Executive Summary
Fundamentals of Nonqualified Deferred Compensation Plans and
Options for Phantom Stock Plan
November 11, 2013

1. **<u>Purposes of Executive Summary.</u>** The purposes of this Executive Summary are (a) to summarize the fundamentals of nonqualified deferred compensation plans and (b) to set forth various options regarding the adoption of a phantom stock plan – a type of nonqualified deferred compensation plan – in order to retain key management of the Company.

2. **<u>Options.</u>** This Executive Summary sets forth a number of options regarding the plan design of the new plan. Although there are other options that could have been included, these are the most common options that our clients use. For ease of tracking which options you prefer, we have inserted check boxes.

3. **<u>Phantom Stock Plans in General.</u>** A phantom stock plan is a type of nonqualified deferred compensation plan.

   (a) Phantom stock plans (also sometimes called by names such as shadow stock, participation stock, unit stock, or performance stock plans) give key employees many of the benefits of stock ownership of a company without giving them actual equity, requiring them to make an investment, or making them liable for corporate liabilities.

   (b) In general, phantom stock is merely a promise by the company to pay a bonus in the future, usually based on increases in the equity value of the company. The valuation formula is set forth in the phantom stock plan.

4. **<u>"Top Hat" Status.</u>** The proposed plan would be what is commonly referred to as a "top hat" plan. "Top hat" plan status is important, because it exempts the plan from most of the onerous requirements under ERISA.

   - In order to be a "top hat" plan, the plan can only benefit a "select group of management and highly compensated employees."

   - It is our understanding that the plan is intended to benefit four or five of the Company's key managers; therefore, it appears that the plan would easily qualify for "top hat" status.

5. **<u>Plan Governed by Code § 409A.</u>** Congress made sweeping changes to the rules governing nonqualified deferred compensation plans with the enactment of Section 409A of the Internal Revenue Code (the **"Code"**) in 2004. Code § 409A and its accompanying Treasury regulations are very complex and contain an almost dizzying array of restrictions on nonqualified deferred compensation plans. A full explanation of these restrictions is beyond the scope of this Executive Summary, but some of the restrictions are summarized below. The proposed plan would be drafted to comply with Code § 409A.

6. **<u>Code § 409A Penalties.</u>** Code § 409A compliance is important because the penalties for violating Code § 409A – even if the violation is a mistake – are draconian. The penalties may be summarized as follows:

   - The participant must include his/her benefit in taxable income in the year in which it vests;

   - The participant must pay a 20% penalty tax on his/her benefit in the year in which it vests; and
   - The participant must pay interest at the IRS underpayment rate plus 1%.

7. **Tax Status.**

- **FICA Taxes.** The Company and participants in the plan would owe FICA taxes (i.e., Social Security and Medicare taxes) at the time the benefits under the plan vest.

- **Income Taxes.** However, unless a violation of Code § 409A occurred, a participant would not owe income tax until a distribution (i.e., a payment) is actually made from the plan.

- **Company Deductions.** The Company would not be able to take a tax deduction on the benefits provided under the plan until distribution is made to the participants.

8. **Funding.** The funding for the plan would come from the Company's general assets. Benefits in the plan could be funded in one of the following ways:

CHECK ONLY ONE OPTION

- ☐ **Rabbi Trust.** Benefits could be funded through a "rabbi" trust.

    - A rabbi trust is a grantor trust – usually irrevocable – in which the Company would be treated as the owner of the assets for tax purposes.

    - The primary advantage of an irrevocable rabbi trust is that it provides the participants with security, since the Company would not be able to use the assets of the trust to pay bills and the assets of the trust would only be available to creditors of the Company in the event of the Company's bankruptcy or insolvency.

- ☐ **Set Assets Aside.** Benefits could also be funded without using a rabbi trust, by setting aside plan assets in the name of the Company. The plan assets could be used by the Company to pay its normal bills and/or claims by creditors.

