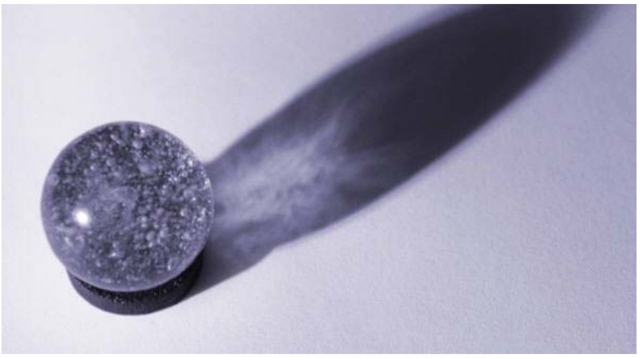
LABOR AND EMPLOYMENT LAW UPDATE



WHAT LOOMS BEYOND JANUARY 1, 2008? PART II: THE NONQUALIFIED DEFERRED COMPENSATION REGULATIONS

The terrain for deferred compensation will become daunting on January 1, 2008, when the final regulations adopted by the IRS become effective. The tax consequences of noncompliant plans are harsh and are not limited to the high-level executives who were Congress' originally intended target.

HOW WILL UNSUSPECTING RECIPIENTS BE AFFECTED? The tax burden and penalties of Section 409A are not limited to officers and directors who may have been complicit in the negotiation or design of an ill-conceived deferred compensation plan. All recipients under a noncompliant plan can be subjected to income taxes *before* compensation is received *plus* interest and a 20% penalty. The regulations do not spare persons who may have little or no choice about the method of their compensation or little knowledge about the tax consequences of an election of deferred compensation.

For some recipients, a tax bill from the IRS before receipt of the deferred income can mean financial insolvency. Homesteads are not exempt from IRS foreclosure. Claims by disgruntled recipients who are caught off guard by the tax burden and penalty are therefore almost a certainty.

WHAT CLAIMS AGAINST EMPLOYERS WILL LIKELY BE BROUGHT BY DISGRUNTLED RECIPIENTS? Deferred compensation arrangements have already been the subject of claims under a variety of legal theories. These theories can be tapped to address the taxes and penalties of Section 409A.

BREACH OF CONTRACT: Where participation in a deferred compensation plan is provided as part of a contract with the service provider, the failure to pay the promised compensation can be the basis of a claim for breach of contract. A tax burden which diminishes or erases (at least in the short term) promised compensation may also be tantamount to a contractual breach.

PAY DAY LAWS. Full and timely payment of employee compensation is required by many state statutes. Saddling employees with an early and exorbitant tax burden may violate such statutes.

ERISA: For deferred compensation plans which are also ERISA plans (e.g. severance pay plans, 401(k) wrap plans, etc.) claims may be brought under the terms of the plan itself or under statutory provisions establishing fiduciary duties for plan sponsors, administrators or trustees. A claim based upon a disabling tax burden could be pursued in a similar manner.

STATE TORT THEORIES: Among the state tort theories which may be asserted by a deferred compensation claimant, depending upon the particular state, are negligence, breach of fiduciary duty, breach of covenant of good faith and fair dealing, fraud, and possibly a variety of statutory claims that could vary from state to state. Some of these tort theories may allow for punitive damages.

IS A GROSSED-UP-FOR-TAX PAYMENT AN ALTERNATIVE TO LITIGATION? Some commentators have suggested that potential litigation can be avoided if the company reimburses the tax bills of recipients of deferred compensation. Since a tax reimbursement is itself taxable income, the amount which must ultimately be paid by a company is actually substantially more than the tax bill incurred. A grossed-up-for-tax payment is permitted by Section 409A, but still would need to be paid earlier than intended under a deferred compensation plan to avoid (1) a lawsuit, and (2) treatment as yet another deferred compensation plan which creates only greater damage and potential liability.

WILL THIRD PARTY CLAIMS BE FAR BEHIND? Even companies who elect to provide a disgruntled recipient with a grossed-up-for-tax payment rather than face the prospect of a costly lawsuit, will likely turn for answers and money to third parties who were involved in the design or negotiation of a flawed deferred compensation plan. Possible third party claims include professional negligence, contribution and indemnity, breach of contract and breach of fiduciary duty, among others.

WHO SHOULD BE CONCERNED ABOUT POSSIBLE CLAIMS? Concern about possible claims by disgruntled recipients should not be limited to the companies who provide or administer noncompliant deferred compensation plans. Many of the legal theories for third party claims should be of concern to others as well.

INSURERS: Companies who provide EPLI, ERISA fiduciary, D&O and E&O liability lines should begin to manage this risk arising out of claims on deferred compensation plans.

TRUSTEES: Trustees of ERISA plans which provide deferred compensation are subject to being sued for breach of fiduciary duties.

DIRECTORS AND OFFICERS: Corporate directors and officers who recommend and approve deferred compensation plans may also have liability exposure.

LEGAL AND ACCOUNTING PROFESSIONALS: Attorneys, accountants and tax advisors who provide advice regarding deferred compensation plans may be vulnerable to third party actions alleging professional malpractice.

EMPLOYEES AND CONSULTANTS: Employees and consultants who recommend, design and administer flawed deferred compensation plans should be concerned about personal liability.

WHAT ELSE LOOMS BEYOND JANUARY 1, 2008? The unknown. Although adopted with the intent to give meaning and enforcement authority to Section 409A, the IRS regulations are still vulnerable to interpretation. How the IRS and tax courts will construe the provisions is unknown. While it is anticipated that claims will be brought by disgruntled recipients, the full array of claims which will be brought by creative plaintiffs' attorneys or desperate claimants is unknown.

A "SEA CHANGE?" The IRS official who called Section 409A a "sea change" in deferred compensation understated its likely effect. Instead, the ripple effect of the law will likely extend far and wide.

ADDITIONAL QUESTIONS? If you have any questions about Section 409A, the new IRS regulations or executive compensation in general, please contact Robert Chadwick or Bruce Campbell at Campbell & LeBoeuf, P.C.

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