The Ten Most Significant Matters Your CEO Should Know About His Or Her Employment Contract

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Among other things, your CEO should understand that even the most unlikely provisions of the contract can have serious tax implications.

IN THE CONTEXT of almost any organizational structure, the contents of the CEO's employment agreement can have tax consequences. But it is important to begin at the beginning, by making sure that what appears to be an employment agreement, or what is being discussed, is actually an employment agreement. For example, it is important to distinguish between an employment agreement and an executive severance agreement. Severance agreements cover little more than severance pay issues. Employment agreements typically address broader issues such as:

- Job responsibilities and reporting relationships;
- Policy and covenant issues that apply during the term of employment;
- Severance pay running to the end of a fixed term of employment;
- Ability to engage in paid or unpaid outside professional activities;
- Locked-in terms of compensation and benefits; and
- Special provisions negotiated with the executive, such as sabbatical, housing, or loans.

Do not expect a severance agreement to cover issues like these. Especially in the context of exempt organization boards, employment agreements sometimes provide some severance pay protection, but usually don't amount to full-blown employment agreements — particularly for positions other than that of the CEO.

When you review the agreement, consider whether you are reviewing it from the perspective of the executive or the organization. On any given issue under an employment or severance agreement, these perspectives will be quite different. Most of the terms that are negotiated in the agreement will arise, or be triggered, or become material issues, only if the relationship between the CEO and the organization goes terribly awry. As a result, there is a natural and significant divergence of perspective on many key issues. Effective employment agreements balance organization and executive needs and perspectives.

When issues arise under existing or contemplated agreements, consider the distinctly different interests of the organization and the CEO on that issue. Do not expect the CEO to wear his or her "company hat" when looking at any issue pertaining to his or her employment or severance agreement. It is always a good idea to have legal representation on both sides, even if the negotiations are relatively friendly and expected to stay that way.

Consider the professional, ethical, employment, and fiduciary issues of the person or entity whose interest you are representing when you look at an employment agreement issues for a key executive. If the CEO asks General Counsel or outside counsel to consider an issue under the CEO's employment or severance agreement, counsel should consider the perspective from which he/she is being asked to review that issue. Counsel should make it clear to the CEO that counsel cannot advise the CEO personally on the issue, and that counsel is always viewing every issue under the agreement on behalf of the organization, and toward representing the best interests of the organization.

Often an issue that starts off as an innocent question about the agreement, and which can be addressed rather simply from the organization's perspective and in the organization's interest, will become an issue in the CEO's interest (or be viewed as such). It can be very difficult to separate the CEO's interest from the organization's interest on any issue under the agreement.

If the General Counsel is being asked to address an issue under the CEO's agreement, it may put the General Counsel in the uncomfortable position of acting in the organization's best interest while addressing an issue of personal interest to the General Counsel's ultimate superior. It may be advisable for the General Counsel to advise the CEO in advance that any issues under the agreement should be addressed by outside counsel to the organization and by the CEO's personal counsel.

Consider the ethical issues of whether, when, how and with whom to raise issues, as counsel, with respect to the CEO's employment or severance agreement. When you know that an issue will trigger very different reactions and interests, and you have an ongoing relationship with the CEO and with the Board (whether you are General Counsel or outside counsel for matters that include advising the organization on employment/severance agreement matters), do you raise issues on your own initiative? Do you alert the CEO if you are going to raise an issue with the Board? Do you raise the issue with the Board and advise the Board member or committee to speak to the CEO about the issue having been raised? It is often useful to discuss up front how and with whom these issues will be addressed.

Of course, the most significant issues in any employment or severance agreement are going to be personal to that situation, and will be driven in part by special issues and circumstances. Succession planning issues may be incredibly important to the organization when the CEO is 65 years old and there is no clear successor, and may be far less important when the CEO is 45 and there are very able executives ready to assume the CEO role if necessary. Severance pay protection may be very important to the CEO if he/she had to relocate in taking the position, but may be somewhat less important if he/she is from the area and would have other meaningful and comparable opportunities to remain in the area after leaving the organization. That said, we will try to identify and describe what frequently the most important considerations are in an employment or severance agreement between an exempt organization and its CEO.

