
409A Issues in Employment Agreements

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Any overview of issues arising under section 409A¹ is dangerous and probably ill-advised, for both the writer and the reader. Section 409A is a world unto itself, with its own language, and no summary can replace the legislation and the related Treasury Regulations. This paper, therefore, should serve only as a readers' guide to 409A for those who draft and negotiate employment agreements.² Part I provides an overview of section 409A that is, given the nearly 400 pages of Treasury Regulations, necessarily incomplete. Part II describes some but not all of the section 409A issues that may come up in the context of an employment agreement, and includes sample contract language where appropriate.

I. Overview of Section 409A

A. The General Rule

Section 409A governs the taxation of nonqualified deferred compensation plans. Under 409A, a nonqualified deferred compensation plan must specify the time and form of payment and prohibit acceleration or further deferral, except in limited circumstances. Failure to satisfy these requirements results in taxation of the employee on deferred amounts when those amounts vest (whether or not paid); an additional excise tax of 20%; and interest at the underpayment rate plus 1%.³ Compensation that violates section 409A can be taxed at marginal rates exceeding 75% .

B. Definitions and Concepts; Scope

Section 409A applies only to **nonqualified** deferred compensation plans. Qualified employer plans, like 401(k) plans, are exempt.⁴

“The term **plan** includes any agreement, method, program, or other arrangement, including an agreement, method, program or other arrangement that applies to one person or individual.”⁵

Unless an exception applies, a plan provides for the **deferral** of compensation if it provides that a service provider has a legally binding right during a taxable year to

¹ Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, and the Treasury Regulations promulgated thereunder.

² The generic label of “employment agreement” includes severance agreements and noncompete agreements that may exist in addition to or instead of a more comprehensive employment agreement.

³ Section 409(a)(1).

⁴ Treas. Reg. § 1.409A-1(a)(2).

⁵ Treas. Reg. § 1.409A-1(c)(1).

compensation that, pursuant to its terms, is or may be payable to or on behalf of the service provider in a later taxable year.⁶

A **legally binding right** includes a contractual right (even if contingent or conditional) that is enforceable under the applicable law or laws governing the contract, as well as an enforceable right created under other applicable law, like a statute (including ERISA).⁷ A legally binding right exists, even though actual payment of the compensation may be subject to vesting requirements.⁸

As defined under 409A, almost any right to compensation in the future is a nonqualified deferred compensation plan. The result is the extensive and often unexpected application of 409A, which covers bonus payments, equity compensation, severance, reimbursement arrangements, insurance and other forms of compensation and benefits.

C. Time and Form of Payment

The primary requirement of section 409A is that the nonqualified deferred compensation plan specify the time and form of payment.

Under section 409A, the plan must specify that the compensation will be paid no earlier than:⁹

- The employee's separation from service
- The date the employee becomes disabled
- The employee's death
- A specified time (or pursuant to a fixed schedule)
- A change in control
- The occurrence of an unforeseeable emergency

Other than death, each of the events listed above is defined in the Treasury Regulations, and a plan that is not exempt from 409A must use the defined term from the regulations, with only certain permitted modifications.

The plan also must specify whether the payment will be made in a lump sum or in installments. Section 409A does not require the specification of the medium of payment (cash or in-kind).¹⁰

⁶ Treas. Reg. § 1.409A-1(b)(1).

⁷ Treas. Reg. § 1.409A-1(b)(1). See also T.D. 9321, section III.B.

⁸ T.D. 9321, section III.B.

⁹ Section 409A(a)(2).

¹⁰ See T.D. 9321, section III.D.6.

D. Documentary and Operational Compliance

Not only must nonqualified deferred compensation actually be paid in compliance with section 409A (operational compliance), the written documents providing for such compensation must comply as well (documentary compliance).

E. Exemptions, Exceptions, Exclusions

Section 409A starts with a broadly applicable general rule, then layers in, mainly through the Treasury Regulations, a number of important exemptions, exceptions and exclusions. A traditional nonqualified deferred compensation plan, like a salary or bonus deferral plan, generally must comply with section 409A and all of its restrictions. But many other plans that provide broadly defined deferred compensation, including employment agreements, often can fit within an exclusion found in the Treasury Regulations. The regulations even permit the use of exemptions in combination, known by practitioners as “stacking.”

