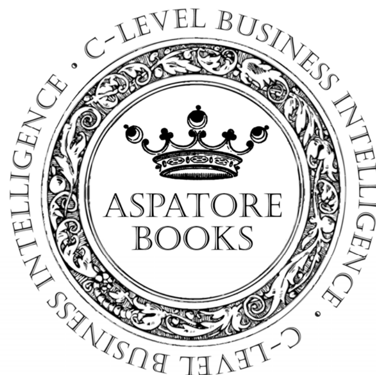
INSIDE THE MINDS

Employee Benefits and Executive Compensation Client Strategies

Leading Lawyers on Formulating a Client Strategy, Analyzing Relevant Documentation, and Understanding Tax Complications



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Perspectives for Management and Executives on Structuring and Negotiating the Package: It's Not Just About the Dollars

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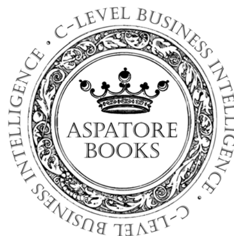


Constructing the Compensation Plan: Threshold Concerns

Clients seek counsel at various stages of the employment process—some at the search and interview stage, some at the term sheet stage, and some at the offer stage or soon thereafter when an offer letter has been issued and an employment agreement is to be prepared, negotiated, and executed. The process will vary from company to company and will, in many respects, be dictated by the seniority of the position being filled.

Once an individual has been identified by the employer as the appropriate candidate for a position, it must consider constructing an offer to that individual. The employer, in structuring the offer and the compensation package, must balance several competing issues and address the needs of both the prospective employee and the employer. An employer's goal is to provide the prospect with compensation and benefits commensurate with the duties and responsibilities of the position, and to acquire a qualified individual who will perform in that position while protecting the assets of the employer and its shareholders. The employment offer should be structured for acceptance and prepared in consideration of the marketplace for similar positions for companies of similar size. Employers strive to bring new executives into their fold and anticipate significant return on their employment investment. We have found that using a term sheet prior to preparation of the employment documents is a valuable tool, just as it is in most transactions.

Protecting the Corporate Jewels

At the outset of the employment relationship, companies project dollars that will be invested in the new employee, the experience and opportunity available to the new employee, and the concern about losing that individual to another company, and the commensurate training-related investment yet to be made in that individual.. From an employer's perspective, one of the issues that must be addressed when structuring the employment offer, in addition to the compensatory aspects, is restrictive covenants that protect the company from competition, solicitation, interference with a client and other employee relationships, as well as the protection of trade secrets and other proprietary and confidential information. Taking into account the potential length of service of the executive, how long should that executive

be kept from, for example, competing against it following termination of the employment relationship? How long should the employer keep the employee from being able to solicit its clients and/or employees? The clients and other key employees are the lifeblood of the company, so it is very important for the employer impose restrictive covenants that have teeth in them—that maximize the available enforceability based on current law to protect the company. At the same time, the covenants must be reasonable in scope, geographic range, and duration, and they must be likely to be upheld by a court of competent jurisdiction. Knowledge of current law within the applicable jurisdiction concerning these covenants is critical to the design of a protective package that works. It is also important for the employer to consider the dissemination of confidential information from the very beginning of the individual's employment with the company, while keeping the issue of balance in focus. The counterargument an employer will hear with respect to restrictive covenants will be that they are too restrictive to encourage the acceptance of the offer. Therefore, employers should pay critical attention to the legal landscape of enforceability of these covenants within its industry and jurisdiction to avoid dissuading any potential employment offer from being accepted.

The goal of the prospective employee is to minimize the scope and duration of the restrictions and, at a minimum, seek maximum compensation (severance) in the event of termination of employment.

