example 4:

**Full Parachute Tax Gross Up**

<table>
<thead>
<tr>
<th></th>
<th>Executive A</th>
<th>Executive B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Uncapped payment</strong></td>
<td>$800,000</td>
<td>$1,100,000</td>
</tr>
<tr>
<td><strong>Base amount</strong></td>
<td>$255,000</td>
<td>$255,000</td>
</tr>
<tr>
<td><strong>3x base amount</strong></td>
<td>$765,000</td>
<td>$765,000</td>
</tr>
<tr>
<td><strong>Excise tax</strong></td>
<td>$109,000</td>
<td>$169,000</td>
</tr>
<tr>
<td><strong>Gross up payment</strong></td>
<td>$272,500</td>
<td>$422,500</td>
</tr>
<tr>
<td><strong>Total payment</strong></td>
<td>$1,072,500</td>
<td>$1,522,500</td>
</tr>
<tr>
<td><strong>Net after-tax to Executive</strong></td>
<td>$480,000</td>
<td>$660,000</td>
</tr>
<tr>
<td><strong>Cost to Company</strong></td>
<td>$970,500</td>
<td>$1,420,500</td>
</tr>
</tbody>
</table>

Thus, it would cost the company an additional $511,500 ($970,500 vs. $459,000) to provide Executive A an extra $21,000 ($480,000 - $459,000) on an after-tax basis and an additional $961,500 ($1,420,500 - $459,000) to provide Executive B with an additional $201,000 ($660,000 – $459,000).

V. WAIVERS AND RELEASES

Avoidance of litigation is one of the most common reasons for providing severance benefits (whether to senior management or under a broad-based plan). Severance pay is the currency used to secure waivers and releases of employment-based claims from terminated employees and officers. However, unless properly structured and obtained, such waivers and releases may be unenforceable. Ironically, post-employment litigation often involves the enforceability of the waiver and release.

In general, an employee’s waiver and release of employment-related claims will be enforced if the employee knowingly and voluntarily executed the release agreement and the employee receives some consideration for the release.

A. Waiver of General Employment Discrimination Claims. With regard to a waiver and release of general employment discrimination claims (other than age discrimination claims), courts will look at the totality of the circumstances to determine whether the release was knowing and voluntary, taking into account the following factors:

- Clarity and specificity of the release taking into account the employee’s level of education;
- The length of time the employee had to consider whether to sign the release;
- Whether the employee consulted or was encouraged to consult with an attorney;
- Whether the employee negotiated the terms of the release; and
Whether the release was secured by fraud, coercion or duress.

See e.g., Hamilton v. Ford Motor Co., 561 F.3d 709 (7th Cir. 2009) (upholding enforceability of a release that was clear and unambiguous on its face; the release was signed by a high school graduate who had taken some college courses and was represented by legal counsel) and Wastak v. Lehigh Health Network, 342 F.3d 281 (3d Cir. 2003) (using totality of the circumstances to determine whether the release was knowing and voluntary).

B. Age Discrimination in Employment Act Claims. Congress enacted the Older Workers Benefit Protection Act (the “OWBPA”) in 1990 to impose specific conditions to the enforceability of a waiver and release of age discrimination claims brought under the ADEA. Under the OWBPA, a waiver and release will not be considered knowing and voluntary unless it meets all of the following conditions:

1. Wording of an ADEA Waiver. To be enforceable under the ADEA, the waiver must be written in plain language in a manner calculated to be understood by the average participant in the program, taking into account the average employee’s comprehension and education. In addition, the waiver must include the following provisions:
   - The waiver must specifically refer to release of claims under the ADEA.
   - The employee must be advised, in writing, to consult with an attorney prior to executing the waiver and release.
   - The waiver must provide that it does not apply to any claims arising after the release is executed.

29 C.F.R. § 1625.22(b).

2. Consideration for the Waiver and Release. The employee must receive something of value (in addition to any benefits or compensation to which the employee is otherwise entitled) in consideration for the waiver and release. 29 C.F.R. § 1625.22(d).

3. Consideration Period and Rescission Period. Employees must be given a period of at least 21 days to consider whether to execute the waiver and release. If, however, the waiver agreement is obtained in connection with an “exit incentive or other employment termination program” offered to a group or class of employees, the employee must be given at least 45 days to consider whether to execute the agreement. 29 C.F.R. § 1625.22(e)(1).

