Executive Compensation

ERISA Basics
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I. HIRING THE EXECUTIVE

A. The Employment Package

Top corporate executives work in a fast-paced, dynamic, global economy in which stockholders expect results. Given the high stakes, employers competing for the services of talented executives pay top dollar, and during the employment relationship the right pay package will include one or more of the following:

1. Bonuses

Bonuses take the form of annual and/or long-term performance based compensation. Organizational goals, self-initiated or by comparison to a peer group, present the target(s), which, if met, result in additional compensation (in excess of base salary) to the executive.

2. Equity Compensation

The focus of equity compensation is to align executive and stockholder interests. As stock price increases, the executive benefits in step with stockholders.

3. Deferred Compensation

Deferred Compensation functions to defer taxation of compensation that otherwise could be paid currently and to facilitate retirement savings at a level commensurate with the earning capacity of the executive.

B. Bonuses

1. Structure

Bonuses reward executives based on job performance and company results in order to provide an incentive for executives to put forth their best efforts to increase (or help to increase) corporate efficacy and profitability. Annual bonuses are payable upon attainment of corporate fiscal year goals. Long-term bonuses (commonly referred to as "long-term incentives") are based on multi-year cycles—usually a cycle of three fiscal years.

2. Code Section 162(m) Generally

Code Section 162(m) limits the tax deductibility of compensation paid to the chief executive officer (or an individual acting in that capacity) and the next top four most highly compensated officers of a public company to $1,000,000 per year. Compensation that is "performance based," however, is not subject to the $1,000,000 limit. To be "performance based" under Section 162(m) compensation must satisfy the following requirements:

- The compensation must be paid solely upon account of the attainment of one or more "pre-established" "objective performance goals";

- The performance goals must be established by a compensation committee comprised exclusively of two or more "outside directors";

- The material terms of the performance goals and the maximum amount that can be paid to any covered executive under the plan must be disclosed to and approved by the shareholders; and

- The compensation committee of "outside directors" must certify that indeed the performance goals have been met prior to payment.

3. 162(m) Pre-established Objective Criteria

- 162(m) performance goals will be treated as pre-established if established not later than 90 days after commencement of the service period to which the goal relates (but not after 25% of the period has elapsed) AND if the outcome of the goal is substantially uncertain at the time the committee actually establishes the goal.

- 162(m) performance goals may be individual, based on a business unit or the whole corporation.

- Objective performance criteria under 162(m) typically include: (1) total stockholder return; (2) such total stockholder return as compared to total return (on a comparable basis) of a publicly available index such as, but not limited to, the Standard & Poor's 500 Stock Index; (3) net income; (4) pretax earnings; (5) earnings before interest expense, taxes, depreciation and amortization; (6) pretax operating earnings after interest expense and before bonuses and extraordinary or special items; (7) operating margin; (8) earnings per share; (9) return on equity; (10) return on capital; (11) return on investment; (12) operating earnings; (13) working capital; (14) ratio of debt to stockholders' equity and (15) revenue. Additional objective criteria that are industry specific are frequently added to this list.

4. Outside Director Under 162(m)

An "outside director" may not

- receive remuneration directly or indirectly from the corporation other than directors fees;

- be a current employee of the corporation, a current or former officer of the corporation, or be a former employee who is receiving deferred compensation from the corporation.

5. Reapproval

Even after performance based compensation has been established and approved by stockholders, the Section 162(m) regulations require that stockholders reapprove the performance goals under the plan every 5 years.

C. Equity Compensation

The most common forms of equity compensation are: (1) stock options (non-qualified stock options and incentive stock options); (2) restricted stock; and (3) stock appreciation rights.

1. Stock Options

A stock option is a contract between a company and an employee or other service provider, such as an independent director of the company or a consultant, under which the company grants the optionee the right to purchase the company's stock at a price that ordinarily remains fixed for an extended period of time (the option "term"). The actual purchase of shares underlying the option is called the "exercise of the option," and this right to purchase (or "exercise") stock may vest over time. Some additional terminology includes:

- *Exercise Price* or *Strike Price*: The price at which shares may be purchased upon exercise of the option.
- *Grant Date*: the date all corporate action necessary to grant the option is taken and the option price, number of options and option recipient is determined.
- *Spread*: The difference between the current value of the shares and the exercise price.
- *Underwater*: If the value of the shares is less than the exercise price, the option is referred to as being "underwater."

Options traditionally have been preferred to grants of restricted stock because options offer optionees upside potential with respect to the stock, but (1) unlike restricted stock that is purchased, options do not require the optionee to expend cash until exercise, and (2) unlike restricted stock awarded at no cost, options require a monetary investment ultimately to be made by the executive. In addition, options allow the executive to control the timing of taxation unlike restricted stock.

There are two types of compensatory options: incentive stock options ("ISOs") and non-qualified stock options ("NSOs"). ISOs are a form of stock option that satisfy the requirements of Section 422 of the Code. NSOs do not meet the requirements of Section 422 of the Code.

a. Incentive Stock Options

- *Grant:*

  - Only available to employees.

  - Grantee must exercise stock within three months after termination of employment to maintain ISO status. May be extended if termination of employment occurs as a result of death or disability.

  - ISOs must be granted pursuant to a stock option plan that states the maximum shares subject to the plan and is approved by the company's shareholders within twelve months before or after its adoption.

  - Option must be granted within ten years from the earlier of shareholder approval of the plan or adoption of the plan.

- *Exercise Price and Term:*

  - The exercise price may not be less than the fair market value of the stock at the time of grant.

  - The term must be within ten years from the date of grant.

  - If a grantee owns more than 10% of the company voting stock at time of grant, the exercise price must be 110% of the fair market value and the option term must not exceed five years.

- *Restrictions:*

  - No more than $100,000 worth of ISOs may first become exercisable (i.e., vested) by a grantee in a calendar year. The $100,000 of "value" is determined by looking at the contractual exercise price. The excess value is deemed to be an NSO.

  - Option is not transferable except by will or the laws of descent and distribution.