1. The CEO should retain personal counsel for the review and negotiation of the employment agreement, and should keep his or her personal counsel available during the course of employment to address any issues that arise.

This is a recommendation even in the most friendly of negotiations. Often the cost of legal representation is reimbursed by the organization, so as to encourage the CEO to secure personal counsel. Note, however, that if the fees of the CEO's personal counsel are reimbursed or paid directly by the organization, those payments will be considered taxable income to the CEO.

2. If the CEO wishes to have the flexibility to engage in various paid or unpaid professional activities, the parameters for those activities should be addressed and articulated at the outset in the agreement.

It is customary for Boards to give the CEO wide latitude in engaging in unpaid outside professional activities, as long as these outside activities and obligations do not interfere with the responsibilities of the CEO to the employing organization.

Note, however, that important organization interests may be at issue: some activities may generate actual or perceived conflicts of interest, some activities may be at odds with the organization's stated mission or the manner in which the organization wishes to be perceived, and/or some activities may divert what the Board would consider to be too great a portion of the CEO's time and attention. Is there a point at which the outside activities are so great, in time and attention that the CEO is not able to carry out all the duties and responsibilities of his or her CEO position for the organization, or might actually be receiving unreasonable compensation for the services actually being provided to the organization?

The CEO should expect the Board to have a keen interest in this provision, to place particular restrictions on paid activities, to set boundaries on time commitment of these activities, and to keep a right of advance approval for most or all activities. That said, many organizations want their CEOs to be highly visible in the community and to engage in a wide variety of professional activities. Certainly this objective can be in tension with the equally valid need to place even reasonable restrictions on such activities. Note that conflicts of interest should be vetted carefully as the activities of the CEO could affect the organization's reputation, relationships, and operations.

3. Understand what will be disclosed annually on the Form 990 return, and help the Board or its relevant compensation committee to articulate the value provided by the CEO in return for all compensation and benefits.

Many elements of the CEO's compensation and benefits will have to be disclosed on the Form 990. The disclosable elements commonly include:

- Base salary;
- Incentive pay when determined, declared, and vested;
- Deferred compensation as it is being earned, whether or not vested;

- Deferred compensation when it is vested (as a second disclosure, if vesting occurs in a year later than the year in which it was earned);
- Retention bonus amounts amortized over the retention period (whether or not eventually vested and paid);
- Value of all benefits and perquisites (with some special rules about estimating the value of certain benefits, and excluding items having a value of less than $10,000); and
- Severance payments and benefits paid out within five years after termination of employment (because a former CEO remains a disclosable position on the 990 for a five-year look-back period, and because severance payments and benefits are disclosable when provided and not when they are merely a potential future benefit).

Also disclosable, in the form of checkboxes and required narrative explanation, are a variety of special benefits and arrangements:

- First-class or charter travel;
- Travel for companions;
- Tax indemnification and gross-up payments;
- Discretionary spending account;
- Housing allowance or residence for personal use;
- Payments for business use of personal residence;
- Health or social club dues or initiation fees; and
- Personal services (e.g., maid, chauffer, chef).

The need to highlight these types of payments and benefits, and to explain them in the narrative section of Schedule J of Form 990, has caused many organizations to rethink whether to provide at least certain of these types of benefits. To avoid separate and special disclosure, a strategy worth considering is to reduce any "special" benefits to their monetary equivalent and to provide them in the form of additional compensation. Note that it will be necessary to determine (whether under the employment agreement or separately) whether any such additional compensation payments are treated as compensation for purposes of other benefit plans and arrangements (such as nonqualified deferred compensation plans and supplemental retirement plans) — it is certainly possible to provide in the employment agreement that these types of compensation payments will not be treated as compensation for purposes of other benefit plans and arrangements.