When compensation is not subject to 409A, the parties will have greater flexibility in the future, along with less compliance risk, so it usually is preferable to be exempt and outside of 409A, even when compliance may not be onerous. Consequently, much of the effort and analysis engendered by 409A is directed at ensuring that 409A does not apply rather than at crafting terms that comply with the restrictions.

F. Who Bears the Risk?

The employee is liable for any tax imposed by section 409A. The employer would have some additional reporting and employment tax obligations, but the material risk of additional taxes resulting from noncompliance is borne, at least initially, by the employee. Taken to the extreme, this fact can cause employers to take unreasonable positions in the negotiation of issues potentially affected by 409A, or it can cause employers to be indifferent. This is, of course, short-sighted. Compensation taxed at rates as high as 75% is hardly good for morale or recruitment. Also, the IRS is increasing its 409A audits at the company level, and poor compliance on one issue tends to make the IRS curious about other issues. Companies can expect a similar level of scrutiny in an acquisition. Acquisition agreements now include representations covering 409A compliance, and 409A is now an important part of a buyer’s due diligence process. 409A issues can slow a transaction down and even affect the price. Although the rule imposes the tax on the employee, and most agreements specifically limit the employer’s liability to the employee for any 409A-related damages, noncompliance with 409A is a losing proposition for an employer.

II. The Issues

A. Equity Awards

Section 409A mercifully includes some important exceptions for equity awards. Awards of restricted property that are already subject to section 83, such as grants of restricted stock, are not subject to section 409A.¹¹ Qualified stock options also are exempt.¹² Nonqualified stock options are exempt if they meet certain conditions, the most important of which is that the exercise price of the option equal or exceed the fair market value of the underlying stock on the date of grant.¹³

Equity and equity-based awards do still present 409A issues, but those issues do not often arise in the drafting or negotiation of employment agreements. Employment agreements typically include only a reference to the right to receive equity or equity-based awards, while the terms of the awards are set out in a separate plan or agreement. Any 409A issues would be handled in that separate plan or agreement.

One issue that might be addressed in the employment agreement is the acceleration of vesting. A plan may not specify whether vesting is accelerated upon the occurrence of certain events, or it may leave vesting to the discretion of the plan administrator, so an employee may want to deal with that issue in the contract. This is okay. It is not an impermissible acceleration under section 409A if the employer waives a vesting requirement and accelerates vesting.¹⁴

B. Severance

Severance payments, usually in the form of salary continuation, are the main form of nonqualified deferred compensation provided in employment agreements. Most severance payments fit within one or both of the two important exclusions described below — the short-term deferral exclusion and the 2x2 rule.

1. Short-term deferral

Section 409A provides an important exception — often referred to as the short-term deferral exclusion — for compensation that is paid quickly after it is earned or becomes vested. Payments that must be made and that are in fact made within the short-term deferral period are not treated as deferred compensation under 409A. Annual bonuses and incentive awards that are designed to be paid immediately upon vesting typically fall within the short-term deferral exclusion.

¹¹ Treas. Reg. § 1.409A-1(b)(6)(i).

¹² Treas. Reg. § 1.409A-1(b)(5)(ii).

¹³ Treas. Reg. § 1.409A-1(b)(5)(i).

¹⁴ Treas. Reg. § 1.409A-3(j)(1).

The short-term deferral period ends on the later of the 15th day of the third month following the end of the employee's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the employer's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

Although the regulations do not expressly state that March 15 is the end of the short-term deferral period, it is okay if your agreement does. When attempting to take advantage of the short-term deferral exclusion you will never get it wrong if you use the next March 15 as the deadline:

The Executive's annual bonus shall be paid no later than March 15 of the year following the calendar year to which it relates.

For fiscal year companies, this is a conservative approach that may shorten the short-term deferral period that is otherwise available under the regulations. For example, in the case of compensation payable to an employee of a June 30 fiscal year company that vests on July 1, 2013, the short-term deferral period would not end until September 15, 2014. If the contract specifies the following March 15 as the deadline, rather than using the longer description, the company gives up six months of deferral in this example.

Although many drafters opt for the March 15 formulation — concluding that the possible loss of a few months of deferral is a small price to pay for simplicity — some drafters choose the other route:

All incentive bonus payments described in Section 6(D) shall be paid to Executive, to the extent earned, in no event later than the last day of the “applicable 2-1/2 month period”, as such term is defined in Treasury Regulation Section 1.409A-1(b)(4)(i)(A) with respect to such payment's treatment as a “short-term deferral” for purposes of Section 409A.

