

Drafting Exec Bonus Language That Won't Spark Litigation

By **Steven Sholk**

For both employers and executives, an annual bonus is an important component of an executive's compensation package.

In light of its importance, precise drafting of the bonus is essential in unambiguously establishing each party's rights and obligations under the common law of contracts.

Two 2020 cases, one in a New York federal district court and one in a Florida state appellate court, illustrate the litigation risks of imprecise drafting. In addition, the bonus must satisfy Section 409A of the Internal Revenue Code or an exemption thereto.



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In *Sobel v. Major Energy Services LLC* in the U.S. District Court for the Southern District of New York,^[1] Spark Energy LLC offered David Sobel the position of chief financial officer of Major Energy Services, a subsidiary of Spark Energy.

A Jan. 30, 2017, letter agreement provided for the following annual bonus:

Bonus: You will be eligible to participate in Spark [Energy's] annual bonus program. Your target bonus will be 50% of your base salary. This bonus is discretionary and you must be an active employee at the time of any payout to receive payment.

In March and April 2019, Sobel was advised that he would receive 80% of his target bonus. However, before he received his bonus his employment was terminated.

Sobel sued Major Energy and Spark Energy, which moved to dismiss his complaint. The defendants argued that "at the time of any payout" meant the time when Sobel received the payment.

Since Sobel's employment was terminated before he received payment, he was not an active employee at the time of payout and was not entitled to his bonus.

The Southern District of New York held in its decision that the defendants' interpretation was not the only reasonable one and denied their motion to dismiss.

The phrase "at the time of any payout" was ambiguous and potentially meant the time when: (1) any funds earmarked for the payment are electronically released from a corporate account; (2) any bonus check is signed; (3) any bonus check is placed in the mail; or (4) the bonus payment is received by the intended recipient.

In *Lincare Holdings Inc. v. Ford* in Florida's Second District Court of Appeal,^[2] Sharon Ford worked in Lincare's in-house legal department as director of mergers and acquisitions.

Her annual bonus was based on a formula that gave her a percentage of pro forma revenues from Lincare's acquisitions over the prior year.

Ford and Lincare were unable to agree on the amount of her bonus for 2016, and Ford's employment ended in early 2017.

Ford sued Lincare, which argued that since Ford was no longer employed when her 2016 bonus was due to be paid in spring 2017, she was not entitled to it.

Lincare relied on its bonus policy, which provided for a \$4 million bonus pool to be paid out to employees by a specified date each year for the prior year's performance.

It also provided that all nonexecutive employees must be employed at the time of payment.

There was testimony that Ford's bonuses each year were paid out of the bonus pool and were always paid at the same time as all the other employees.

There was also testimony that the policy applied to all the administrative staff in Lincare's headquarters, including Ford.

The jury found that Ford was ineligible for her bonus since she was no longer employed when it was to be paid.

The trial court granted Ford's motion for a directed verdict on the ground that the policy could not affect her bonus because she had fulfilled her obligations under her contract and did not consent to the policy.

The Florida appeals court reversed and remanded the case for reinstatement of the jury's verdict. Since Ford's contract was silent as to when and how her bonus vested or would be paid, Lincare's bonus policy, as shown by the trial court testimony, filled in any missing terms.

The lesson of Major Energy and Lincare is that a well-drafted annual bonus should:

- Address whether the amount of a bonus is discretionary, or nondiscretionary based on attainment of specified performance goals;
- Address whether the employee must be employed on the date of payment for a bonus paid as a lump sum, or on the date of payment of the first installment for a bonus paid in installments;
- If the employee does not have to be employed on the date of payment, address whether the employee must be employed on an earlier date, such as the last day of the calendar year for which a bonus is earned;
- Define the date of payment as the earliest of the times that any funds earmarked for the payment are electronically released from the employer's account, any check is placed in the mail or delivered to an overnight delivery service, or any check is hand-delivered; and

- Provide for the time and form of payment.

In addition to unambiguous terms, the bonus must safely navigate the piranha-filled waters of Section 409A dealing with the permissible times and forms of payment of deferred compensation.

When a bonus, whether discretionary or nondiscretionary, requires that an employee be employed on the date of payment, and the bonus is paid within the short-term deferral period, the bonus is a short-term deferral exempt from Section 409A.

In addition, when a discretionary bonus is awarded and paid in one taxable year, it is not a plan of deferred compensation subject to Section 409A.[3]

The short-term deferral exemption requires that the employee actually or constructively receive payment within the following short-term deferral period: the last day of the period ending on the later of: (1) the 15th day of the third month after the end of the employee's taxable year in which the right to any payment is no longer subject to a substantial risk of forfeiture, otherwise known as the vesting date; or (2) the 15th day of the third month after the end of the employer's first taxable year in which the vesting date occurs.[4]

A substantial risk of forfeiture includes the condition of the performance of substantial future services, and the possibility of forfeiture is substantial.[5]

When the entire bonus is paid as a lump sum on the vesting date, vesting and payment occur simultaneously and the short-term deferral exemption is satisfied.

The advantage of the exemption is that the arrangement escapes Section 409A's prohibition on the acceleration of payments,[6] and the six-month delay requirement for payments to specified employees due to a separation from service.[7]

When the payment of a bonus is discretionary, a plan of deferred compensation does not exist before the date the bonus is paid.

Whether a plan provides for the deferral of compensation generally is determined at the time the employee obtains a legally binding right to the compensation.[8]

A plan provides for the deferral of compensation if the employee has a legally binding right during a taxable year to compensation that is or may be payable in a later taxable year.