The Form 990 disclosure implications can influence the strategic decisions as to how to provide certain elements of compensation and benefits. For example, if an organization and CEO are considering whether to enter into a retention incentive (for example, $200,000 at the end of a three-year retention period) or an incentive compensation arrangement (again, $200,000 at the end of a three-year performance period, but only if certain goals are satisfied), the Form 990 reporting implications may affect the decision:

- The retention incentive would be amortized and reported over the three-year period, and in the third year (if earned and paid) would be fully reported (with an amount reported on Schedule J, column (F) as the portion of the benefit that was disclosed on the two prior 990s while the retention benefit was earned);
- The incentive compensation amount would be reported only in year three to the extent it is earned;
- If the CEO leaves during year three and forfeits whatever arrangement was in place, two-thirds of the retention benefit will have been reported on 990s, and none of the incentive compensation opportunity will ever be reported; and

- While these reporting considerations are important, the Board will need to consider first and foremost what is in the best interest of the organization in terms of retaining, motivating and appropriately compensating the CEO.

When the Form 990 disclosure implications are expected to be significant for the organization, the CEO should help the Board (or relevant compensation committee) to be ready to articulate the value provided by the CEO in exchange for the compensation and benefits provided. This is not to say that the CEO's judgment as to the reasonableness of his or her compensation is substituted for that of the Board or committee; it is still the Board or committee that determines whether compensation is reasonable. However, if and when questions and challenges arise as the result of Form 990 disclosures of compensation and benefits, the Board or committee needs to be in a position to defend the compensation provided and to articulate all the ways in which the CEO provides the value for which the compensation is being provided. The CEO is uniquely positioned to equip the Board or committee with the information it needs in this regard.

CEOs should make sure that the Board or committee is familiar with the full extent of the CEO's compensation/benefits package and major compensation- related components (of the agreement) if the CEO is terminated, understands how and when the various elements of compensation and benefits will be disclosed on the Form 990, is comfortable with the reasonableness of the entire arrangement (as approved by the Board or committee), and is ready to defend the arrangement. Full transparency with the Board or committee on these issues is an absolute must.

4. The agreement's term and renewals do not mean anything if employment can be terminated at any time in exchange for the payment of severance pay and benefits.

A considerable amount of energy is often wasted in the negotiation of an employment agreement on issues of contract length, renewal terms and whether renewals are automatic or subject to separate approval. If an organization can at any time terminate the CEO without cause and pay 24 months of severance pay, and if a nonrenewal decision results in nothing other than the same 24 months of severance pay, then the length of the contract and the structure of renewals have no practical effect.

The length of the contract and the structure of renewals can have separate and significant meaning, such as in the following situations:

- When employment can be terminated at the end of a contract term (initial or renewal) without the payment of severance benefits;
- When the organization's ability to terminate employment without cause is curtailed or eliminated during a particular contract period; or
- When the terms of the agreement are locked in place for a particular contract period and cannot be amended or curtailed by the organization without the CEO's consent.

CEOs should consider whether there are special rights and features that they want to lock into place for a particular period, and organizations should consider whether there are such rights and features that they are willing to have locked in place for a particular period. That will then serve as the basis for a consideration of the length of the initial contract period, the length of renewal periods, whether renewals occur automatically, and what rights may change at the end of particular contract periods.

All that being said, it would be wise not to overlook the message being sent to the CEO on an issue like terms and renewals. Sometimes the agreement term is more symbolic than substantive as a means of demonstrating the organization's confidence in the continued employment of the CEO, and sometimes symbols are important.

5. Reach an early common understanding as to who reviews and approves business and travel expense reimbursements, and consider stating it as a requirement in the employment agreement.

Misunderstandings on who reviews and approves the CEO's expense reimbursements can lead to no one serving in this role (i.e., the expenses are automatically paid), or to the CFO or a more junior member of the finance department conducting the review and approval. These approaches can lead to conflicts of interest (for example, where the CFO is expected to act in the best interest of the organization while reviewing and approving financial transactions directly involving the CFO's direct or ultimate superior) and/or to noncompliance issues such as:

- Automatic excess benefit transactions involving taxable benefits not treated as compensatory and reported as such under any agreement or in any tax filing;
- Noncompliance with organization policies;
- Use of organization funds for lavish or extravagant expenses.

Internal and external perceptions of the CEO and the reasonableness of the CEO's compensation and benefits are often disproportionately shaped by the little things, such as expense reimbursements, discretionary expense allowances, and the lack of an independent review and approval of expenses.