The short-term deferral exclusion is the most important 409A exemption. Annual bonuses and incentive awards that are designed to be paid immediately upon vesting typically fall within the short-term deferral exclusion. Severance that is payable in a lump sum likely will fall within the short-term deferral exclusion. Salary continuation, or at least a portion of it, may even fit. When you are looking for 409A exemptions, the short-term deferral exclusion is the place to start.

2. Separation Pay Exception (2x2 Rule)

After the short-term deferral exclusion, the second most important exemption is the separation pay safe harbor, or the two times two rule (2x2). In many cases, the

2x2 rule alone, or in tandem with the short-term deferral exclusion, will exempt severance payments from 409A.

Under the 2x2 rule,¹⁵ a separation pay plan that provides for separation pay only upon an **involuntary** separation from service does not provide for a deferral of compensation to the extent that the separation pay, or a portion of the separation pay, meets the following requirements:

- The separation pay does not exceed two times the lesser of
 - The sum of the employee’s annualized compensation based on the annual rate of pay for the year preceding the year of termination; or
 - The section 401(a)(17) limit for the year in which the termination occurs;¹⁶
- The plan provides that the separation pay must be paid no later than the last day of the second taxable year of the employee following the year of termination

Salary continuation longer than two years is unusual, so the second prong of the 2x2 rule (paid by end of second taxable year after the termination year) rarely presents a problem. The amount typically is the culprit. Salary continuation for a highly compensated executive might exceed the amount limitation (a maximum of \$510,000 for 2013). The rule, however, is not an all-or-nothing proposition: the portion of the severance that meets the 2x2 requirements will be exempt.

3. Good Reason

The application of the separation pay safe harbor and the short-term deferral exclusion depend largely on whether compensation is payable solely upon an involuntary termination without cause. Under the regulations, a voluntary termination by the employee for “good reason” may be treated as an involuntary termination.

The general rule is that “a good reason (or a similar condition) must be defined to require actions taken by the service recipient resulting in a material negative change to the service provider in the service relationship, such as the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received for performing such services.”¹⁷ In response to

¹⁵ Treas. Reg. § 1.409A-1(b)(9)(iii).

¹⁶ The 401(a)(17) limit is adjusted annually for inflation. For 2013, the limit is \$255,000. Therefore, the maximum amount excludable under the 2x2 rule for a termination occurring in 2013 is \$510,000.

¹⁷ Treas. Reg. § 1.409A-1(n)(2)(i).

practitioner criticism of this general rule, the IRS added a safe harbor to the final regulations to provide more certainty that a voluntary termination for good reason would be treated as an involuntary termination for purposes of section 409A.

The safe harbor¹⁸ requires the following:

- 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 service provider:
 - A material diminution in the service provider's base compensation.
 - A material diminution in the service provider's authority, duties, or responsibilities.
 - A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body with respect to an entity other than a corporation).
 - A material diminution in the budget over which the service provider retains authority.
 - A material change in the geographic location at which the service provider must perform the services.
 - Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services.
- The amount, time, and form of payment upon the separation from service must be substantially identical to the amount, time and form of payment payable due to an actual involuntary separation from service, to the extent such a right exists.
- The service provider must be required to provide notice to the service recipient of the existence of the condition described in paragraph (n)(2)(ii)(A) of this section within a period not to exceed 90 days of the initial existence of the condition, upon the notice of which the service recipient must be provided a period of at least 30 days during which it may remedy the condition and not be required to pay the amount.

Here is an example of a compliant good reason definition:

¹⁸ Treas. Reg. § 1.409A-1(n)(2)(ii).

“Good Reason” for purposes of this Employment Agreement means the occurrence of any of the following without the Employee's consent: (i) a material adverse change in Employee's title, duties or responsibilities (including reporting responsibilities); (ii) a material reduction in Employee's base salary; and (iii) any relocation of Employee's principal office by more than 50 miles from her office in [City], [State] (this does not apply to customary business travel throughout the U.S. and abroad associated with her role as [title] as required and determined by her job duties under Section 1. Employer and Employee agree that “Good Reason“ shall not exist unless and until Employee provides the Employer with written notice of the acts alleged to constitute Good Reason within ninety (90) days of Employee's knowledge of the occurrence of such event, and Employer fails to cure such acts within thirty (30) days of receipt of such notice, if curable. Employee must terminate her employment within sixty (60) days following the expiration of such cure period for the termination to be on account of Good Reason.