Compensation Offered: Not Just Dollars

This same kind of balance must be considered when the employer is considering the amount of compensation to be made in the employment offer. Many times, compensation is just about the dollars offered to the individual as salary, bonus and equity participation. Obviously, that is a key component, as the employer wants the compensation to be comparable to what the marketplace is offering. However, this consideration must take into account a number of factors, including the prevailing availability of individuals to fill the position, the level of skill and education and experience the individual must have to handle the position, and the amount of potential new clients or opportunities this employee may bring to the company. All of these issues must be considered in determining the overall compensation offer. Consideration must be given to the incentive portion

of compensation, which may have several components. Again, this goes back to balance. The idea is to give the individual the incentive to work for the company on a prospective basis, taking into account issues such as the potential future cash flow of the company and the potential equity issues that may be associated with incentive compensation. While stock options provide another vehicle by which the executive can be compensated, the employer needs to focus on the total compensatory picture, and carefully address such issues as the amount of stock ownership the executive may receive, the restrictions that may accompany such stock grants, and how the stock ownership will stay with the employer if the individual decides to leave the company. It goes back to the need to balance the compensation package with the needs of the company and the realities of the market for such an individual.

Rights and Responsibilities Within the Contract

The primary focus of the employment contract is to delineate the rights and responsibilities of the parties. As noted above, there are a number of methods by which an employer can compensate the employee. The parties may have already discussed the general level of compensation that will be payable to the employee on an annual basis. However, the employer should look to utilize incentive compensation to the extent possible to protect its interests, while providing the employee with an incentive to achieve significant goals on behalf of the employer, in furtherance of its interests. Accordingly, the use of equity and equity-based compensation, target-related bonus structures, and variable compensation structures should all be carefully considered by the employer when structuring the employment contract..

Deferred compensation is another way to both provide incentive to an executive, and yet manage the cash flow of the company by providing that individual with the promise of a payment of compensation at some later date. However, recent changes to certain provisions of the Internal Revenue Code have placed restrictions on the types of deferred compensation arrangements that can be provided. But even beyond the restrictions, or the requirements that need to be addressed in designing a deferred compensation arrangement, one of the key elements to be considered by an employer when including such an arrangement is cash

flow. It's easy for an employer to over-promise deferred compensation to an executive to entice him or her to accept an employment offer from the company, but by doing so the company has to take into account the fact that those promises will, at some point, need to be fulfilled. So it's important that the company be consider its future cash flow projections and future business projections, so cash will be available to cover the deferred compensation obligations. While deferred compensation can be an incentive for an individual to accept an offer of employment with the company, executives are very much aware of the fact that deferred compensation is really a promise to pay compensation in the future. It is an unsecured promise in most circumstances, so the executive is assuming some level of risk based upon faith that the company will be in solid financial health with sufficient funds available to pay the individual in the future.

Termination Is a Hard Process

Events of termination need to be clearly defined within an employment contract. These events include termination with or without cause, and with or without good reason, change in control, resignation, death, disability, and non-renewal. Each of these events requires the parties to address under what circumstances the employer may terminate the employee and the commensurate post-termination payment obligations associated with each such event. Because of its potential implications, the definition of cause can be a contentious issue to negotiate. An employer who discovers one of its employees stealing from the company, or embezzling funds, or disclosing confidential information is said to have cause for terminating that employee. These elements of the definition are generally straightforward. However, many employers want protection from an employee who may act contrary to the best interests of the company. In addition, the employer structuring the executive compensation package must consider what particular elements of the definition of cause may be applicable to their industry or particular circumstances. A so-called boilerplate definition of cause should never be used by an employer without considering how that may affect its overall business operations, for just as business operations of different corporations are unique, so should the definition of cause be unique with respect to the particular industry or individual.

The flipside to cause consists of those events the employee could consider as good reason to terminate the employment relationship. These include material breach by the company of the employment contract, change in control, relocation of the workplace outside a specific radius, and diminution of duties or title, all of which will provide the employee with the right to terminate the contract and trigger the company's obligation to make payments to the terminating employee that typically equate to the payments warranted in a termination by the company without cause.

Another often-overlooked element of an employment contract involves the death or disability of the employee. With this issue, the philosophy of the company comes into play. What portions of the compensatory elements of an employment contract should be paid if the employee dies or becomes disabled, and what does it mean to be disabled? A definition of *disability* should be included within the employment contract, but there are variations to such a definition. Is being disabled, for example, the same as the definition for Social Security benefits purposes, and does it fall under the company's disability insurance policy? Is that definition sufficient, or is there another definition that would be more applicable to the particular industry? Once the definition of disability has been determined, a number of other issues may arise. For example, what rights does the employee have once the employment contract ends due to a disability? How long will be company be obligated to continue to compensate the employee before disability insurance becomes a key source of compensation for that individual.