The CEO would be well advised to place himself or herself beyond reproach on the issue of expenses and how they are incurred, reviewed, approved and treated for tax purposes. A prevalent practice is to have the Board Chair ultimately responsible for signing off on the CEO's expenses.

6. Severance pay is about much more than what is paid (such as base salary or total compensation) and for how long, and could have its own "top ten" list of critical issues.

Health Benefits Continuation

Can health benefits be provided under the organization's group health benefits plan for longer than the severance period? For longer than the COBRA continuation period? For as long as it takes to reach Medicare eligibility age?

Self-insured health benefit plans can provide what otherwise would be discriminatory coverage, but the cost of coverage, if paid by the organization, must be treated as taxable income to the former executive. Organizations have been able to provide insured coverage without taxing the former executive on the cost of coverage, but the Affordable Care Act includes nondiscrimination requirements for insured arrangements, and this type of coverage (for a senior executive only) will be curtailed or will be taxable once the regulations are issued. This is an evolving issue, and the parties to the agreement should not assume that what can be done today (in terms of extended health benefits coverage) can continue to be done for the duration of the agreement or relationship.

Some health plan administrators and stop-loss insurance providers will challenge coverage to a former employee that extends beyond the COBRA coverage continuation period. The availability of coverage through health insurance exchanges may decrease the urgency of keeping coverage in place with the former employer until Medicare eligibility age. At a minimum, the CEO should expect the organization to include "fail-safe" language limiting the organization's exposure to the premium cost of its coverage (payable in cash to the former executive) if continued coverage in the organization's group health benefits plan is prohibited by law, plan or policy.

Mitigation

Will there be a period during which severance pay is offset by income earned from or paid by a subsequent employer or recipient of independent contractor services? Organizations frequently increase the mitigation/offset period rather than decrease the severance pay period (if they want to decrease exposure). Many variations are possible, such as the following:

- No mitigation after a change in control, but mitigation in all other circumstances;
- No mitigation during an initial period (such as the first half of the severance pay period), but mitigation for the remainder of the period; or
- No mitigation up to a certain amount of income earned.

Note that "no mitigation" is more common for the CEO position than for other executive positions, due to the risk associated with the CEO position and the time it takes to find a comparable position with another organization.

"Good Reason" Triggers

Many agreements allow the CEO to terminate employment voluntarily following a "good reason" event and to receive the same severance benefits that apply to an involuntary termination without cause.

Good reason events typically address material diminution of job scope or authority, breach of the agreement by the employer, material decrease in compensation, change in work location, and/or change in reporting relationship. Note that "material diminution" is subject to wide differences in interpretation, so it may be useful to provide some additional definition, description or examples of materiality.

Time periods are important elements:

- Time after the claimed event to trigger a termination;
- Prior notice of termination effective date; and
- Time for organization to cure the defect.

Good reason events also often serve as vesting events for other benefits, such as deferred compensation. The definitions for different purposes should be coordinated, or intended distinctions should be understood by both parties.

Bear in mind that the consequences of a good reason termination need not be identical to the consequences of an involuntary termination without cause.

Restrictive Covenants

As severance pay practices tighten, organizations are paying closer attention to restrictive covenants. This is another example of how some organizations keep the severance pay amount and duration at a higher level while adding important protections for the organization. Common examples:

- Covenant not to compete;
- Nondisparagement;
- Nonsolicitation;
- Confidentiality of proprietary information; and
- Post-termination cooperation.

Customization

If greater severance pay coverage earlier in the relationship is particularly important because of the risk and cost to the CEO of coming to the organization, it is worth considering a front-loaded severance pay arrangement that is structured to diminish over the CEO's period of service.

Cause Terminations

A particularly difficult issue to address in the severance pay provisions is the issue of when the organization can terminate the CEO for "cause" and avoid paying severance pay (as well as potentially to avoid other forms of payment, such as earned but unpaid incentive pay, prorated incentive pay for performance periods in progress, and forms of deferred compensation and retirement supplements).