Employees and their attorneys often try to change the good reason definition in ways that remove it from the safe harbor. For example, the safe harbor only covers a material diminution in the employee's base compensation, so employees often want to add something to cover their bonus opportunity or incentive pay. That addition would place the definition outside the safe harbor, where no one can be certain of whether the definition, based on all the facts and circumstances, will satisfy the general rule. A small deviation from the safe harbor calls into question the availability of the short-term deferral exclusion, the application of the separation pay safe harbor, and may lead to imposition of the six-month delay (discussed in II.F., below). It generally is not worthwhile to the employer or the employee for the provision to stray from the safe harbor.

C. Installment Payments

Under 409A, a right to a series of installment payments will be treated as a right to a single payment (the default rule), or as a right to a series of separate payments (if the plan document so provides).¹⁹ It is generally preferable that each installment be treated as a separate payment so that it can be analyzed separately under 409A.

Take for example a contract that provides for 18 months of salary continuation upon termination without cause. Some but not all of the severance payments would be made within the short-term deferral period and therefore excluded from section 409A. If each installment is treated as a separate payment, then we would analyze whether each individual installment meets the short-term deferral

¹⁹ Treas. Reg. § 1.409A-2(b)(2)(iii).

exclusion. On the other hand, if the installments are treated as a single payment, then none of the installment payments would meet the short-term deferral exclusion because a portion of the single payment would be made after the end of the short-term deferral period.²⁰ This is just one example of the flexibility afforded by separate payment treatment.²¹

It is now customary to include the following or similar language in any contract that provides for salary continuation or severance payments made in installments (usually in the 409A boiler plate provision):

If an amount is to be paid under this Agreement in two or more installments, each installment shall be treated as a separate payment for purposes of Code Section 409A.

D. Reimbursement Arrangements

Nontaxable benefits are not subject to section 409A.²² Nontaxable reimbursement during employment, such as reimbursement of business expenses, and nontaxable post-employment reimbursement arrangements, such as dependent care coverage under section 129 and reimbursement of legal expenses under section 120, do not raise 409A issues.

On the other hand, reimbursement arrangements that are taxable must satisfy section 409A. A plan that provides for taxable reimbursement or in-kind benefits must provide:²³

- for the reimbursement of expenses incurred during an objectively and specifically prescribed period (including the lifetime of the service provider).
- that the amount of expenses eligible for reimbursement during a service provider's taxable year may not affect the expenses eligible for reimbursement in any other taxable year.
- that the reimbursement of an eligible expense is made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred.
- that the right to reimbursement is not subject to liquidation or exchange for another benefit.

²⁰ See Treas. Reg. § 1.409A-1(b)(4)(i)(G).

²¹ Another example is the ability to postpone the payment of particular installments without having to delay the entire series. See Treas. Reg. § 1.409A-2(b)(9), Ex. 18.

²² See T.D. 9321, section III.K.

²³ Treas. Reg. § 1.409A-3(i)(1)(iv)(A).

There is a special exception for the reimbursement of certain expenses in connection with an employee's termination (voluntary or involuntary). The expenses covered by this exception include (i) expenses not otherwise excludable from gross income for expenses the employee could deduct under section 162 or 167 as business expenses incurred in connection with the performance of services, (ii) reasonable outplacement expenses and (iii) reasonable moving expenses actually incurred and directly related to the termination. To be excluded, such expenses must be incurred during the period beginning on the employee's termination date and ending on the last day of the second taxable year following the employee's taxable year during which the termination occurred.²⁴

In some cases, an employer's generally applicable reimbursement policy will apply and the issue will be whether reimbursements made in accordance with that policy meet section 409A. In those cases, the drafter of the employment agreement needs to be aware that reimbursement arrangements can raise 409A issues, and be careful not to deviate from the company's generally applicable policy (assuming that policy is 409A compliant).

Increasingly, however, employment agreements are addressing this issue directly. Below is a representative provision:

To the extent that the reimbursement of any expenses or the provision of any in-kind benefits under this Employment Agreement is subject to Section 409A, (i) the amount of such expenses eligible for reimbursement, or in-kind benefits to be provided, during any one calendar year shall not affect the amount of such expenses eligible for reimbursement, or in-kind benefits to be provided, in any other calendar year (provided, that, this clause (i) will not be violated with regard to expenses reimbursed under any arrangement covered by Code Section 105(b) solely because such expenses are subject to a limit related to the period the arrangement is in effect); (ii) reimbursement of any such expense shall be made by no later than December 31 of the year following the calendar year in which such expense is incurred; and (iii) Employee's right to receive such reimbursements or in-kind benefits shall not be subject to liquidation or exchange for another benefit.