- *Benefit:* Potential for spread to be taxed at capital gains rates, rather that at ordinary income rates.

b. Non-Qualified Stock Options

- *Exercise Price:*
  - The exercise price may equal the fair market value of the stock at the time of grant; or
  - The exercise price may equal the fair market value of the stock at the time of grant discounted by a set percentage.
    - The price should equal at least 33% of fair market value to avoid possible tax treatment as a grant of stock.
    - The difference between the fair market value of the stock and the exercise price for options granted to employees will constitute a charge to earnings. The fair market value of stock for options granted to non-employees will constitute a charge to earnings.
- *Term:* Flexible, but a 10-year limit is typical.
- *Transferability:* Sometimes a NSO will be transferable to family members for estate planning purposes. Although there is no recognizable income at the time of the transfer, when the transferred option is exercised, the original grantee owes tax on the spread.

2. Restricted Stock

Restricted stock is a stock award that is sold or awarded to an employee on the condition that the employee tender back the stock if the vesting conditions are not satisfied. The stock is most often "restricted" in that the company has a right to repurchase the stock for a nominal sum upon the employee's termination, and that any transferee of the restricted stock will take the shares subject to such repurchase right. These restrictions generally lapse over time based on the employee's continued performance of services. This so-called "vesting" constitute "golden handcuffs" on the employees and helps assure the continued allegiance and commitment of key employees in implementing the company's business plan. Companies also may sell or grant employees restricted stock with the restrictions on the stock lapsing upon the achievement of certain performance objectives.

Restricted stock grants are becoming more common for public companies because they are thought to reward long term performance with less emphasis on quarter to quarter corporate earnings.

3. Stock Appreciation Rights ("SARs")

A SAR entitles the holder to receive cash usually in an amount equal to the difference between the fair market value of the shares on the date of grant and the time of exercise over the exercise price. SARs may be granted to provide the economic benefit of stock ownership without requiring purchase of shares.

4. Tax Consequences

a. Options

- Generally no tax on grant or at the time of vesting.

- The following table summarizes the tax consequences of options at the time of exercise and later when shares purchased upon the exercise of the option are sold.

Event	***NSO***	***ISO***
Exercise	➢ The spread between the purchase price and the fair market value at the time of exercise is taxed as ordinary income. ➢ Subject to withholding and FICA/FUTA taxes. ➢ The company may deduct the amount of ordinary income recognized. However, the employer's tax deduction may be subject to Code Section 162(m), which limits a public company's deduction in a given year to $1 million for compensation paid in that year to each of the named executive officers.	➢ No tax on exercise, but may result in additional tax liability under Alternative Minimum Tax ("AMT") because the spread at exercise is included as an item of adjustment under the AMT. ➢ No withholding or FICA/FUTA taxes due currently.

Sale of Stock	➢ The difference between the sales price and basis is taxed as long-term or short capital gain depending on the holding period.	➢ Qualifying Disposition
		    ➢ Gain on sale is taxed at long-term capital gains rate.
		    ➢ No withholding or FICA/FUTA taxes.
		    ➢ No deduction to the company.
		➢ Disqualifying Disposition
		    ➢ Spread at exercise is recognized as ordinary income.
		    ➢ The company may deduct the amount of ordinary income recognized, subject to section 162(m) limitation.
		    ➢ No withholding or FICA/FUTA taxes.
		    ➢ Any additional sales proceeds are taxed at capital gains rate.

b. Restricted Stock

- No Code Section 83(b) election.
  - ➢ No tax at date of grant or purchase.
  - ➢ Employee has ordinary income on the spread when the shares are transferable or are no longer subject to a substantial risk of forfeiture, whichever is earlier.
  - ➢ Capital gains holding period commences on date shares are transferable or no longer subject to a substantial risk of forfeiture.
  - ➢ Withholding and FICA/FUTA taxes on vesting.
- Code Section 83(b) election (within 30 days of transfer of shares).
  - ➢ Employee has ordinary income (subject to withholding taxes) at the date of the grant or purchase equal to the fair market value of the shares on that date (less purchase price, if any).
  - ➢ Capital gains holding period commences immediately after the transfer of shares to the grantee.
  - ➢ If grantee subsequently forfeits stock, no taxes may be recovered.
- Dividends paid while stock is subject to restrictions are treated as compensation income and subject to withholding taxes.
- Dividends are deductible while stock is subject to restrictions in the absence of 83(b) election.
- The company is entitled to an income tax deduction equal to the ordinary income recognized by the employee with respect to the purchase or lapsing of restrictions on restricted stock. Thus, the timing and amount of the company's deduction, if any, will depend on whether the employee timely files a Code Section 83(b) election.

c. SARs

- No tax upon grant or vesting, as long as nontransferable and exercise eliminates ability to share in future appreciation of the "gross" shares subject to the award.
- Upon exercise of the SAR, spread is recognized as ordinary income.

- The value of the SAR is subject to withholding, and may be subject to FICA/FUTA taxes.

- Upon exercise, the company may deduct the amount of ordinary income recognized.

D. Executive Compensation -- Compliance Prerequisites and Considerations

1. Shareholder Approval of Equity Compensation Plans

NYSE and NASDAQ require that all equity compensation plans, and any material revisions to such plans, be subject to shareholder approval. The final rules eliminate the previously available exception for "broadly-based" plans.

a. Material Revisions

The final NYSE and NASDAQ rules include the following non-exclusive list of examples of revisions to equity compensation programs considered "material" and thus requiring shareholder approval:

- A material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spin off or similar transaction);

- An expansion of the types of awards available under the plan;

- A material expansion of the class of employees, directors or other service providers eligible to participate in the plan;

- A material extension of the term of the plan;

- A material change to the method of determining the strike price of options under the plan; and

- The deletion or limitation of any provision prohibiting repricing of options.

b. Exemptions

An NYSE or NASDAQ listed company may rely on any of the following exceptions to the requirement of obtaining shareholder approval of equity compensation plans.

- Employment inducement awards, as described below in paragraph c.;

- Certain grants or plan revisions in connection with a merger or acquisition, as described below in paragraph d.;

- Plans intended to meet the requirements of Section 401(a) (such as ESOPs or 401(k) plans) or Section 423 of the Internal Revenue Code; or

- Parallel "excess plans" accompanying qualified plans.