In the case of a negotiated severance package, the 21 or 45-day consideration period will restart whenever there is a material modification to the severance package that is being offered unless the employee agrees that material changes will not restart the running of the 21 or 45-day consideration period. 29 C.F.R. § 1625.22(e)(4). The employee may execute the waiver agreement at any time during the 21 or 45-day consideration period.
The employee may revoke the waiver agreement at any during the 7-day revocation period that begins on the date the employee signs the waiver agreement. The employee and employer may agree to extend the revocation period, but it may not be reduced. 29 C.F.R. § 1625.22(e)(5).

4. **Special Provisions for Exit Incentive and Other Employment Termination Programs.** If the waiver is sought in connection with an exit incentive or other employment termination program, the employer must provide the employee with additional information regarding who is eligible to participate in the program.

An “exit incentive program” is a voluntary program offered to a group or class of employees who are offered additional compensation or benefits in exchange for their decision to resign voluntarily and sign the release. An “other employment termination program” usually refers to a reduction in force or layoff of group or class of employees who are offered additional compensation or benefits in return for their decision to sign a waiver. In general, a “program” will exist when an employer offers a standardized package of additional compensation or benefits to two or more terminated employees in exchange for a waiver. Individually negotiated severance packages are generally not treated as part of a program. 29 C.F.R. § 1625.22(f)(1).

The required information must be given to each employee in the “decisional unit” who is asked to sign a waiver agreement. The decisional unit is the portion of the employer’s organizational structure that includes the terminated employees who are being asked to sign a waiver agreement. The decisional unit may be a division, business unit, a facility, a factory or even a job classification. 29 C.F.R. § 1625.22(f)(3).

Each employee who is asked to sign a waiver agreement in connection with an exit incentive or other termination program must receive the following information:

- The class, unit, or group of individuals covered by the program,
- The eligibility factors for participation in the program and any time limits applicable to such program;
- The job titles and ages of all employees eligible or selected for the program and the ages of all employees in the same job classification or organizational unit who are not eligible or selected for the program.

29 C.F.R. § 1625.22(f)(1). Failure to provide an employee with the required information may invalidate the employee’s waiver and release. Ruehl v. Viacom, 500 F.3d 375 (3d Cir. 2007). In Ruehl, Viacom argued that the waiver and release should not be invalidated because Viacom made the required information available to Ruehl. The court, without deciding whether providing the required information on request would satisfy the information requirement, concluded that the release was invalid because Viacom had failed to inform the employee how to get the information. Id. at 382. See also Kruchowski v. Weyerhaeuser Co., 446 F.3d 1090, 1095 (10th Cir. 2006) (invalidating ADEA waiver because the employer defined the “decisional unit” too broadly); Adams v. Ameritech Servs., Inc., 231 F.3d 414, 431 (7th Cir. 2000)
(invalidating ADEA waiver because the information was provided with respect to “salary grades” rather than “job title); Tung v. Texaco, Inc., 150 F.3d 206, 209 (2d Cir. 1998) (invalidating the ADEA waiver because the required information was not provided 45 days before the employee signed the waiver).

5. **Release Cannot Prohibit Participation in EEOC Proceedings.** A waiver agreement may not include any provision that prohibits the employee from (or penalizes an employee for) filing a charge or complaint with the EEOC or participating in any investigation or proceeding conducted by the EEOC. 29 C.F.R. § 1625.22(i). The waiver agreement should provide that while the waiver may not prohibit the employee from filing or participating in a charge or complaint with the EEOC, the employee agrees not to accept any damages or other compensation arising from any EEOC action. In Syverson v. IBM Corp., 472 F.3d 1072, 1082 (9th Cir. 2007), the court held that a statement that release does not preclude the employee from filing a charge with the EEOC when coupled with a statement that the ADEA prohibits age discrimination and is enforced by the EEOC created an ambiguity in the release. As a result of the ambiguity, the release was invalid because it was not knowingly and voluntarily given. This case demonstrates the necessity for clarity in the release language.

6. **No Waiver of Claims Arising After Execution of the Waiver Agreement.** An employee may not waive any rights or claims that may arise after the date the waiver agreement is executed. This requirement does not, however, bar the enforcement of agreements to perform future employment-related actions, such as the employee’s agreement to retire or terminate employment at a future date. 29 C.F.R. § 1625.22(c). It is not uncommon to provide employees with a copy of the waiver agreement in advance of a scheduled termination (whether under a voluntary termination program or a scheduled termination date under a reduction in force). If the waiver agreement is given to the employee prior to the employee’s termination date, the waiver agreement should provide that the agreement will not be effective unless executed by the employee on or after his termination date to ensure that the release covers all employment-related claims. If it is not possible to delay the execution of the waiver agreement until the employee’s termination date, the waiver agreement should provide that the consideration for the waiver agreement is conditioned on the termination of the employee’s employment.