E. Health Insurance

Health insurance presents a special case. Section 409A does not apply to any Archer medical savings account, any health savings account, or "any other medical reimbursement arrangement including a health reimbursement arrangement that satisfies the requirements of section 105 and 106 such that the benefits or reimbursements provided under such arrangements are not includible

²⁴ Treas. Reg. § 1.409A-1(b)(9)(v).

in income.”²⁵ In addition, post-termination health benefits of the type that are deductible under section 213 that are provided during the applicable COBRA continuation period²⁶ also are exempt.²⁷ The majority of employer-provided health plans, therefore, are exempt from section 409A.

Taxable health insurance arrangements, however, are subject to 409A. Under section 105(h), a self-insured health plan must not discriminate in favor of highly compensated individuals.²⁸ If a self-insured plan violates the nondiscrimination rules — examples of discrimination include special health coverage (supplemental top-hat coverage) or post-employment coverage that is more favorable for executives — the health coverage becomes taxable and thus subject to 409A. To avoid application of section 409A, the provision of taxable health coverage must comply with the rules applicable to reimbursement arrangements that are described above. Those requirements, particularly the time limit for reimbursement, are not easily met when applied to health plans.

There currently is no standard approach to this issue for drafters of employment agreements. Companies appear to be fashioning solutions that do not affect the contract, or they are ignoring the issue (not a good idea). The combination of section 409A and the pending extension by the Affordable Care Act of nondiscrimination rules to insured plans has caused the IRS to refocus on section 105(h), which previously did not receive a lot of attention. At a minimum, the potential 409A exposure should motivate companies to reexamine compliance with section 105(h).

F. Six-month Delay

For “specified employees,” a group that generally includes the 50 most highly compensated officers of a public company,²⁹ deferred compensation that is payable upon the employee’s separation from service cannot be paid until six months after the employee’s separation from service (or, if earlier, the employee’s death).³⁰

²⁵ Treas. Reg. § 1.409A-1(a)(5).

²⁶ Generally 18 months. See section 4980B.

²⁷ Treas. Reg. § 1.409A-1(b)(9)(v)(B).

²⁸ The Patient Protection and Affordable Care Act enacted on March 23, 2010 would extend the nondiscrimination rules to cover insured plans as well as the self-insured plans already covered by section 105(h). This could subject even more health plans to section 409A. Rules implementing this legislation, however, have yet to be adopted, so no one knows how the law might affect the application of section 409A to health plans.

²⁹ This is somewhat of an oversimplification. The definition, which runs for nearly two pages, is in Treas. Reg. § 1.409A-1(i).

³⁰ Treas. Reg. § 1.409A-3(i)(2)(i).

This six-month delay must be addressed in the written document, and there are two ways to comply.³¹ The Treasury Regulations permit a universal delay approach: each payment due under the plan is simply delayed by six months. The far more popular approach authorized by the regulations is the hold-and-release approach. Under that method, everything that would have been paid during the six-month period following termination is held and paid on the first day of the seventh month, and any remaining payments are made as originally specified under the agreement. The following is an example of a provision that takes the hold-and-release approach:

If Employee is a “specified employee” within the meaning of Treasury Regulation Section 1.409A -1(i) as of the date of the Employee's separation from service (within the meaning of Treas. Reg. Section 1.409A-1(h)), then any payment or benefit pursuant to this Employment Agreement on account of Employee's separation from service, to the extent such payment constitutes non-qualified deferred compensation subject to Section 409A and required to be delayed pursuant to Section 409A(a)(2)(B)(i) of the Code (after taking into account any exclusions applicable to such payment under Section 409A), shall not be made until the first business day after (i) the expiration of six (6) months from the date of Employee's separation from service, or (ii) if earlier, the date of Employee's death (the “Delay Period”). Upon the expiration of the Delay Period, all payments and benefits delayed pursuant to this Employment Agreement (whether they would have otherwise been payable in a single sum or in installments in the absence of such delay), [together with interest at the applicable federal rate under Section 7872(f)(2)(A) of the Code in effect on the date of Employee's separation from service]³² will be paid or reimbursed to Employee in a lump sum and any remaining payments and benefits due under this Employment Agreement will be paid or provided in accordance with the normal payment dates specified for them herein.