What Happens When the Company Is Acquired, Merged, Consolidated, or Otherwise?

In the current environment of mergers and consolidations of industries and companies, the effect of a combination of entities, or a takeover by an unrelated entity, needs to be addressed in the employment contract. This is referred to as a *change in control*. For example, what happens to the executive if the company merges out of existence, or if it is consolidated within its industry with another corporation? Should the employee be entitled to payments of severance amounts? If so, to what compensatory amounts should the employee be entitled? Does it matter if the employee stays in the employ of the company following the transaction? In addressing this issue,

the employer should consult its tax counsel as part of the employment contract process. There are a number of tax laws that may effect whether an employee is entitled to the payment of compensation amounts following a consolidation transaction. For example, one of the provisions of Internal Revenue Code Section 409A provides a definition of *change in control*. If there is such a change in control in the company as defined in Section 409A, the deferred compensation payments to which the executive otherwise would be entitled in the future might be payable as of the date of the change, even though the employee may stay in the employ of the company. Is that what is intended by the employer? Does the company intend that if it changes owners, the individual will be entitled to receive his or her deferred compensation payments? All of these issues need to be considered in structuring these types of arrangements. Further, the Internal Revenue Code generally provides that deferred compensation may only be paid in accordance with the above-referenced definition of change in control. (See Appendix A for a sample "change in control" definition.)

How Does Section 409A Treat Changes in Control?

Under Section 409A, a deferred compensation arrangement can provide for payouts only upon certain defined events. Under normal circumstances, payouts are triggered by a "separation from service" or made pursuant to a payment schedule fixed at the time of the deferral. However, if provided in the deferred compensation arrangement, a "change in control event," as defined under Section 409A, can also trigger payouts. Thus, a primary purpose of the "change in control event" definition is to establish when such payouts may be made. As explained below, the definition affects not only payments directly triggered by a change in control event, but also certain "earn-out" payments and payments made upon a plan termination.

Equity compensation arrangements such as options and stock appreciation rights can run afoul of Section 409A if they are impermissibly modified. The proposed regulations set forth rules for how to convert options or stock appreciation rights in a corporate transaction so the conversion does not constitute an impermissible modification.

What Is a "Change in Control Event"?

Section 409A breaks down change in control events into three specific types: a change in ownership of the corporation, a change in effective control of the corporation, and a change in the ownership of a substantial portion of the assets of the corporation. The rules under Section 409A are similar to those that apply under Section 280G (the golden parachute rules). However, the Section 409A definition is in some ways narrower and in other ways broader than the golden parachute definition. Some events that trigger the golden parachute rules will not trigger permissible payouts under Section 409A, and vice versa. These distinctions might be confusing to employees, who might assume a change in control is a change in control for all purposes. It is possible, for example, that an executive would become subject to the excise tax under the golden parachute rules upon consummation of a transaction but not be permitted to receive a distribution of deferred compensation under a plan he or she understood permitted a distribution on a change in control. Differences between the Section 409A definition and the golden parachute definition are discussed below.

Change in Ownership

A change in ownership of the corporation occurs when one person or a group acquires stock that, combined with stock previously owned, controls more than 50 percent of the value or voting power of the stock of the corporation. The 50 percent threshold is the same under the golden parachute rules.

Change in Effective Control

A change in effective control occurs on the date that, during any twelve-month period, either (a) any person or group acquires stock possessing 30 percent of the voting power of the corporation, or (b) the majority of the board is replaced by persons whose appointment or election is not endorsed by a majority of the board. The Section 409A rule is narrower than the golden parachute rule. An acquisition of stock having only 20 percent of a corporation's voting power can trigger golden parachute treatment.

Change in Ownership of a Substantial Portion of Assets

A change in ownership of a substantial portion of the assets occurs on the date a person or group acquires, during any twelve-month period, assets of the corporation having a total gross fair market value equal to 40 percent or more of the total gross fair market value of all the corporation's assets. Again, the Section 409A rule is narrower than the golden parachute rule. An acquisition of 33.3 percent of a corporation's assets can trigger golden parachute treatment.