- ☐ **No Funding.** The Company could decide not to use a rabbi trust or to set aside any assets. Participants would likely not feel as much of a sense of security with this option, since no assets would be set aside or placed in a rabbi trust in order to pay benefits later.

9. **Subject to Claims of Creditors.**

- All benefits in the plan – whether or not in a rabbi trust – must remain subject to the claims of the Company's creditors until distribution occurs.

- Each participant would stand in the shoes of an unsecured creditor until distribution occurs.

- As discussed above, the assets in a rabbi trust would only be subject to the claims of creditors in the event of the Company's bankruptcy or insolvency.

10. **Structure of Plan.** The plan document(s) could be structured in one of the following ways:

    CHECK ONLY ONE OPTION

    - ☐ **Single Plan Document.** As a single plan document that is used for all participants. Under this option, all of the participants would be subject to the same rules, as set forth in the plan document.

    - ☐ **Separate Agreements.** As separate agreements between the Company and each participant. Under this option, the plan could be customized for each participant.

11. **Options for Designating Participants.** The Company would have full discretion to determine which key managers participate in the plan (so long as "top hat" status is maintained). The plan document would explain how participants are designated. Options include the following:

    CHECK ONLY ONE OPTION

    - ☐ **Designation by Board.** Participants could be designated by Board resolution.

    - ☐ **Designation by CEO.** Participants could be designated by the CEO, without needing approval of the Board.

    If a single plan document is used, designated participants could be listed on a confidential exhibit to the plan document or in some other way that would keep the names of the participants confidential.

12. **Amount of Phantom Stock Issued.** The Company can issue phantom stock to the participants on an annual basis or on some other frequency. The amount of phantom stock issued to each participant is often based on the perceived value of the participant to the Company. Options for determining the amount of phantom stock awarded to a participant include the following:

    CHECK ONLY ONE OPTION

    - ☐ **Fixed Amount.** A fixed annual amount (such as 50 shares).

    - ☐ **Minimum Amount.** A minimum annual number of shares, with the total number determined annually in the Company's sole discretion.

    - ☐ **Full Discretion.** A number of shares that is determined annually (or on some other frequency) in the Company's sole discretion.

    - ☐ **Full Discretion After X Years.** A fixed or minimum number of shares for the first X number of years, with subsequent amounts determined in the Company's sole discretion.

13. **Earnings in a Phantom Stock Plan.** As noted above, the value of a participant's phantom stock award is determined based on a formula that is usually tied to the value of the company. If the Company decides to implement a phantom stock plan, the formula will be tailored to the Company's specific requirements.

14. **Options for Vesting.** The Company has full flexibility to establish whatever vesting conditions it desires. Vesting options include 0% vested until the earliest of any or all of the following:

CHECK ANY OR ALL

- ☐ **Retirement Age.** Termination of employment on or after the participant's "retirement age" (this could be age 65 or any other age that makes sense).
- ☐ **Death.** Termination of employment due to the participant's death.
- ☐ **Long-Term Disability.** Termination of employment due to the participant's long-term disability.
- ☐ **Termination Without Cause.** Termination of the participant's employment without "cause" by the Company (the Company has full flexibility in how to define "cause" in the plan document).
- ☐ **Change in Control.** A change in control of the Company (change in control for vesting purposes can be defined in the plan document in the Company's sole discretion).
- ☐ **Vesting Schedule.** A vesting schedule (such as 10% per year) could be used.

15. **Options for Distribution Events.** Code § 409A imposes very strict limits on the events that can trigger a distribution (i.e., a payment) from a nonqualified plan. The distribution events allowed under Code § 409A include the following:

CHECK ANY OR ALL

- ☐ **Separation from Service. "**Separation from service" of the participant (as defined in the IRS guidance for Code § 409A). "Separation from service" generally means a termination of employment for any reason, including death.
- ☐ **Retirement Age.** The participant's specified "retirement age."
- ☐ **Change in Control Event.** Change in control event (unlike a change in control for vesting purposes, a change in control for distribution purposes must be strictly defined to comply with Code § 409A and generally means (i) a sale of substantially all assets of the Company, (ii) a change in ownership of the Company, or (iii) a change in effective control of the Company).
- ☐ **Death.** The participant's death.
- ☐ **Disability.** The participant's "disability" (as defined in the IRS guidance for Code § 409A).
- ☐ **Unforeseeable Emergency.** An "unforeseeable emergency" of the participant (as defined in the IRS guidance for Code § 409A).