Notice that the provision above would delay a payment only “to the extent such payment constitutes non-qualified deferred compensation subject to Section 409A.” A payment that is exempt from 409A, like a payment that qualifies as a short-term deferral, is not subject to the six-month delay. This is where the election to treat installments as separate payments, together with the stacking of exemptions, can be especially useful: each of the first six installments, when analyzed as separate payments, likely will fit within the short-term deferral exclusion or satisfy the 2x2 rule, which means that each installment will not be treated as deferred compensation and will not be subject to the six month delay.

³¹ See Treas. Reg. § 1.409A-3(i)(2)(ii).

³² The bracketed language providing for the accrual of interest on any delayed payments is not standard, but is becoming increasingly popular.

The six-month delay rule is one of the 409A rules that require documentary compliance as well as operational compliance. A provision similar to the one above needs to be in any public company plan or agreement that provides for compensation upon separation from service. Although not required, it is not uncommon to include such a provision in the plans or agreements of private companies that might become public, so that it does not have to be added later.

G. Releases

Many employment agreements condition the payment of severance on the employee's execution of a release of claims. Prior to 409A, a release provision might have looked like this one:

[Do not use.] Notwithstanding any other provision of this Agreement to the contrary, the Employee acknowledges and agrees that any and all payments, other than the payment of any earned or accrued and unpaid Base Salary, Bonus and Benefits, to which the Employee is entitled under this Section 8 are conditioned upon and subject to the Employee's execution of a general waiver and release, in such reasonable form as may be prepared by the Company's attorneys, of all claims and issues arising under the Employment Agreement or Employee's employment with the Company, except for such matters covered by provisions of this Agreement which expressly survive the termination of this Agreement.
[Do not use.]

A release provision like the one above is problematic under 409A because the payment of severance is dependent on the employee's completion of further actions by no particular deadline. According to the IRS, this gives the employee impermissible discretion to time the payment (or the initiation of installment payments) to the employee's advantage by signing or withholding the release.³³

The IRS has approved two solutions to this problem.³⁴ The document may provide that the payment will be made on the 60th or 90th day following termination, provided that the release has become irrevocable prior to the payment date. Or the document may allow for payment within a period of up to 90 days following termination, so long as the document states that if the period spans two calendar years the payment will be made in the second year.

Here is an example of a 409A-compliant release provision:

³³ This seems highly theoretical, since most employees actually need their salary continuation and would only delay the signing of a release if there were an actual dispute regarding the contents of the release.

³⁴ See IRS Notice 2010-6, section VI.B.2 and IRS Notice 2010-80, section III.B.

Notwithstanding any other provision of this Agreement to the contrary, the Employee acknowledges and agrees that any and all payments, other than the payment of any earned or accrued and unpaid Base Salary, Bonus and Benefits, to which the Employee is entitled under this Section 7 are conditioned upon and subject to the Employee's execution of a general waiver and release substantially in the form of Exhibit A attached hereto, becoming effective by the 90th day following the Employee's separation from service. Such payments will commence the day following the date the release becomes effective, provided that if the 90 day period spans two calendar years, the payments will commence in the second calendar year.

Under both approaches, the employee forfeits his or her right to severance if the release is not effective in time. To prevent sandbagging by the employer, and to contribute to a smoother process even where the parties are on good terms, practitioners recommend attaching the form of release to the employment agreement. Negotiating the form of release at the same time as the rest of the employment agreement can be a burden, but it is becoming a best practice, particularly for public companies.

H. Boilerplate

Some drafters of employment agreements choose to address 409A issues in various places throughout the document, but many now choose to address them all in one place. In every case, there will be a 409A boilerplate provision and its primary purpose will be to reinforce the contract's compliance with 409A.