Who Is a Group?

Shareholders are treated as a group if they are shareholders in a corporation that enters into a merger, consolidation, purchase, or acquisition of stock, or similar transaction with the corporation. However, shareholders will not be deemed a group simply because they purchase stock of the corporation at the same time or in the same public offering.

What's the Relevant Corporation?

Under Section 409A, a change in control event need not relate to the entire group of affiliated corporations. Instead, the analysis under Section 409A focuses on whether there was a change in control of (i) the employee's direct employer (the corporation for which the employee performed services), (ii) any corporation or corporations liable for the payment to the employee, or (iii) any corporate parents having at least 50 percent ownership of the direct employer corporation or a corporation liable for payment to the employee. By contrast, the golden parachute rules focus on the entire affiliated group of corporations. The result of this approach is that a Section 409A change in control event can occur that does not constitute a change in control under the golden parachute rules.

For example, assume a parent corporation owns 100 percent of two operating subsidiaries. Subsidiary A represents 30 percent of the assets of the parent, and Subsidiary B represents 70 percent of the assets of the parent. If the parent sells Subsidiary A, the employees of Subsidiary A have a Section 409A change in control event because Subsidiary A is their direct employer. However, the employees of the parent and Subsidiary B do not

have a change in control event. By contrast, if the parent sells Subsidiary B, there is a Section 409A change in control event for the employees of all three corporations. (In the sale of Subsidiary B, the employees of the parent have a change in control event because the sale represents a change in ownership of more than 40 percent of the parent's assets. Because the parent is at least a majority owner of Subsidiaries A and B, the change in control of the parent is also considered a change in control for the employees of Subsidiaries A and B.)

Under the golden parachute rules, the analysis focuses on the entire group of corporations. Thus, for example, the sale of Subsidiary A would not be a change in control for any employee under the golden parachute rules, and the sale of Subsidiary B would be a change in control for all employees.

Taxing Complications

The potential income tax consequences of the compensation package offered to the executive should also be considered by the prospective employer. Such income tax consequences are different when viewed from the differing perspectives of the employer and the employee. An employer will want the compensation package paid to the employee to result in income tax deductions early in the employment relationship, while an employee will, depending upon the circumstances, want the recognition of income to occur much later in the employment relationship. This can result in future income tax consequences for the employer. The employer must therefore balance the desires of the employee to defer compensation payments to a later date, while providing for adequate compensation throughout the employment relationship. This balance can be difficult to achieve, but incentive compensation structures can be useful in achieving this balance. In addition, the employer must consider the possibility that the employment relationship may not continue for the long term. In such circumstances, the employee is looking to receive cash compensation and receive it as soon as possible. The employer wants to defer that payment as long as possible so that, if for whatever reason the executive does not work out, the company does not pay a significant amount of money initially for a relatively short period of work. In our experience, we have found that employers use a variety of deferred compensation arrangements to have the

executives view their employment with horizons of different lengths, and structure multiple plans to layer the compensation structure.

From an employer's perspective, the elements of most employment packages are negotiable, within certain limits. Factors such as industry norms, the particular position being filled, and the skill and experience levels will dictate whether an element of an executive's employment is negotiable. Typically, while there can be some deviations or circumstances in particular industries or particular employment positions, compensation is going to be the negotiating starting point for the employer. The employer, of course, wants to get the most for its money and therefore wants to pay a fair amount of compensation, while demonstrating that the amount of compensation paid to an executive will be a good investment.

The tax and regulatory consequences of certain compensatory elements must also be considered in the negotiation of an employment contract. As mentioned above, certain compensation elements are currently deductible for income tax purposes by the employer. Certain other amounts, however, which are deferred under the terms of the employment contract, can only be deducted in the future. However, the overall tax structure of the compensatory package needs to be considered by the employer, particularly some of the regulatory aspects, including Internal Revenue Code Section 280G and Section 409A.

What Does Section 280G Cover?

Section 280G denies a deduction for any excess parachute payment made by an employer which is subject to it provisions. In conjunction with Section 280G, Section 4999 imposes a non-deductible 20 percent excise tax on the recipient of any excess parachute payment, within the meaning of Section 280G(b).