An employee does not have a legally binding right to the extent that the employer can reduce or eliminate the compensation after the employee performs the services that create the right to the compensation.[9]

For a discretionary bonus that requires the employee to be employed on the date that the employer awards the bonus, the plan can provide for the deferral of compensation and the employer can designate the time and form of payment by the time that the employee has a legally binding right to the compensation or, if later, the time the employee would otherwise have to make a deferral election. In addition, the plan must not provide the employee with the right to elect the time or form of payment.[10]

When the employer awards a discretionary bonus, the employee obtains a legally binding right to the bonus on the date of the award. Accordingly, on that date the employer can

place service-based vesting conditions on the bonus and provide for payments on nondiscretionary and objectively determinable dates.[11]

For a nondiscretionary bonus, the employee obtains a legally binding right on the date that the employer adopts the bonus arrangement. Accordingly, only on that date can the employer place vesting conditions and designate the time and form of payment.[12]

For both a discretionary and nondiscretionary bonus, an arrangement can permit an employee to make a deferral election for the time and form of payment for compensation for services performed during an employee's taxable year only if the employee makes the election by the close of the prior taxable year.[13]

For example, under the facts of Major Energy, the arrangement can provide for an employee's deferral election by Dec. 31, 2017. Under the facts of Lincare, the arrangement can provide for an employee's deferral election by Dec. 31, 2015.

When a discretionary or nondiscretionary bonus requires that an employee be employed on the date of payment, and the employee has a separation from service before that date, the parties can provide in a separation agreement for payment of all or a portion of the bonus as a component of separation pay or the entire separation pay.

When the separation pay is the subject of bona fide, arm's length negotiations at the time of the separation from service, an initial deferral election may be made at any time up to the time when the employee obtains a legally binding right to the separation pay.[14]

For example, the parties can provide for payment of the entire amount of separation pay as a lump sum on the 45th day after the date of separation from service, which would qualify as an exempt short-term deferral.

In this manner, the arrangement takes into account any review and revocation periods the employee may have under federal and state employment law.

As another example, the parties can provide for installment payments commencing on the 45th day after the date of separation from service, or the first regularly scheduled payroll period after the 45th day after the date of separation from service.

When the employee must comply with restrictive covenants, the arrangement can provide for the employee's forfeiture of installment payments for failure to comply with the covenants.

The provision for separation pay is premised on the absence of a legally binding right for the employee to the separation pay on the date of separation from service.

For a discretionary bonus, there are two grounds for finding the absence of a legally binding right.

First, the discretionary nature of the bonus means that the employee lacks this right.

Second, on a separation from service before the date of payment, the employee loses any legally binding right to the bonus.

For a nondiscretionary bonus, the sole ground for finding the absence of a legally binding right is the loss of any legally binding right.

For a nondiscretionary bonus, the parties must consider Section 409A's substitution rule.

This rule provides that the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation.

A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of deferred compensation, but there is no forfeiture or voluntary relinquishment if an amount is paid or a legally binding right to a payment is created that acts as a substitute for the forfeited or voluntarily relinquished amounts.

When the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, the payment substitutes for the deferred compensation.[15]

There are two approaches to dealing with the substitution rule.

First, the parties can take the position that since the employee has lost any legally binding right to the bonus due to contractual provisions that were put in place at the time the contract was entered into well before the date of separation from service, there is no deferred compensation to be substituted for.

Furthermore, since the employee has already lost any legally binding right to the bonus, the separation pay does not result in an actual or potential reduction of, or current or future offset to, any deferred compensation.

Second, the parties can provide that the time and form of payment of the separation pay are the same as the original bonus. For example, if the original bonus was a short-term deferral, the parties should structure the separation pay as a short-term deferral.

Furthermore, since the substitution rule applies to a payment made as a substitute for deferred compensation, if the original bonus was a short-term deferral and the separation pay is a short-term deferral, there are no plans of deferred compensation and the substitution rule should not apply.

As another example, if the original bonus was to be paid in installments over one year, the parties should structure the separation pay to be paid in the same installments over one year.

In drafting annual bonus provisions, counsel for both the employer and executive must ensure that the language is sufficiently precise so that it does not create any ambiguity under the common law of contracts.

Counsel must also ensure that the bonus, whether paid during employment or as separation pay, runs the gauntlet of Section 409A.

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as legal advice.

[1] Sobel v. Major Energy Services LLC, 2020 WL 5362357 (S.D.N.Y. Sept. 8, 2020).

[2] Lincare Holdings Inc. v. Ford, 2020 WL 5804085 (Fla. Ct. App. Sept. 30, 2020).

[3] Treas. Reg. §1.409A-1(b)(1).

[4] Treas. Reg. §1.409A-1(b)(4)(i).

[5] I.R.C. §409A(d)(4); Treas. Reg. §1.409A-1(d).

[6] I.R.C. §409A(a)(3); Treas. Reg. §1.409A-3(j)(1).

[7] I.R.C. §409A(a)(2)(B)(i); Treas. Reg. §§1.409A-1(c)(3)(v) and 1.409A-3(i)(2).

[8] Treas. Reg. §1.409A-1(a)(1).

[9] Treas. Reg. §1.409A-1(b)(1).

[10] Treas. Reg. §1.409A-2(a)(2).

[11] I.R.C. §409A(a)(2)(A)(iv); Treas. Reg. §1.409A-3(a)(4) and (b) and (i)(1).

[12] Treas. Reg. §1.409A-2(b)(9), ex. 2.

[13] I.R.C. §409A(a)(4)(B)(i); Treas. Reg. §1.409A-2(a)(3) and (b)(9), ex. 3; Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §VI.A, 72 F.R. 19,234, 19,251 (April 17, 2007).

[14] Treas. Reg. §1.409A-2(a)(11).

[15] Treas. Reg. §1.409A-3(f).