In order to rely on these exceptions a company must have the exception approved by the company's independent compensation committee or a majority of the company's independent directors. In the case of an NYSE-listed company, the company also must notify the NYSE in writing when one of the exceptions is used.

c. Inducement Awards Exemption

A grant of options or other equity-based compensation as a material inducement to a person being hired by a company or any of its subsidiaries is not subject to the shareholder approval rules. The final rules clarify that this exception is available for grants to new employees in connection with a merger or acquisition and grants to employees being rehired following a bona fide period of interruption of employment. If an NYSE-listed company relies on this hiring inducement exception, the company must promptly disclose in a press release the material terms of the grant, including the recipient and the number of shares involved.

d. Mergers and Acquisitions Exemption

The rule provides that shareholder approval is not required in connection with mergers and acquisitions to:

- Convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction; or

- Use shares available under a plan acquired in connection with the transaction for post-transaction grants with respect to the equity of the listed company, either under the acquired plan or another plan, if the following conditions are met:

  - The plan of the acquired company was "pre-existing" and not adopted in contemplation of the transaction;

  - The pre-existing plan was previously approved by the shareholders of the acquired company;

  - The number of shares available for grants under the pre-existing plan or another plan is appropriately adjusted to reflect the transaction;

  - The time during which the shares are available under the pre-existing plan or another plan is not extended beyond the period when the shares would have been available under the pre-existing plan if the transaction had not occurred; and

- The options or other awards are not made to individuals who were employed immediately before the transaction by the post-transaction listed company or its subsidiaries, i.e., future options and other awards are generally limited to employees of the target company.

2. Section 162(m) Applied to Equity Compensation

a. Options and SARs

The exercise of NSOs and SARs gives rise to ordinary income to executives, and, in the unlikely event that ISOs are awarded to an executive, a disqualifying position of ISO shares could give rise to ordinary income. These items of ordinary income if generated count towards the $1 million per year compensation deduction limit under Code Section 162(m). As in the case of bonuses, if the award of the options or SARs is "performance based" under Section 162(m), the income elements generated at the time of exercise or subsequent sale of the stock would not be rendered nondeductible by Code Section 162(m), and most stock option grants are structured to qualify for the "performance based" exception. In order for stock options or SARs to be performance based, the following conditions must be satisfied:

- The grant must have been made pursuant to a stockholder-approved plan, setting explicit limits on the number of shares that can be awarded to a participant.
- The award must have been made by a committee of "outside directors" of the board of the company. See Section I.B.4 above.
- The exercise price of the option or SARs CANNOT be less than fair market value of the stock on the date of grant.
- The 5-year shareholder reapproval rule does not apply to options and SARs that are granted at fair market value.

b. Restricted Stock

The ordinary income an executive recognizes when restricted stock vests (or at the time of grant, where a Section 83(b) election has been made) also counts towards the deductibility limit under Code Section 162(m).

That income element can be made exempt from the Section 162(m) limit, and thus be deductible without regard to the limit, if the restricted stock is subject to "performance based" vesting criteria or award criteria. Restricted stock will only be treated as performance based if entitlement to the stock is conditioned in the same manner as described for bonuses under Section I.B.2, 3 and 4, above.

3. Accounting Rules

To date, most companies have accounted for equity compensation under APB Opinion No. 25, titled "Accounting for Stock Issued to Employees." On March 31, 2004, the Financial Standards Accounting Board ("FASB") issued proposed standards for "share-based payments" (i.e., equity compensation awards) in an exposure draft of amendments to FASB Statement 123. In 2005, APB 25 is expected to be replaced with FASB Statement No. 123, as amended.

The focus here are those rules proposed under Statement 123, since employers now are in the midst of planning changes to their equity compensation program to minimize the impact of Statement 123 and other new developments. APB 25 is described to provide context for the changes.

a. Options and SARs

- The accounting treating for options and SARs under APB 25 favored the award of stock options over SARs. Options typically are issued in a fixed number, with a fixed exercise price of fair market value at the time of grant, and the right to exercise the options usually vests in increments over a set period of time based solely on continued service (rather than any additional performance criteria). Such an option award is considered a fixed award with zero value on the grant date, because the exercise price is equal to the fair market value on the date of grant, and as a result a company making such an award did not incur the compensation charge earnings on account of the award. A SAR issued identical terms, however, had a very different accounting treatment, whether or not the SAR could be settled in cash or stock. A company making such an award was required to recognize a continuing charge to earnings for any appreciation in the fair market value of the shares of stock covered by the SAR until the SAR was exercised.

- Under the new Statement 123 exposure draft, stock options and stock settled SARs are treated as equity "appreciation awards." The "fair value" is taken as a charge to earnings over the vesting period of the award.

    - Fair value can be determined based on an option pricing model such as the binomial model or the Black Scholes model which takes into account the following inputs to assign a value to the option or SAR right itself, in contrast to the value of the underlying share: (1) exercise price, (2) expected term (including assumptions on vesting), (3) current fair market value of the underlying shares, (4) volatility of the underlying shares, (5) dividends, and (6) interest rates assumptions over the expected life of the option or SAR.

    - Under this fair value accounting methodology, SARs, because only exercisable for the net shares representing the appreciation in value on the underlying stock, have a similar fair value than stock options which permit the acquisition of all shares to which the award relates.

- Cash settled SARs are not equity awards under Statement 123, and therefore continue to have variable accounting treatment.

- Under APB 25, performance-vested options resulted in the variable award accounting treatment applicable to SARs until the performance goals were achieved or not. Under the new Statement 123, performance-vested options are no longer treated as variable awards, but rather the compensation cost is measured at the grant date, and that cost is recognized based on an estimate of the likelihood of achieving the performance goal, with adjustments made (up or down) each period to reflect the current estimate of forfeitures and the actual number of awards that vest. We expect to see more performance-vested options.