An excess parachute payment is defined in Section 280G(b)(1) as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. Section 280G(b)(2)(A) defines a parachute payment as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change in the ownership of a

corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation (a change in ownership or control), and (ii) the aggregate present value of the payments in the nature of compensation that are contingent on such change equals or exceeds an amount equal to three times the base amount.

What about a Gross-Up on the 280G Excise Tax?

A "gross-up" payment is a payment of taxable income by a third party (typically an employer) that is intended to satisfy the income tax liability of an individual with respect to an item of income. For example, an employer may agree to pay the income tax liability of an employee with respect to his or her year-end bonus. Because the payment of the employee's income tax liability is further taxable income to the employee under the provisions of Internal Revenue Code Section 61, the payor typically will engage in a gross-up calculation, by which the payor will pay an amount sufficient to satisfy the income tax liability of the initial taxable payment, as well as the additional income tax due on the gross-up payments.[1]

Additional Thoughts on the Package

Another issue that employees need to keep in mind is that not all elements of a particular compensation package will be applicable to all executives. An executive in one position in the company is not necessarily going to be entitled to the same level of compensation, or all the incentive compensation elements, as another executive may be entitled In that regard, we have always counseled employers to inform the executive early in the process about what types of compensation will and will not be paid with respect to this position, as this tends to make the negotiations smoother.

When to Negotiate Severance

The argument against negotiating a severance arrangement as part of the employment contract is that the parties don't want to focus on the relationship potentially going bad right at the outset of employment discussions, or what is also called the "romance stage." However, we have

[1] Refer to Appendix B

found that both parties are more at ease knowing how their relationship may end, and what may in fact be paid due to the cessation of the employment relationship. Viewing the employment and post-employment relationship is analogous to the considerations made by couples entering into pre-nuptial agreements.

Employers providing severance payments upon termination of employment should negotiate such arrangements as part of the employment contract. This is beneficial to both parties. However, the employer must also consider that the amount of severance payments that may be reasonable and fair may not be definitely determinable at the outset of employment. Accordingly, the employer may want to consider providing a formula-based severance arrangement, with the amount of severance paid to the employee being based on all the relevant facts and circumstances, including the clients, business, and talent the executive brings to the company. The employee will want to lock in certain minimums, accelerations, and continuations of compensation, equity vesting, and benefits, all of which will be based on the particular event of termination.

The circumstances surrounding the employee's termination should also be considered when determining the manner in which severance payments will be made under the terms of the contract. For example, if the employment contract ended on bad terms or due to "bad acts," such as based on a termination with cause, the employer will want to address its obligations to the employee as soon as possible to promptly end the relationship with the company. We have had situations where employment relationships have ended very poorly, but because of the manner in which the employment contract was structured, the former employee was entitled to severance payments from the corporation for several years. Further, the length of the severance compensation is often linked to the duration of the post-employment restrictive covenants, such as non-compete, non-solicitation, non-poach (non-solicitation of employees), and confidentiality.

One final aspect of an employment contract, and one of the issues that is often overlooked until the employment relationship has been severed, is a release of claims by the former employee. We routinely counsel employers to put together a severance package as part of the employment contract, and to include the draft separation agreement and release documents as a

negotiated exhibit to the contract. By proceeding in this manner, the employee has an opportunity to review the documents so he or she will understand the rights he or she will be waiving, and to pre-approve the documents, thereby avoiding the difficulties of negotiating a severance arrangement for several weeks or months after the employee informs the employer of his or her intention to terminate employment. Engaging in the latter process is almost like negotiating the employment contract again, but under the cloud of a potentially adversarial relationship. By providing the employee with a severance arrangement as part of the employment contract, and including a release agreement with this package, the employee will know specifically what will be paid on a prospective basis and what the parties' post-employment rights and obligations may be under certain circumstances.

What's Your Leverage?

A critical aspect to any deal, and employment contracts are no different, is the leverage that each party brings to the transaction table. The respective goals of the parties will be reflected in construction of the offer, the terms and conditions of the employment and severance packages, and the restrictive covenants and their respective scope and duration. Each is dependent upon the value that each party believes they offer. The employment contract is the vehicle by which those interests are reconciled, hopefully providing a roadmap for mutual success.