VI. **BANKRUPTCY CONSIDERATIONS**

Before the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “BAPCPA”), there were few restrictions on the design and implementation of severance and retention arrangements for executives of employers that had filed for protection under the Bankruptcy Code. Employers thus had considerable discretion in designing key employee retention plans (commonly called “KERPs”) to retain key employees.

Driven largely by perceived abuses, the BAPCPA amended the Bankruptcy Code to impose severe limits and restrictions on severance and retention pay for executives. In amending the Bankruptcy Code, Congress was concerned that existing practices rewarded the management team that may have been responsible for driving the employer into bankruptcy by providing
substantial severance and retention benefits, with no identifiable special benefit to the creditors of the company.

Generally, Bankruptcy Code Section 503(c) limits the extent to which compensation and benefits can be paid as administrative expenses as follows:

A. **Retention Benefits.** Section 503(c)(1) of the Bankruptcy Code\(^\text{21}\) prohibits the payment of retention benefits to the debtor’s insiders (generally defined as an officer, director, or other person who controls the debtor or a relative of any such person\(^\text{22}\)) unless the court finds

1. the payment is essential to retain the insider because he or she has a bona fide job offer from another business for the same or greater rate of compensation,

2. the services provided by the insider are essential to the survival of the debtor, and

3. the retention compensation payable to an insider cannot exceed:

   a) 10 times the average retention compensation given to non-management employees during the same calendar year, or

   b) if no retention compensation was incurred for non-management employees in the year in which the insider receives the retention compensation, the retention compensation payable to the insider cannot exceed 25% of the retention compensation paid to such insider for any reason during the prior calendar year.

B. **Severance Pay Limits.** Section 503(c)(2) of the Bankruptcy Code\(^\text{23}\) limits the amount of severance benefits payable to insiders. Insiders are prohibited from receiving any severance pay unless:

1. it is part of a severance program that is generally available to all full-time employees, and

2. the amount of severance benefits payable to any insider may not exceed 10 times the average amount of severance paid to non-management employees during the year.

C. **TARP Restrictions.** The American Recovery and Reinvestment Act of 2009 imposed new executive compensation restrictions on companies that received Federal financial support through the Troubled Assets Relief Program (“TARP”), established in 2008 pursuant to the Emergency Economic Stabilization Act of 2008 (“EESA”), or other programs.


1. **No “Golden Parachute” for Top 10 Executives.** Under these restrictions, TARP recipients may not pay golden parachute payments to:

   a) the top five officers named in the company’s annual proxy statement (or equivalent individuals at any privately-held TARP recipient), or

   b) the next five most highly compensated executives.

A “golden parachute payment” is defined as any payment that is made on account of the employee’s termination of employment regardless of the reason for the termination or as a result of a change of control of the TARP recipient. The following payments, however, are not considered golden parachute payments: (i) distributions from a qualified retirement plan, (ii) payments made on account of a termination of employment due to the employee’s death or disability, and (iii) any severance payment that is required to be paid under applicable state or foreign law that is independent of any contract or agreement and is made to all employees within the appropriate jurisdiction. 31 C.F.R. § 30.1, Q&A-1.

2. **Restrictions on Retention Pay**. TARP recipients are prohibited from paying certain executives any retention pay, bonuses or incentive compensation. The class of employees to whom the prohibition applies varies based on the amount of TARP assistance received as follows:

   a) **Less than $25 Million in TARP Assistance.** The single most highly compensated employee.

   b) **At least $25 Million but less than $250 Million in TARP Assistance.** The five most highly compensated employees.

   c) **At least $250 Million but less than $500 Million in TARP Assistance.** The top five officers named on the annual proxy (or equivalent individuals for privately-held TARP recipients) and the 10 next most highly compensated employees.

   d) **At least $500 Million in TARP Assistance.** The top five officers named on the annual proxy (or equivalent individuals for privately-held TARP recipients) and the 20 next most highly compensated employees.

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24 An exception applies for the payment of long-term restricted stock awards that (i) do not fully vest during the period in which the Federal financial assistance remains outstanding, (ii) has a value in an amount that does not exceed one-third of the affected employee’s total annual compensation, and (iii) is subject to such other terms and conditions as the Secretary of the Treasury may determine to be in the public interest. EESA § 111(b)(3)(D)(i).