Because 409A requires documentary as well as operational compliance, some kind of savings clause would seem to be in order. For example, it is tempting to include something like: "Notwithstanding any other provision of this plan, no election shall be permitted, and no payment shall be made that would violate the requirements of or cause taxation to any person under section 409A." The Treasury Regulations, however, require that savings clauses be disregarded when determining the terms of a plan, thus devaluing such provisions.³⁵

Although a savings clause cannot cure a noncompliant term or supply a compliant one, it is possible to include language to resolve in the drafter's favor any ambiguity regarding the application of 409A. In Notice 2010-6, the IRS allowed that "[i]f the plan also contains a provision requiring that the term be interpreted to comply with the requirements of § 409A (or a plan provision with the same effect) . . . the provision is not ambiguous and complies with the requirements of § 409A and § 1.409A-3(a)."³⁶ This is the reason nearly every 409A boilerplate

³⁵ Treas. Reg. § 1.409A-1(c)(1).

³⁶ IRS Notice 2010-6, IV.B.1.

provision now begins with something like: “All provisions of this Agreement shall be interpreted in a manner consistent with Code Section 409A and the regulations and other guidance promulgated thereunder.”

After establishing that the agreement should be interpreted to comply with or be exempt from section 409A, most boilerplate provisions also reserve the right to amend the agreement to achieve compliance. The shorter provisions stop there. Here is an example of a short 409A boilerplate provision that might be used in an agreement where the type of compensation raises few 409A issues, or where 409A issues are addressed in individual provisions throughout the agreement:

Section 409A Compliance. The Company and Executive intend that any amounts or benefits payable or provided under this Agreement comply with the provisions of Section 409A of the Internal Revenue Code and the treasury regulations relating thereto so as not to subject Executive to the payment of the tax, interest and any tax penalty which may be imposed under Code Section 409A. The provisions of this Agreement shall be interpreted in a manner consistent with such intent. In furtherance thereof, to the extent that any provision hereof would otherwise result in Executive being subject to payment of tax, interest and tax penalty under Code Section 409A, the Company and Executive agree to amend this Agreement in a manner that brings this Agreement into compliance with Code Section 409A and preserves to the maximum extent possible the economic value of the relevant payment or benefit under this Agreement to Executive.

Some boilerplate provisions also expressly disclaim the employer’s liability for any 409A violations, the concern being that all of the employer’s efforts to ensure compliance may be misinterpreted as some kind of warranty. This seems to be less of a concern now than it was when 409A was new to everyone, but the disclaimer language is still somewhat prevalent. Also, to no one’s surprise, the awkward “separation from service” has yet to transplant “termination” as the term of choice in contracts. To ensure compliance with 409A, many boilerplate provisions now state that one means the other. This kind of housekeeping, along with provisions that address the six-month delay rule, the reimbursement safe harbor and other issues can be addressed in the 409A boilerplate provision, thus making the 409A boilerplate provision something of a Swiss Army knife that provides a tool for many of the different issues described in this paper.³⁷

Here is an example of a 409A boilerplate provision that tries to address nearly all of the issues in one place:

³⁷ This is a much more efficient approach when drafting or reviewing is divided among specialists.

22. Compliance with Section 409A. Notwithstanding any other provision of this Agreement to the contrary, the provision, time and manner of payment or distribution of all compensation and benefits provided by this Agreement that constitute nonqualified deferred compensation subject to and not exempted from the requirements of Code Section 409A (“Section 409A Deferred Compensation”) shall be subject to, limited by and construed in accordance with the requirements of Code Section 409A and all regulations and other guidance promulgated by the Secretary of the Treasury pursuant to such Section (such Section, regulations and other guidance being referred to herein as “Section 409A”), including the following:

(a) **Separation from Service.** Payments and benefits constituting Section 409A Deferred Compensation otherwise payable or provided pursuant to Section 8 upon the Executive’s termination of employment shall be paid or provided only at the time of a termination of the Executive’s employment that constitutes a Separation from Service. For the purposes of this Agreement, a “Separation from Service” is a separation from service within the meaning of Treasury Regulation Section 1.409A-1(h).

(b) **Six-Month Delay Applicable to Specified Employees.** If, at the time of a Separation from Service of the Executive, the Executive is a “specified employee” within the meaning of Section 409A(a)(2)(B)(i) (a “Specified Employee”), then any payments and benefits constituting Section 409A Deferred Compensation to be paid or provided pursuant to Section 8 upon the Separation from Service of the Executive shall be paid or provided commencing on the later of (i) the date that is six months after the date of such Separation from Service or, if earlier, the date of death of the Executive (in either case, the “Delayed Payment Date”), or (ii) the date or dates on which such Section 409A Deferred Compensation would otherwise be paid or provided in accordance with Section 8. All such amounts that would, but for this Section 22(b), become payable prior to the Delayed Payment Date shall be accumulated and paid on the Delayed Payment Date.

