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CLIENT UPDATE

Deferred Compensation and Bankruptcy: A Match Not Made in Heaven

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As corporate bankruptcies have increased, there is also an increased need for these companies to retain key executives. Congress made this more difficult in 2005, when it enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Among other things, this act imposed significant restrictions on a bankruptcy court's ability to approve new retention and severance arrangements to senior executives and others who play a critical role in helping a company emerge from bankruptcy. In addition, some courts have imposed enhanced standards for adopting new bonus programs and incentive compensation arrangements. Even where a company can satisfy the applicable bankruptcy-imposed standards, it may simply wish to restore or enhance its pre-bankruptcy incentives. However, this may be just as problematic because if the arrangements are "deferred compensation" under §409A of the Internal Revenue Code, the tax law may severely limit the company's ability to modify these prior incentives.

Section 409A limits how and when employees can elect to defer compensation, prohibits employers or employees from accelerating the payment of deferred compensation, and restricts when an employee can receive payment for his or her deferred compensation. Deferral elections that do not comply with §409A, or deferred compensation payments other than in accordance with six specified trigger events (an employee's separation from service, pursuant to a fixed time or schedule, a change of ownership or effective control, death, disability and an employee's unforeseeable emergency) will violate the statute and will result in, at a minimum, a 20% penalty tax on the affected employee.

Some of the more common techniques that can be used to restore or enhance a company's pre-bankruptcy incentives which also implicate §409A include (without regard to other legal restrictions that may apply):

- <u>Extension of Stock Options and Other Stock Rights</u>. The company may desire to re-price its stock options to the current fair market value of the underlying common stock or extend the life of the stock options. Both actions implicate §409A because they may be considered an impermissible grant of additional benefits to employees. However, if done correctly, these actions can comply with §409A. For example, as long as the stock options are "underwater", a company can re-price its outstanding stock options and give employees the full original life of the option to exercise. In addition, and regardless of whether the options are underwater, a company can extend the life of a stock option to the earlier of the date the stock option would have otherwise expired by its original terms and the 10th anniversary of the grant date.

- Payment Delays and Deferral Elections. A company in bankruptcy may desire to delay payment of deferred compensation to a date when it is no longer in bankruptcy. Under §409A's standard payment delay procedures, any election to delay payment must generally be made at least 12 months before payment would otherwise be made, must defer payment for at least *five years*, and the election cannot take effect for 12 months (such that, if there is an intervening event that would have otherwise triggered payment under the original election, payment must be made in accordance with the original election). Because these procedures are quite strict, they may not be as useful.

  However, there are other, more flexible methods. For example, a payment may be delayed without running afoul of §409A if the payment would violate the Federal securities laws or other applicable law, include bankruptcy laws. Payment would have to be made as soon as the payment would no longer violate the applicable law. In addition, where a payment cannot be made on time because it is administratively impracticable (because of a condition outside the control of the employer) or because payment would jeopardize the ability of the employer to continue as a going concern, the payment can be delayed so long as the payment is made during the first calendar year it is administratively practicable or would no longer jeopardize the ability of the employer to continue as a going concern. Finally, good faith disputes over the amount of a payment can also delay payment if paid during the first calendar year in which the company concedes payment is due, a settlement agreement is executed, or a final judgment is entered.

- Accelerations. Instead of delaying payment, a company may wish to pay previously accrued deferred compensation. Under §409A, an accelerated payment of deferred compensation will generally violate §409A. However, there are two instances where early payment is permitted. First, upon a bankruptcy court's approval or upon the company's liquidation, as long as payment is included into an employee's income by the later of the calendar year in which the approval or liquidation occurs, the calendar year in which the deferred compensation becomes vested, and the calendar year in which payment is administratively practicable. Second, upon a change in the ownership or effective control of the company, or in the ownership of a substantial portion of its assets, as long as all payments are received within 12 months of such change. While there is one other permitted method of acceleration (i.e., upon termination of the company's deferred compensation arrangements), its usefulness of this method is severely limited because it may not be used if invoked in connection with a change in the company's financial health.

- Substitutions. A company may desire to replace an existing deferred compensation arrangement with one that provides payment on a different schedule. Due to §409A's strict rules on substitutions, replacing the old arrangement with a arrangement will generally result in a violation, causing an employee to be subject to §409A's 20% penalty tax, among others. New arrangements that do not affect the old arrangements appear to work best.

- Funding. Another common method of enhancing incentives is to fund the deferred compensation benefit prior to payment. While it is doubtful a bankruptcy court would permit pre-funding of executive incentives, where assets are set aside in connection with a change in the company's financial health (or funded through an offshore trust), an employee will be immediately subject to §409A's 20% penalty tax, among others. In addition, where the bankrupt company funds its deferred compensation arrangements and has a defined benefit plan, an employee will similarly be subject to §409A's 20% penalty tax.

- Deferred Compensation Arrangements Not Subject to §409A. A company may wish to restore or enhance deferred compensation arrangements not subject to §409A. While most deferred compensation arrangements are subject to §409A, there are several types that are not. For example, if the arrangement is subject to vesting and would be paid within 2½ after the end of the later of the employee's or the company's taxable year, then the arrangement is not subject to §409A and can generally be modified without significant restriction (except for those imposed by the constructive receipt doctrine). In addition, deferred compensation that was earned and vested before January 1, 2005 is "grandfathered" and is not subject to §409A. However, making a "material modification" these grandfather arrangements will make it subject to §409A. A "material modification" is any change to a grandfathered arrangement that either materially enhances an existing right or benefit, or that adds a new material right or benefit. Because most modifications are presumed to be material, employers should refrain from making any modification to pre-2005 deferred compensation arrangements. However, using the express provisions of the grandfathered arrangements would not result in a material modification.

If you have any questions relating to this Client Update please contact your primary attorney at Morrison Cohen LLP or any of the following:

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