David T. Harmon*, a member of Norris McLaughlin & Marcus PA, focuses his practice on the areas of executive compensation and employment law, corporate and business law, and provides representation to institutions of higher education in those areas. He is the Co-Chair of the firm's Executive Compensation and Employee Benefits Group. He represents senior-level employees of both public and private companies in the negotiation of their employment packages and all associated agreements, whether at the commencement of the employment relationship or at termination. His successful negotiation of employment and severance packages for clients includes addressing all aspects of employment and post-employment compensation, respectively, and structures and strategies for those packages. His representation also includes providing advice and counsel to companies in the negotiation of employment and severance packages with their*

employees, and the design of compliance programs, including employee policy manuals, and counseling and training concerning implementation of those policies.

Mr. Harmon represents institutions of higher education through extensive work as their outside general counsel. His work for these clients involves contract preparation and negotiation for licensing, grants, consulting, construction, real estate, and general corporate matters, including the design of strategies to maximize collections and coordination of department practices, procedures, and documentation relating to these strategies. He also represents small and medium-sized companies in all of their general corporate and transactional matters.

Mr. Harmon is a member of the board of directors of the Wall Street Technology Association, and he is a member of the business law and labor and employment sections of the New York State and American Bar Associations. He has published many articles and frequently speaks on various legal topics.

Charles A. Bruder *is also Co-Chair of the firm's Executive Compensation and Employee Benefits Group. He concentrates his practice on the areas of employee benefits and executive compensation. He is experienced in all aspects of defined contribution and defined benefit plans, deferred compensation arrangements, stock option plans, employee stock ownership plans, and other incentive and equity-based compensation arrangements. He frequently counsels clients in the areas of plan qualification and administration issues, Employee Retirement Income Security Act ("ERISA"), fiduciary matters, plan compliance issues, and employee benefits matters in the context of business reorganizations. In addition, he provides counsel regarding group health plans, cafeteria plans, and other health and welfare benefits arrangements. He is also experienced in the areas of executive compensation, stock option planning, and wealth succession planning.*

Prior to commencing his legal career, Mr. Bruder was a senior tax consultant for a national accounting firm, providing tax consulting and financial planning services primarily to corporate executives and high-net worth individuals.

Mr. Bruder is a frequent lecturer in the area of employee benefits and has previously published articles in the Exempt Organizations Tax Review *and the* New Jersey Law Journal.

APPENDIX A

SAMPLE "CHANGE OF CONTROL" DEFINITION

(a) A "Change of Control" shall be deemed to have occurred upon the happening of any of the following events: (i) the consummation of a reorganization, merger or consolidation of the Company with one or more other persons, other than a transaction following which: (A) at least 51% of the equity ownership interests of the entity resulting from such transaction are beneficially owned (within the meaning of Rule 13 d-3 promulgated under the Securities Exchange Act of 1934, as amended ("Exchange Act")) in substantially the same relative proportions by persons who, immediately prior to such transaction, beneficially owned (within the meaning of Rule 13d-3 promulgated under the Exchange Act) at least 51% of the outstanding equity ownership interests in the Company; and (B) at least 51% of the securities entitled to vote generally in the election of directors of the entity resulting from such transaction are beneficially owned (within the meaning of Rule 13d-3 promulgated under the Exchange Act) in substantially the same relative proportions by persons who, immediately prior to such transaction, beneficially owned (within the meaning of Rule 13 d-3 promulgated under the Exchange Act) at least 51% of the securities entitled to vote generally in the election of directors of the Company; (ii) the acquisition of all or substantially all of the assets of the Company or beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 50% or more of the outstanding securities of the Company entitled to vote generally in the election of directors by any person or by any persons acting in concert; (iii) a complete liquidation or dissolution of the Company; (iv) the occurrence of any event if, immediately following such event, at least 50% of the members of the Board of Directors of the Company do not belong to any of the following groups: (A) individuals who were members of the Board of Directors of the Company on the date of this Agreement; or (B) individuals who first became members of the Board of Directors of the Company after the date of this Agreement either: (1) upon election to serve as a member of the Board of Directors of the Company by affirmative vote of two-thirds of the members of such board, or of a nominating committee thereof; in office at the time of such first election; or (2) upon election by the shareholders of the Board of Directors of the Company to serve as a member of such