There is wide agreement on defining cause to include things like breach of the agreement, felony conviction, criminal acts involving dishonesty or theft, and violation of significant Board policies. More ambiguous (and difficult to identify and enforce) are cause events such as acting outside the scope of authority, general references to performance, acts of moral turpitude, and failure to carry out the directions of the Board.

Boards are increasingly wishing to consider a wider range of cause events, including actions that materially and adversely affect or may affect (if known) the reputation of the organization. Some agreements require that a cause termination be approved by a majority of the Board members.

Sunset

One of the most difficult issues to address in the agreement is whether and when there will be a point at which severance pay will no longer be provided. A purely age-based reduction or elimination could run afoul of the Older Workers Benefit Protection Act.

Some organizations provide for a fixed duration of the contract (including renewal periods), with a nonrenewal decision at the end of that period resulting in diminished severance pay or no severance pay. This is an issue that, in the right circumstances, can be folded into a comprehensive succession planning provision.

Sunset provisions are becoming more common, as organizations wish to "reevaluate" employment arrangements during the CEO's career from time to time.

7. Given the pace of change in health care today, CEO agreements should anticipate and define a "change in control" and any special provisions that will apply after the effective date of a change in control.

- Will a change in control include a shared control arrangement, or only situations in which another organization gains more than 50 percent control?
- Will a change in control, in and of itself, trigger any payments (a so-called "single trigger"), or will payments require some type of employment termination (a second trigger)?
- If the second trigger involves material adverse changes to the position or compensation or other terms and conditions of employment, how will materiality be defined and interpreted in a change in control context?
- Will the severance pay provisions differ after a change in control? For example, some agreements that provide for mitigation of regular severance pay will either decrease or eliminate the mitigation of severance pay after a change in control?
- Will any other special contractual protections arise in the event of a change in control? For example, if the organization has certain rights to revise the agreement without the CEO's consent, the agreement could provide that even those limited rights would not apply (without the CEO's consent) following a change in control?
- Will any additional employment termination rights arise after a change in control? For example, the CEO could have the right to terminate for good reason (and receive severance pay) if the agreement is not assumed by the successor controlling organization?

8. A developing good governance practice for exempt organizations is to include some form of clawback of incentive compensation — either in the CEO's employment agreement or incentive pay plan documents.

"Clawback" refers to a situation in which an incentive award has been awarded or paid, but it is subsequently determined that, due to fraud or the misreporting or misstatement of information, the incentive award otherwise would have been a lesser amount or would not have been paid at all, and therefore should be returned to the organization. Public companies are subject to two clawback requirements: Sarbanes-Oxley Act section 304 and Dodd-Frank section 954.

Sarbanes-Oxley Act Section 304

Sarbanes Sarbanes-Oxley Act section 304 requires that both the CEO and CFO pay back to the corporation bonuses or other incentive compensation (along with other forms of compensation) paid during the 12-month period after the release of financial statements that subsequently are restated, if such restatement is due to material noncompliance by the corporation with any financial reporting requirements under federal securities laws and if such noncompliance is due to some form of misconduct. The principal features of the Sarbanes-Oxley clawback provision, according to its strict statutory terms, are as follows:

- Only the CEO and CFO are affected;
- There is no time limit on the clawback, which can apply at any time to any incentive payout made within 12 months after the release of restated financials;
- Clawback requires both material noncompliance and misconduct, neither of which is defined; and
- The triggering "misconduct" can be committed by any employee, and not only the CEO and CFO whose incentive compensation is at risk of being clawed back.

Dodd-Frank Section 954

Dodd-Frank Wall Street Reform and Consumer Protection Act Section 954 requires public companies, under SEC rules, to adopt a clawback policy that includes the following:

- If the company must restate its financial statements due to material noncompliance with financial accounting requirements, incentive-based compensation must be recalculated;
- The material noncompliance need not have been caused by fraud or any other type of misconduct by the company or any employee;
- Any incentive pay provided to any current or former executive officers within the three years preceding the date on which the company is required to issue restated financials must be recalculated in accordance with the restated financials; and
- The amount of the payment that exceeds the recalculated amount must be repaid to the company (in other words, the recovery applies to amounts that would not have been paid if payment had been made in accordance with the corrected financials).