16. **Options for Time of Distribution.** To comply with Code § 409A, the time of distribution must be specified in writing. Options for the time of distribution include the following:

CHECK ONLY ONE OPTION

- ☐ **Date of Distribution Event.** The date of the applicable distribution event.
- ☐ **Within 30 Days.** Within 30 days after the applicable distribution event.
- ☐ **90 Days After.** 90 days after the applicable distribution event.
- ☐ **Following January.** The January following the applicable distribution event.

17. **Options for Form of Distribution.** To comply with Code § 409A, the form of distribution must also be specified in writing. Options for the form of distribution include the following:

CHECK ANY OR ALL

- ☐ **Lump Sum.** A lump sum payment.
- ☐ **Annual Installments.** Annual installments over X years.
- ☐ **Monthly Installments.** Monthly installments over X months.

If installments are allowed, the plan would specify the installment options that are available (e.g., 5 years, 10 years, 36 months, etc.)

18. **Options for Determining Time and Form of Distribution.** Code § 409A allows quite a bit of flexibility in how the time and form of distribution are determined, including the following:

CHECK ONLY ONE OPTION

- ☐ **Hardwire Time and Form.** Write the time and form of distribution into the plan document.
- ☐ **Hardwire Time, Election as to Form.** Write the time of distribution into the plan document, but allow the participant to elect the form of distribution (such as a decision between lump sum or installments, and/or the number of installments).
- ☐ **Hardwire Form, Election as to Time.** Write the form of distribution into the plan document, but allow the participant to elect the form of distribution (such as a decision between "the following January" or "within 30 days").
- ☐ **Election as to Time and Form.** Allow the participant to elect both the time and form of distribution.

If participant election is allowed, the participant would generally need to make an election within **30 days** after the Company makes the first award of phantom stock to the participant. In other words, Code § 409A does not allow a participant to wait until close to retirement to make an election. The plan document would also need to include default provisions, in case an election was not timely made.

19. **<u>Rules for Changing Time and Form of Distribution.</u>** Once the time and form of distribution are established, Code § 409A makes it very difficult – and usually undesirable – to change them. If changes of distribution are permitted by the plan, the following Code § 409A rules must be strictly observed:

    - **12-Month Rule.** The change of election would have to be filed at least 12 months prior to the original time of distribution and would not take effect until 12 months after the change of election is filed; and

    - **5-Year Rule.** The time of distribution would have to be moved to a date that is at least 5 years after the original time of distribution.

20. **<u>Options as to Changing Time and/or Form of Distribution.</u>** The Company has the following options regarding changes of distribution:

    CHECK ONLY ONE OPTION

    - ☐ **No Change Allowed.** Do not allow changes of the time or form of distribution.

    - ☐ **Change Time, not Form.** Allow the participant to change only the time of distribution (subject to the 12-month and 5-year rules explained above).

    - ☐ **Change Time and Form.** Allow the participant to change the form of distribution and (as required by the 5-year rule explained above) the time of distribution.

21. **<u>Non-Competition Covenant.</u>** As a condition to receiving distributions, the plan could prohibit each participant from competing with the Company after termination of employment for a specified period of time.

    CHECK ONLY ONE OPTION

    - ☐ **No Non-Compete.** Select this if no non-competition covenant is desired.

    - ☐ **Non-Compete Included.** Select this if a non-competition covenant is desired.

        CHECK ONE OR BOTH

        - ☐ **Require Repayment.** The plan could provide that if the non-compete provisions are violated, the participant has to repay the benefits already distributed.

        - ☐ **Stop Future Payments.** The plan could provide that no further payments would be made after a violation of the non-compete provisions.