board, but only if nominated for election by affirmative vote of two-thirds of the members of the Board of Directors of the Company, or of a nominating committee thereof, in office at the time of such first nomination; provided, however, that such individual's election or nomination did not result from an actual or threatened election contest (within the meaning of Rule 14a-11 of Regulation 14A promulgated under the Exchange Act) or other actual or threatened solicitation of proxies or consents (within the meaning of Rule l4a-11 of Regulation 14A promulgated under the Exchange Act) other than by or on behalf of the Board of Directors of the Company. For purposes of this Section, the term "person" shall have the meaning assigned to it under Sections 13(d)(3) or 14(d)(2) of the Exchange Act.

(b) For purposes of this Agreement, a "Pending Change of Control" shall mean: (i) the signing of a definitive agreement for a transaction which, if consummated, would result in a Change of Control; (ii) the commencement of a tender offer which, if successful, would result in a Change of Control; or (iii) the circulation of a proxy statement seeking proxies in opposition to management in an election contest which, if successful, would result in a Change of Control.

(c) If the Executive's employment with the Company terminates due to death or Disability, as defined in the Agreement above, after the occurrence of a Pending Change of Control which results in an actual Change of Control within one (1) year after such termination of employment, he (or in the event of his death, his estate) shall be entitled to receive the Payment that would have been payable if a Change of Control had occurred on the date of his termination of employment; provided, that the Payment shall be deferred without interest until, and shall be payable immediately upon, the actual occurrence of a Change of Control.

APPENDIX B

PAYMENT UNDER CHANGE OF CONTROL AND CODE SECTOIN 280G INDEMNIFICATION

Termination by the Executive after a Change of Control.

The Executive shall be entitled, upon five days' written notice from the Executive to the Company, to terminate his employment within ninety days after a Change of Control (as defined on Annex A) and if the Executive makes such election, a cash payment (the "Payment") shall be made to the Executive by the Company, within five business days' of such termination of employment (unless the Executive agrees, in his sole discretion, to receive the Payment or a portion thereof at a later date), equal to the greater of (A) ________________ Dollars ($________) or (B) twice his salary in effect at such time plus twice the greatest annual cash bonus paid to the Executive by the Company . The Executive agrees to use reasonable efforts to cooperate with the Company to avoid or minimize an excise tax under Section 4999 of the Internal Revenue Code of 1986 (the "Code"), provided that the Executive shall receive the Payment within five business days of such termination of the Executive's employment (unless the Executive agrees, in his sole discretion, to receive the Payment or a portion thereof at a later date).

Terms and Conditions of Payments.

The termination payments set forth in Section [ ] and [ ] with respect to Disability, and the making of the Payment under Section [ ], are expressly conditioned upon the Executive's execution and delivery of a severance and general release agreement and the expiration of any applicable revocation periods. The Company and the Executive further agree that the Company may further condition the payment and delivery of any such payments on the receipt of the Executive's resignation from any and all positions which he holds as an officer, director or committee member with respect to the Company, or any subsidiary or affiliate thereof.

Tax Indemnity for Change of Control Payment.

(a) If the Executive's employment terminates under circumstances entitling him (or in the event of his death, his estate) to the Payment described in Section [ ] above, the Company shall pay to the Executive (or in the event of his death, his estate) an additional amount (the "Tax Indemnity Payment") intended to indemnify Executive against the financial effects of the excise tax imposed on excess parachute payments under Section 4999 of the Code. The Tax Indemnity Payment shall be determined under the following formula:

$$X = \frac{EXP}{1\ [(FI \times (1-SLI)) + SLI + E + M]}$$

E = the percentage rate at which an excise tax is assessed under Section 4999 of the Code;

P = the amount with respect to which such excise tax is assessed, determined without regard to this Section 9;

FI = the highest marginal rate of income tax applicable to the Executive under the Code for the taxable year in question;

SLI = the sum of the highest marginal rates of income tax applicable to the Executive under all applicable state and local laws for the taxable year in question; and

M = the highest marginal rate of Medicare tax applicable to the Executive under the Code for the taxable year in question.