Exempt organizations are not required to have clawbacks, but many Board members (due to their public company backgrounds) have been considering whether some form of clawback would show that the organization and its Board are highly attuned to governance practices, and are responsive to the stricter scrutiny to which exempt organizations and their executive compensation are subject. An incentive clawback could also give rise to the following practical issues:

- In some states, incentive compensation may be considered "wages" under the state's wage payment law, and may result in an enforceable action by an employee (even at the executive level) to force the payment of incentive compensation once earned and determined. As a result, the most effective way to implement a clawback may be to do so prospectively, and to have participating employees agree to the terms (including the clawback) as part of their participants in the incentive plan;

- When previously paid and taxed incentive compensation is clawed back, the tax treatment of the forfeited amount is unclear. The executive whose incentive compensation is clawed back will likely have to repay previously taxed compensation at the original value, without taking into account the taxes paid on the compensation;
- If a mechanical recalculation approach were adopted (which would result in revising previously determined incentive awards if and when the financials are restated or corrected), there may be a ripple effect in each succeeding year that would be difficult to address. The revised financial results in one year would affect the baseline in the next year, which would alter the performance in relation to the goal for that year, and so forth.

Because a clawback is at most a good governance practice for exempt organizations, a clawback can be designed to borrow from and blend features of the Sarbanes-Oxley and Dodd-Frank clawbacks to create a more limited, "worst case" approach. The clawback, if adopted, need not be built into the CEO's agreement, but can instead be incorporated into the relevant incentive compensation plan documents.

9. Succession planning is an important area of increasing focus for Boards and compensation committees, but can be a tricky area for the CEO and very difficult to address in the agreement.

It is important first for a Board and the CEO to have a common understanding as to what "succession planning" means and includes. Succession planning can mean variations of these themes:

- Talent development/management — identifying and grooming future leaders from within current leadership of the organization;
- Emergency succession — identifying critical leadership positions, and for each position the person(s) who are best suited to step in if for any reason the current executive were suddenly unable to continue;
- Planned succession of the CEO (and other key executive positions) — establishing a timetable for the departure of the CEO. Also, many executives leave after a CEO retires or leaves (particularly those who may have had an expectation of being considered for the CEO position), so a detailed succession planning process for other positions should also be considered as part of the discussions, to assure leadership continuity.

The Board and the CEO should have regular and frank discussions, in executive session, on the issues of talent development and emergency succession. The Board should defer to the CEO's leadership in these areas, but needs to remain informed as to whether the executive leadership of the organization is stable and will remain at full capacity. On the issue of planned CEO succession, the Board will have several potential organization interests in mind:

- Determining whether internal candidates are available or whether an external search will be needed;
- Having enough time to conduct an orderly search and transition;
- Keeping the vacancy time in the CEO position to a minimum;
- Ending the CEO's employment without paying severance benefits; and/or
- Ending the CEO's supplemental retirement benefits.

These potential objectives are not necessarily in the CEO's personal best interest.

CEOs are well-advised to approach their own succession planning very cautiously. The CEO and the Board should have good and open communication, the CEO should work to identify and develop potential successors within the organization, and appropriate advance notice of resignation or retirement can be incentivized or otherwise built into the agreement. The CEO should bear in mind, however, that his or her leadership influence in the organization is likely to be significantly diminished when advance notice of anticipated resignation or retirement is provided. A CEO who wishes to continue strong leadership of the organization will want to keep the advance notice requirement to a minimum.

10. The CEO should nurture a regular and transparent line of communication with Board leadership.

Many relationships between organizations and their CEOs have soured because of a breakdown in regular communication among the leaders. It is not inappropriate to include the chair of the compensation committee in such regular communication, nor is it inappropriate to make sure that the compensation committee and other Board leadership are fully aware of the CEO's agreement and any issues arising under it.

Most problems that arise as to a CEO's agreement are the result of surprises to the Board. Regular communication with the CEO, and a useful summary of the CEO's agreement for Board leadership, will reduce the chances of such a surprise. The Board should have a complete understanding of both the organization's and the CEO's obligations under the agreement.