(c) **Health Care and Estate Planning Benefits.** In the event that all or any of the health care or estate planning benefits to be provided pursuant to Sections 8 (a)(vii); 8(e)(i)(2)(c) or 8(e)(i)(2)(d) as a result of a Participant’s Separation from Service constitute Section 409A Deferred Compensation, the Company shall provide for such benefits constituting Section 409A Deferred Compensation in a manner that complies with Section 409A. To the extent necessary to comply with Section 409A, the Company shall determine the health care premium cost necessary to provide such benefits constituting Section 409A Deferred Compensation for the applicable coverage period and shall pay such

premium cost which becomes due and payable during the applicable coverage period on the applicable due date for such premiums; provided, however, that if the Executive is a Specified Employee, the Company shall not pay any such premium cost until the Delayed Payment Date. If the Company's payment pursuant to the previous sentence is subject to a Delayed Payment Date, the Executive shall pay the premium cost otherwise payable by the Company prior to the Delayed Payment Date, and on the Delayed Payment Date the Company shall reimburse the Executive for such Company premium cost paid by the Executive and shall pay the balance of the Company's premium cost necessary to provide such benefit coverage for the remainder of the applicable coverage period as and when it becomes due and payable over the applicable period.

(d) **Stock-Based Awards.** The vesting of any stock-based compensation awards which constitute Section 409A Deferred Compensation and are held by the Executive, if the Executive is a Specified Employee, shall be accelerated in accordance with this Agreement to the extent applicable; provided, however, that the payment in settlement of any such awards shall occur on the Delayed Payment Date. Any stock based compensation which vests and becomes payable upon a Change in Control in accordance with Section 8(e)(i)(1) shall not be subject to this Section 22(d).

(e) **Installments.** Executive's right to receive any installment payments payable hereunder shall be treated as a right to receive a series of separate payments and, accordingly, each such installment payment shall at all times be considered a separate and distinct payment for purposes of Section 409A.

(f) **Reimbursements.** To the extent that any reimbursements payable to Executive pursuant to this Agreement are subject to the provisions of Section 409A of the Code, such reimbursements shall be paid to Executive no later than December 31 of the year following the year in which the cost was incurred; the amount of expenses reimbursed in one year shall not affect the amount eligible for reimbursement in any subsequent year; and Executive's right to reimbursement under this Agreement will not be subject to liquidation or exchange for another benefit.

(g) **Rights of the Company; Release of Liability.** It is the mutual intention of the Executive and the Company that the provision of all payments and benefits pursuant to this Agreement be made in compliance with the requirements of Section 409A. To the extent that the provision of any such payment or benefit pursuant to the terms and conditions of this Agreement would fail to comply with the applicable requirements of Section 409A, the Company may, in its sole and absolute

discretion and without the consent of the Executive, make such modifications to the timing or manner of providing such payment and/or benefit to the extent it determines necessary or advisable to comply with the requirements of Section 409A; provided, however, that the Company shall not be obligated to make any such modifications. Any such modifications made by the Company shall, to the maximum extent permitted in compliance with the requirements of Section 409A, preserve the aggregate monetary face value of such payments and/or benefits provided by this Agreement in the absence of such modification; provided, however, that the Company shall in no event be obligated to pay any interest or other compensation in respect of any delay in the provision of such payments or benefits in order to comply with the requirements of Section 409A. The Executive acknowledges that (i) the provisions of this Section 22 may result in a delay in the time which payments would otherwise be made pursuant to this Agreement and (ii) the Company is authorized to amend this Agreement, to void or amend any election made by the Executive under this Agreement and/or to delay the payment of any monies and/or provision of any benefits in such manner as may be determined by the Company, in its discretion, to be necessary or appropriate to comply with Section 409A (including any transition or grandfather rules thereunder) without prior notice to or consent of the Executive. The Executive hereby releases and holds harmless the Company, its directors, officers and stockholders from any and all claims that may arise from or relate to any tax liability, penalties, interest, costs, fees or other liability incurred by the Executive as a result of the application of Code Section 409A.

III. Conclusion

Those who draft and negotiate employment agreements do not need to know section 409A in all its detail, but a passing familiarity is a must. The consequences of violating 409A are disastrous (taxation at rates as high as 75%) but avoidable. And in many cases avoiding 409A requires only a simple sentence or well-placed contract provision.