- In the rapidly declining stock market of the years 2000 to 2002, companies that included options as a component of pay packages to a broad base of employees, were forced to consider option repricings. Under APB 25, a direct lowering of the exercise price of an existing option made the option subject to variable accounting until exercised. This one modification thus resulted in the options being treated like SARs. However, under APB 25, variable accounting could be avoided if the options were cancelled and reissued after six months and one day for fair market value on the new date of grant. The six-month-and-a-day convention is what was deemed to distinguish a repricing (a modification to an existing award) from a bona fide new award. Options exchanged in this manner once again could receive fixed accounting treatment, which would mean no charge to earnings if issued at fair market value. Repricings will become much more simple under Statement 123. An immediate change to the exercise price will simply result in a new "measurement date," and the company would need to recognize as a compensation expense any increase in the fair value of the option on the date of modification over the fair value previously assessed.

b. Restricted Stock

Like stock options and SARs, under the exposure draft to Statement 123, the fair value of restricted stock awards would be determined at the grant date and will be recognized over the vesting period for the award. However, here fair value is assessed as an amount equal to the fair market value of the underlying stock. As a result, the accounting for this simplified form of restricted stock is substantially unchanged from the accounting treatment under APB 25.

c. Effective Date of Changes

The proposed statement is effective for awards granted, modified, or settled in fiscal years beginning after December 15, 2004, with earlier application encouraged. The proposed statement also applies to the nonvested portion of awards outstanding as of the effective date (provided the awards were granted or modified in fiscal years beginning after the December 15, 1994 effective date of Statement 123), using previously estimated grant date fair values calculated for recognition or pro forma disclosures under Statement 123.

4. Registration

Public companies can register plan awards on Form S-8, a relatively simple registration form that is declared effective by the SEC immediately upon filing. Note, however, that under proposed rule changes, consultants who may receive awards registrable on a Form S-8 must satisfy certain requirements or the entire plan will be disqualified from S-8 eligibility. Form S-8 now may cover awards transferred by gift or divorce to family members or trusts for their benefit.

Under a Form S-8, employees may resell shares received pursuant to awards. Underwriters, however, will generally require employees to agree to a lockup of their shares during the 180-day period following an initial public offering. Option plans and agreements should bind employees to lock up their shares.

If a large private company grants awards to employees, it could find itself subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") if the number of holders of securities of any class (including option holders) exceeds 500.

E. Non-Qualified Deferred Compensation Arrangements

1. Structure

Typically deferred compensation arrangements are structured as nonqualified retirement or retirement savings programs. Such deferred compensation arrangements can be developed only for executives and other key or highly compensation employees. Compensation once deferred into a nonqualified deferred compensation arrangement becomes a mere promise to pay the executive an amount at a future date in a prescribed manner. The promise is an unfunded and unsecured promise. The executive therefore becomes an unsecured creditor of the company.

a. Account Based Arrangements

Deferred compensation arrangements can look like defined contribution retirement plans, and in such arrangements, a bookkeeping account will be treated as established on behalf of the participating executive. The bookkeeping account then could be credited with employee deferral, additional employer contributions and hypothetical investment earnings.

- Plans generally permit the deferral of up to 100% of any bonus payable to the executive, and may permit a significant portion of base pay to be deferred into the deferred compensation arrangement as well. Amounts so deferred become property of the company.
- The deferral of 100% of base pay raises contingent benefit issues which may adversely impact the company's 401(k) plan.
- Some programs are designed to "wrap around" the company's 401(k) plan, in order to permit executives to make deferrals, and receive matching and profit

sharing contributions in excess of those permitted after application of the nondiscrimination testing rules applicable to the 401(k) plan, and other limitations such as the $13,000/$15,000 limit on elective deferrals and the $41,000/$43,000 limit on annual additions.

b. Pension Type Arrangements

Defined benefit type deferred compensation arrangements often are called "supplemental executive retirement plans" or "SERPs." If a company maintains such a plan, it typically is designed to wrap around an existing defined benefit pension plan and provide pension benefits in excess of the limitation on compensation ($205,000) and the limitation on benefits payable at normal retirement age under Section 415(b) of the Code ($165,000 annually).

c. Ordinary Income Taxes

If the deferred compensation arrangement is properly designed, taxes will be deferred until payments actually are made from the plan. Accordingly, in a SERP under which the participant receives monthly annuity payments, the benefits are taxed as paid over the remaining life of the executive or even longer where payments are made in the form of a survivor annuity. An account-based program may provide for lump sum distributions or even distributions in installments over five or ten years following termination of employment, giving executives flexibility to defer their minimized tax impact of payments.

2. Designing Arrangements to Avoid Constructive Receipt

a. Section 451

Section 451 of the Code governs when income or right to income is recognized as taxable. The regulations make clear that income is taxable not only when actually received but also when constructively received, as follows:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year to which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intent to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Treasury Regulations § 1.451-2(a).

In practice, the guidelines to avoiding constructive receipt impact the following design elements of deferred compensation arrangements.

- In the case of programs that permit employees to defer a portion of base salary or bonus, the timing of the initial election to defer the pay;

- The timing of elections regarding when and in what form distribution of the executive's bookkeeping account or bookkeeping benefit will be paid to him or her;

- Withdrawal rights, i.e., the ability to elect immediate payment in certain circumstances instead of awaiting the ordinary distribution timing previously elected; and

- The extent to which the company may set aside assets to satisfy its deferred compensation liability (e.g., use of a Rabbi Trust).

3. The Application of ERISA to Nonqualified Arrangements

Under ERISA, an "employee pension benefit plan" must satisfy numerous statutorily mandated requirements including provisions related to funding, nondiscrimination, employee coverage, and distribution. These are essentially the plan qualification rules under the Code. Thus, to avoid these rules, executive deferred compensation must satisfy an ERISA exemption.

- The principal exemption is the "top-hat" exemption. Under the "top hat" exemption, unfunded plans that provide benefits to a select group of management or highly compensated individuals are exempt from numerous provisions of ERISA, including the participation, vesting, funding, and fiduciary responsibility requirements. It is critical for the employer to carefully develop participation criteria in order to ensure that only a "select group" of employees may defer income under the top hat plan. The rationale for the exemption is that the select group has sufficient access to management that the individuals do not need the protections afforded by ERISA.

- "Excess benefit plans," which are plans maintained by an employer for the purpose of providing benefits for employees in excess of the limitations on contributions and benefits imposed on qualified plans by Section 415 of the Internal Revenue Code (the "Code"), are exempted entirely from Title 1 of ERISA. However, such plans are rare.