Such computation shall be made at the expense of the Company by an attorney or a firm of independent certified public accountants selected by the Executive and reasonably satisfactory to the Company (the "Tax Advisor") and shall be based on the following assumptions:

(i) that a change in ownership, a change in effective ownership or control, or a change in the ownership of a substantial portion of the assets, of the Bank or the Company has occurred

within the meaning of Section 280G of the Code (a "280G Change of Control");

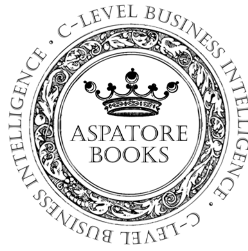
(ii) that all direct or indirect payments made to or benefits conferred upon the Executive on account of his termination of employment are "parachute payments" within the meaning of Section 280G of the Code; and

(iii) that no portion of such payments is reasonable compensation for services rendered prior to his termination of employment.

(b) With respect to any payment that is presumed to be a parachute payment for purposes of Section 280G of the Code, the Tax Indemnity Payment shall be made to the Executive on the earlier of the date the Company, or any direct or indirect subsidiary or affiliate of the Company is required to withhold such tax or the date the tax is required to be paid by the Executive, unless, prior to such date, the Company delivers to the Executive a written opinion, in form and substance reasonably satisfactory to the Executive, of the Tax Advisor or of an attorney or firm of independent certified public accountants selected by the Company and reasonably satisfactory to the Executive, to the effect that the Executive has a reasonable basis on which to conclude that (i) no 280G Change of Control has occurred, or (ii) all or part of the payments or benefits in question are not parachute payments for purposes of Section 280G of the Code, or (iii) all or a part of such payments or benefits constitute reasonable compensation for services rendered prior to or following the 280G Change of Control, or (iv) for some other reason which shall be set forth in detail in such letter, no excise tax is due under Section 4999 of the Code with respect to such payment or benefit (the "Opinion Letter"). If the Company delivers an Opinion Letter, the Tax Advisor shall recompute, and the Company shall make, the Tax Indemnity Payment in reliance on the information contained in the Opinion Letter.

(c) In the event that the Executive's liability for the excise tax under Section 4999 of the Code for a taxable year is subsequently determined to be different than the amount with respect to which the Tax Indemnity payment is made, the Executive or the Company, as the case may be, shall

pay to the other party at the time that the amount of such excise tax is finally determined, an appropriate amount, plus interest, such that the payment made under Section [ ](b), when increased by the amount of the payment made to the Executive under this Section [ ](c), or when reduced by the amount of the payment made to the Company under this Section [ ](c), equals the amount that should have properly been paid to the Executive under Section [ ](a). The interest paid to the Company under this Section [ ](c) shall be determined at the rate provided under Section 1274(b)(2)(B) of the Code. The payment made to the Executive shall include such amount of interest as is necessary to satisfy any interest assessment made by the Internal Revenue Service and an additional amount equal to any monetary penalties assessed by the Internal Revenue Service on account of an underpayment of the excise tax. To confirm that the proper amount, if any, was paid to the Executive under this Section [ ], the Executive shall furnish to the Company a copy of each tax return which reflects a liability for an excise tax, at least 20 days before the date on which such return is required to be filed with the Internal Revenue Service. The Company shall have the right to participate in and control any action, suit or proceeding to which the Executive is a party as a result of positions taken on his federal income tax return with respect to his liability for excise taxes under Section 4999 of the Code.



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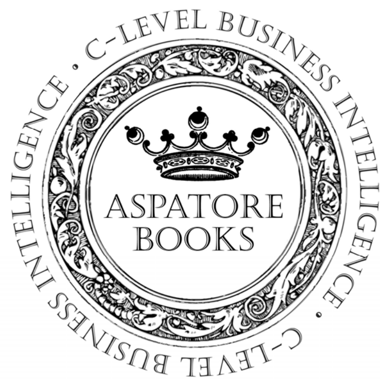
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