4. FICA & FUTA Taxes

The doctrine of constructive receipt does not govern the FICA and FUTA taxation of nonqualified deferred compensation amounts. Instead, FICA (including the Medicare Hospitalization Insurance Tax) and FUTA are due as of the date of vesting, i.e., when any substantial risk of forfeiture of the amount lapses. If the deferred compensation is transferable, the amount will be treated as vested, and therefore, subject to FICA and FUTA taxes.

5. Congressional Action

Congress is currently considering restricting or eliminating a number of typical deferred compensation arrangement practices and provisions. Both the Senate and the House have proposals on the table that would add a new Section 409A to the Internal Revenue Code.

a. Restrictions on Initial Elections

Initial deferral elections are required to be made before the beginning of the taxable year in which the compensation is earned, or at such other time as provided in regulations (with a special 30-day election period for newly eligible participants).

b. Restrictions and Withdrawal Distributions

- Distributions are permitted only upon:
  - separation from service (as determined by Treasury);
  - death;
  - disability (within the meaning of the Social Security Act);
  - a specified time (or pursuant to a fixed schedule);
  - a change of control; and
  - an unforeseeable emergency.
- Premature withdrawal would not be permitted, even if the Plan provided for the forfeiture of a portion of the account balance (e.g., 10%).
- Any subsequent election to delay the timing or change the form of payment generally must (1) not take effect until at least 12 months after the date of the election, or (2) except in the case of elections relating to distributions on death, disability, or unforeseeable emergency. Elections to accelerate the payment form would generally not be permitted.

c. Investment Restrictions

Under one version, investment options must be comparable to those which may be elected under the qualified employer plan with the fewest investment options. If there is no such qualified plan, the investment options must satisfy such requirements as Treasury may prescribe, including requirements limiting the options to certain specified options.

d. Rabbi Trusts

There would be special screening of offshore Rabbi Trusts.

e. Restrictions on Deferral of Stock Option Gains/Restricted Stock

Under one version, gains attributable to stock options and any other property based on employer securities transferred to the taxpayer could not be deferred by electing to instead receive deferred amounts. Taxpayers would be taxed immediately on the present value of the right to receive future payments obtained in exchange for the stock option or other property based on employer securities transferred to the taxpayer.

II. TERMINATIONS AND CHANGE OF CONTROL

A. Executive Severance Generally

Severance protections are likely to be part of an overall pay package the executive negotiates with the company. This is particularly true where the executive has agreed to post-termination confidential information, non-solicitation and non-competition protections in favor of the company.

Typical post-termination benefits include:

- severance (usually defined as a multiple of annual base salary plus last earned bonus) and pay;
- acceleration of vesting for unvested prior equity grants and, possibly, extended exercise periods.

Severance protections may also include "welfare benefits," such as continued participation in employer-sponsored health plans and continued life insurance protections (in both cases, as though still an employee)

B. Severance Type Determines Benefit Level

The duration of continued compensation and other payments, and whether or not stock options will vest, will depend on how the executive has been terminated.

1. Termination for Cause

With misdeeds by CEOs and other corporate leaders continuing to hit the headlines, boards of directors will want to see definitions of cause in executive severance agreements that give the board sufficient leverage to handle material ethical breaches, as well as malfeasance.

a. Cause Example:

"**Cause**" means (i) the commission of a felony or a crime involving moral turpitude or the commission of any other act or omission involving dishonesty or fraud with respect to the Company or any of its affiliates or any of their customers or suppliers, (ii) conduct tending to bring the Company or any of its affiliates into substantial public disgrace or disrepute, (iii) material failure to perform duties of the office held by the Executive as reasonably directed by the Board, and such failure is not cured within thirty (30) days after the Executive receives notice thereof from the Board, (iv) gross negligence or willful misconduct with respect to the Company or any of its affiliates or (v) any material breach of the **[employment agreement]**.

b. Payments

Following termination for cause:

- the executive will not receive post-termination severance;
- depending on the reason for cause the executive may forfeit options and SARs that are vested, but not already exercised, and will forfeit options, SARs and restricted stock not already vested; and
- SERPs and other non-qualified deferred compensation arrangements may include forfeiture provisions for termination for cause.

2. Termination Without Cause

An executive should not be penalized for an unsuccessful match that results, for example, from a clash with the company's Board about legitimate organizational goals. The executive may have been lured from a productive relationship, and securing comparable employment is not likely to happen in the near-term with non-competition covenants in place.

a. Term Employment Agreements

With an agreement with a specified term, if the employer terminates the agreement without cause, then the executive is entitled to the agreement's compensation and benefits for the duration of the specified term.

b. Other Agreements

If the agreement was at-will, then the severance terms will determine what benefits the executive will receive. Unvested equity grants may accelerate as a result of the executive being terminated without cause. Survey results show, for example, that a CEO of a large public corporation will receive:

- at least two times base salary and bonus as severance;
- two years of health benefits continuation;
- two years of stock option vesting;
- Severance payments are often made in installments, usually for either the duration of the term or for the length of the non-compete period, so that the employer can stop payment if the executive violates the confidential information or non-compete provisions of the agreement; and

- Usually senior executives are not required to find new employment following termination (i.e., the terminated executive is not required to mitigate the employer's damages) and any benefits of new employment are not offset against the severance benefits.

3. Executive Quits for "Good Reason"

The analogue to being terminated without cause is when the executive quits for "Good Reason" (also known as resigning after a constructive termination). Good Reason means that the executive has quit the employer because the employer has unilaterally changed a basic term or condition of the employment agreement. Without provision for resigning due to "Good Reason," an executive who, for example, experiences a reduction in pay or stature would be left with little choice but to either sue or leave without severance.

"**Good Reason**" provisions, outside of a change of control, provide both sides with some certainty. Rather than relying upon the uncertain outcomes associated with litigation over whether the executive's quitting was justified, good reason provisions establish the amount of liquidated damages.

a. Good Reason Example

For purposes of this Agreement, "Good Reason" means that either:

(i) the Executive has resigned from the Company within thirty (30) days after the date that his authority, duties or responsibilities have been materially diminished as CEO (except that this will not constitute Good Reason if, in connection with or following a Change in Control (as defined in Section 5), he has been designated to re-assume his former authority, duties or responsibilities as CEO pursuant to this Agreement within 12 months after such transactions);

(ii) the Executive has resigned from the Company within thirty (30) days after the date on which his Base Salary has been reduced by more than 10% (except for pay reductions proportionately applied to either all Company officers, where "officers" are defined in the Company's bylaws); or

(iii) the Executive has resigned from the Company (or its successor) within thirty (30) days after the date that the successor/surviving entity in a Change in Control does not assume this Agreement**[; or]**

(iv) **[the Executive has resigned from the Company (or its successor) within thirty (30) days after the date that he is required to relocate his office by more than 50 miles]**.

b. Payment

The severance and other benefits provided would be the same as for a termination without cause.

4. Terminations Following A Change Of Control

"**Change of Control**" provisions are designed to reduce the executive's personal uncertainty and anxiety and to facilitate a smooth management transition in the event that the employer undergoes new ownership and/or control. These objectives are achieved by providing the executive with enhanced severance if he/she is willing to stay with the employer both before and for a certain amount of time after a change of control. Generally, change of control provisions adopted by the employer's Board are analyzed under the business judgment rule which means the provisions will normally be upheld. However, change of control provisions receive stricter scrutiny if they were prepared in anticipation of or within a close proximity in time to the change of control. Under these circumstances, the Board must be independent and act reasonably and in good faith.

a. Single Trigger versus Double Trigger

Most change of control provisions either become operative upon the change of control event ("single trigger") or after both a change of control and an involuntary/constructive termination of the executive's employment ("double trigger") within a defined period of time after the change of control.

- Single trigger provisions are more susceptible to stockholder challenge and are used less frequently. However, several employment agreements now contain a short window of time (usually for the thirty days that follow one year after the change of control) whereby the executive can receive severance benefits under a voluntary termination (even without Good Reason) during the specified window (the so-called, "modified single trigger"). This provision is designed to facilitate management continuity and also enable the new ownership to evaluate the existing management for a period of time.

- Will Sarbanes-Oxley be the death knell of such provisions?

b. Typical Change of Control Benefits

- Equity grants generally receive accelerated vesting upon a change of control with an extended period of time to exercise stock options. The extended time period is designed to permit the executive to exercise and sell without running afoul of SEC short swing profit rules.

- Post-term severance payments are usually provided in a cash lump sum after a change of control to guarantee that the executive does not get cheated out of full payment if the new employer is unfriendly. Generally, a CEO of a large public company will receive a cash severance payment at least equal to 300% of his/her base salary and a bonus measure, so benefits are enhanced above the level provided for an involuntary termination without cause or resigning for Good Reason. SERP or other benefits payable at a date later than, or in installments following, the change of control are often funded through an irrevocable grantor "rabbi" trust prior to the change event to provide protection to the executive.

- Change of control benefits payable to certain key executives of certain kinds of corporations may constitute "golden parachute payments" subject to certain tax penalties on both the employer and the executive. Severance payments, accelerated vesting of stock and/or options, and the accelerated vesting and/or payment of nonqualified pension benefits or life insurance in connection with a change of control may all qualify as parachute payments.

C. Change of Control/Golden Parachute Rules

1. Parachute Payments and Excess Parachute Payments

Payment of an *excess parachute payment* (defined below) has two adverse tax consequences.

- First, the recipient is subject to a 20% excise tax. As you will see from the example below this has a dramatic and punitive effect when the parachute payment limit is exceeded only slightly.

- Second, the corporation making the payment is not permitted to deduct the amount of the excess parachute payment. Even if the loss of this deduction is not a meaningful consideration for a company, the punitive imposition of the excise tax remains a significant concern.

2. Severance Could Result in Excess Parachute Payments

For an excess parachute payment to exist, there must first be a parachute payment. A *parachute payment* is any payment in the nature of compensation to a *disqualified individual* that is *contingent* on a change in the ownership or control of a corporation (or of a substantial portion of a corporation's assets) if the aggregate present value of all such payments to the individual equals or exceeds three times the individual's *base amount*. Any separation payments made on account of termination of employment that occurs within one year of a change in control is presumed to be a payment contingent on a change in control. It does not even matter if the employment agreement makes no reference to a change in control either as an explicit contingency or otherwise. If the payments happen to follow a change in control by less than one year, the payments would be deemed to create a parachute payment under the following condition:

If Payments > 300% of *Base Amount*

The *base amount* generally is average compensation reported on Form W-2 paid to the individual during the five years *preceding* the year in which the change in control occurs.

Several factors interact to make the base amount materially smaller than the current rate of compensation, and, as a result, severance payable at a rate three times current compensation is likely to trigger a parachute payment. Some factors interacting to lower the base amount are:

- The fact that it is an average over past years, and, if compensation is increasing, then by definition the average would be less than the current rate of payment.

- Bonuses are generally paid in the year after the year to which they relate and this generally has the effect of reducing average W-2 compensation.

- Executives often participate in non-qualified deferred compensation plans that permit them to contribute a portion of pay (sometimes 50% or more) to deferred compensation plans. Executives who utilize these programs inadvertently reduce the base amount further, since deferred amounts are not included in Form W-2 taxable wages in the year they otherwise would be paid.

3. Definitions

a. Change in Control

A change in control occurs upon a change in the ownership or effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation.

b. Disqualified Individual

An individual who is an employee, independent contractor or other person specified in the regulations who performs personal services for any corporation and who is an officer, a shareholder or highly compensated individual. A shareholder is anyone who owns stock of the employing corporation with a value in excess of 1% of the total value of all outstanding shares of all classes of stock. Constructive ownership rules apply. Any vested stock options are constructively owned. For purposes of determining whether someone is a disqualified individual, options which are exercisable or are exercisable upon the condition of an insubstantial event are considered outstanding stock, while options which are not currently exercisable upon the occurrence of a substantial condition precedent are not considered outstanding stock. A highly paid individual is one of the highest paid 1% of employees or if less one of the highest paid 250 employees.

4. Count All Change of Control Payments

- The value of options or other equity awards for which vesting is accelerated in a change of control counts as a payment contingent on a change of control (value is based on fair value using a Black-Scholes type valuation model).

- Welfare benefits provided following a change of control termination are another common payment that counts in determining whether there are excess parachute payments.

5. Punitive Application of Excise Tax

Although a *disqualified individual* will have a *parachute payment* for purposes of the tax rules only if his or her payments equal or exceed three times the base amount, the reach of the adverse tax treatment extends beyond this excess (i.e., the amount that exceeds three times the base amount*)*. The 20% excise tax and disallowance of deduction applies to an *excess parachute payment*, which is defined as the amount paid in excess of **the *base amount***. That is, the excess parachute payment is the amount greater than one times the compensation average.

6. Tailored Example

Here is an example of a hypothetical CEO entitled to severance of three times base salary plus bonus. Let's assume a 2003 change in control and a 2003 termination under the employment agreement terms:

Year	***Base Comp***	***Bonus***	***LTIP***	***Other Comp***	***Total W-2***
2002	$850,000	$300,000	$238,280	$11,243	$1,399,523
2001	$825,000	$425,000	$0	$10,228	$1,260,228
2000	$775,000	$525,000	$0	$9,668	$1,309,668
1999	$725,000	$455,000	$0	$8,864	$1,188,864
1998	$650,000	$350,000	$0	$8,456	$1,008,456
Average of Total					$1,233,348

Based on these figures, the CEO would have a parachute payment and an excess parachute payment if the severance amount payable to him exceeds 300% of $1,233,348 (or ***$3,700,044***).

We know that the bonus paid to the CEO in 2003 is $750,000. If we assume that salary for 2003 equal 2002 levels, upon the change in control, the CEO would be entitled to payments of at least $4,800,000. Because this number results in a parachute payment, the excess parachute payment is calculated as follows:

CEO payment – base amount = excess parachute payment

$4,800,000 – $1,233,348 = $3,566,652

The excess parachute payment of $3,566,652 is non-deductible to the company and is subject to a 20% excess tax in addition to the ordinary tax payable on the total payment of $4,800,000.

a.	CEO Payment Gross	$4,800,000
b.	Federal, State & FICA Taxes (~45%)	2,160,000
c.	Net CEO Payment Pre-280G (a – b)	2,640,000
d.	Excess Parachute Payment	3,566,652
e.	20% Parachute Tax (20% x d)	713,330
f.	Payment to CEO After Excise Tax (c – e)	1,926,670

Observation: Note that under the scenario posed, if the company simply had capped the payments to the CEO at $1 less than 300% of the Base Amount, there would be no excise tax imposed. At an assumed tax rate of 45%, the CEO would receive $2,035,024 ((capped amount - $1) x (1 – 45%)) even though the payment were capped, and this amount is more than the $1,926,670 figure that he would receive if the company did not have a plan to address 280G. In addition, with the cap, the company would have saved itself more than $1.5 million by paying out $3,700,043 instead of $4,833,729, and taking a deduction on the whole payment of $3,700,043 instead of just $1,233,348.

7. Contract Provisions Aimed at Protecting the CEO or Company from Excess Parachute Payment Problem

There are basically three commonly-used approaches to deal with the *excess parachute payment* problem.

a. Absolute Cut-Back

First, in some cases the employment, option, restricted stock and other agreements in effect with persons who are likely to be *disqualified individuals* include a provision to the effect that the individual will not be entitled to receive any payment that would constitute a *parachute payment* and that, if a reduction in cash payments, vesting of options or stock or other benefits is necessary to prevent that result, the individual will be given the opportunity to decide which payments, options, stock and other benefits will be reduced to satisfy the limitation.

b. Modified Cut-Back (Best After-Tax Result)

Second, in some cases the operative agreements provide that the individual will not be entitled to receive any amount that would constitute an *excess parachute payment* unless, after payment of applicable excise and income taxes, the amount retained by the individual would be greater (or in some cases, materially greater) than the corresponding amount if the total payments had been limited as described in the first alternative. In other words, if the individual would be better off, after taxes, to pay the excise tax and receive the higher payment, that amount would be paid (and the corporation would lose its deduction for the *excess parachute payment* amount).

Conversely, the corporation would save money on the payment itself and on the deduction, if the individual would not be "better off" after payment of the uncapped amount. In some contracts, "better off" may include a materiality standard, so that the net uncapped payment would, for example, have to exceed the capped payment by at least 5% for the uncapped amount to be paid.

c. Gross-Up

Third, in some cases a corporation agrees to pay an additional amount (commonly referred to as a "gross-up" payment) sufficient to pay the excise tax imposed on the original excess parachute payment, plus any income and excise taxes that are imposed on the gross-up payment itself. Under this scenario, the individual receives an after-tax amount equal to the excise tax on the original excess parachute payment and therefore is left in the same after-tax position as he or she would have been in had the excise tax never been enacted. However, the cost to the paying corporation always is very high, since both the gross-up payment and the original excess parachute payment will be nondeductible. (Gross-up payments are frequently three times the amount of the excise tax.)

8. Ad Hoc Strategies to Address the Excess Parachute Problem

There are two other common strategies for reducing or eliminating the excess parachute payment problem.

a. Non-Compete Agreement

It is not uncommon in connection with negotiation of a transaction to implement a significant non-competition agreement (where there is no such agreement already in place) with the disqualified person, and to assign a sufficient amount of the payment that otherwise would be made as severance to the non-compete. The value of the non-competition agreement, because it is treated as a payment in consideration for abstaining from performing services after the change in control, is not treated as contingent on the change in control. The objective is to get the payments treated as contingent on a change in control below the 300% base amount. In order to support the value of the competition agreement, a compensation survey is highly advisable. Consequently, implementing this approach can be costly and sometimes time consuming.

b. Option Exercises Intended to Increase the Base Amount

If a transaction is negotiated in year one and circumstances permit the transaction to close in year two, the deliberate exercise of non-qualified options in year one could be undertaken to increase the base amount sufficiently, so that subsequent payments in year two would be less than 300% of the base amount.

III. REQUIREMENTS OF THE SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act of 2002 (the "SOA") was enacted on July 30, 2002 in an effort to address issues of corporate governance, securities regulation and the conduct and practices of the accounting profession. This section briefly describes provisions of the SOA that affect executive compensation arrangements.

A. Prohibition on Personal Loans to Executives

Section 402 of the SOA amends Section 13 of the Exchange Act to prohibit a public company from extending, arranging or renewing an extension of credit in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that company. This section affects any issuer the securities of which are registered under Section 12 of the Exchange Act, that is required to file reports under Section 15(d) of the Exchange Act, or that has a pending registration statement filed under the Securities Act of 1933. It is unclear whether various plan transactions, including loans from 401(k) plans, cashless exercise of stock options, and split-dollar insurance policies, may constitute such impermissible loans. The SOA contains limited exceptions for loans made or provided in the ordinary course of a corporation's regular business, for example, consumer credit companies, registered U.S. broker-dealers and certain banks.

B. Trading Ban During Pension Plan Blackout Periods

Section 306(a) of the SOA prohibits any director or executive officer of an issuer of any equity security (other than an exempted security) from engaging in any transaction in any equity security of the issuer acquired in connection with his service or employment as a director or executive officer during any plan "blackout period. A "blackout period" is any period of more than three consecutive business days during which the ability of at least 50% of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer held in such an individual account is temporarily suspended by the issuer or fiduciary of the plan, subject to certain exceptions. Issuers are required to timely notify their directors and executive officers and the SEC of a blackout period that could affect them. The SEC has issued final rules to clarify the application of this provision.

C. Notice of Blackout Periods

Section 306(b) of the SOA amends Section 101 of ERISA to require plan administrators to notify affected plan participants and beneficiaries at least 30 days in advance of any blackout period with respect to an individual account plan. The 30-day advance notice requirement does not apply where a deferral of the blackout period would violate the fiduciary duty provisions of ERISA and a fiduciary of the plan reasonably so determines in writing, or if the inability to provide the 30-day advance notice is due to unforeseeable events or circumstances beyond the control of the plan administrator and a fiduciary of the plan reasonably so determines in writing.

For this purpose, a blackout period includes periods when loans, investment changes or plan distributions are restricted for at least three consecutive business days. This rule applies regardless of the number of participants affected, and regardless of whether the employer's stock is publicly traded or employer stock is an available investment under any of the employer's retirement plans. Plan administrators may be subject to civil penalties of up to $100 a day for each participant to whom notice is not given. Plan administrators are also required to provide timely notice to issuers of any employer securities subject to the blackout period. The Department of Labor has issued interim final rules under ERISA that implement this provision.

D. Forfeiture of Certain Bonuses and Profits

Section 304 of the SOA provides that if a publicly traded company is required to prepare an accounting restatement due to its material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the company must reimburse the company for any bonus or other incentive-based or equity-based compensation received by that person from the company during the 12-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document containing the financial reporting error, and any profits realized from the sale of the company's securities during that 12-month period.

E. Accelerated Disclosure of Certain Transactions

Section 403 of the SOA amends Section 16(a) of the Exchange Act to require directors, officers and 10% beneficial owners of any company with a class of publicly-traded equity securities to file reports (Form 4) for transactions involving changes in ownership of company stock generally within two business days after the transaction has been executed. In addition, necessary disclosures must be filed at the time the securities first become registered on a national securities exchange or by the effective date of the initial registration statement relating to the securities; within ten days of becoming a director, officer or 10% holder; or at such other time established by the SEC where such two business day period is not feasible. The report must be filed electronically and posted on the company's website within one business day after filing. This provision affects the timing of reports for stock option and restricted stock grants and option exercises, among other transactions. The SEC has issued final rules implementing electronic filing and website posting of Forms 3, 4 and 5.

F. Criminal Penalties for Violations of the Exchange Act or ERISA

Sections 904 and 1106 of the SOA increase the criminal penalties for violation of the Exchange Act or ERISA's reporting and disclosure requirements. Individuals who willfully violate the Exchange Act may be fined up to $5 million and/or sentenced to up to 20 years in prison. Individuals who violate ERISA's reporting and disclosure requirements may be fined up to $100,000 and/or sentenced to up to 10 years in prison. Corporations may be subject to fines of up to $25 million for willfully violating the Exchange Act and up to $500,000 for violating ERISA's reporting and disclosure requirements.

G. Compensation Committees

1. NYSE Corporate Governance Rules

The NYSE corporate governance rules require that a company listed on the NYSE must have a compensation committee composed entirely of independent directors. An independent director is one who the board of directors affirmatively determines has no material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company). Companies must disclose these determinations and any standards adopted for making the determinations. In addition, the rules list several classes of persons who are not independent, including, among others: a director who is or has been an employee, or whose immediate family member is or has been an executive officer, of the listed company within the past three years, and a director who has received, or whose immediate family member has received, more than $100,000 of direct compensation from the company, except payments for board service or deferred compensation for prior service, in the past three years.

The compensation committee must have a written charter that addresses the committee's purpose and responsibilities. These responsibilities must, at a minimum, include direct responsibility to:

- review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation;

- make recommendations to the board with respect to non-CEO compensation, incentive compensation plans, and equity-based plans; and

- produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC.

The compensation committee's charter must address the annual performance evaluation of the committee as well. The committee's charter should also address committee member qualifications, committee member appointment and removal, committee structure and operations (including authority to delegate to subcommittees), and committee reporting to the board.

In addition, listed companies are required to adopt and disclose corporate governance guidelines, which must include, among other subjects, director compensation guidelines.

2. NASDAQ Corporate Governance Rules

The NASDAQ corporate governance rules require that compensation of the chief executive officer and all other executive officers of the company be determined or recommended to the board for determination by either a majority of the independent directors or a compensation committee comprised solely of independent directors (subject to an exceptional and limited circumstances exception). For this purpose, "independent director" means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The rules list several classes of persons who are not independent, including, among others: a director who is or has been employed in any capacity, or whose family member is or has been employed as an executive officer, by the company or its affiliate in the past three years, and a director who has accepted, or whose family member has accepted, payments from the company in excess of $60,000 other than for board service in the past three years, subject to certain exceptions.

H. Shareholder Approval

The NYSE and NASDAQ require that all equity compensation plans and any material revisions to such plans be subject to shareholder approval, as described above in section D.1.