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CASH-SETTLED RSUs: SECTION 409A LEADS TO VALUATION DISAGREEMENT

By
John L. Utz
Utz, Miller & Eickman, LLC
jutz@utzmiller.com

How does one value a cash-settled RSU where payment is delayed for six months under the Section 409A rules? Does one use the value of the stock on the date of distribution, following the six month delay? Or is it instead proper to value the stock at the time of the executive's retirement that triggered the payment, ignoring the six month delay?

One employer facing this issue made payment based on the value of the stock on retirement, but soon after doing so thought better of its approach, claiming that it should have used the company's stock value on distribution (following the six month delay). A federal appeals court rejected the employer's attempt to change its mind, letting the executive keep the $540,000 by which the company's stock had dropped during the six months between the executive's retirement and the date of payment. *Graphic Packaging Holding Co. v. Humphrey*, 2010 U.S. App. LEXIS 23718, 50 EBC 1289 (11th Cir. 2010).

The value of a restricted stock unit depends, of course, on the value of the company's stock. This is an obvious and natural conclusion where an RSU is settled in stock. If an RSU is paid in cash, one must determine the date as of which the company's stock will be valued, to know the amount owed to the executive.

Where RSUs are paid as soon as they vest, it is natural to use the vesting date for determining the stock's value, with cash payment made shortly thereafter. Some companies, though, don't make an immediate cash payment upon vesting, instead waiting to make payment until some later date. That later date might be the time of the executive's separation from service, the executive's attainment of a particular age, or a specified date in the future. This delay in payment following vesting has a couple of consequences. One is that the Tax Code Section 409A rules will likely apply, since the failure to pay quickly upon vesting will make unavailable the short-term deferral exception to those rules. The second is that there needs to be some understanding about the date as of which the company's stock will be valued – that is, whether it will be valued upon vesting, upon distribution, or as of some other date.

In the *Graphic Packaging* case, the court rejected the company's claim that it had overpaid its former CEO when it paid the CEO based on the company's stock value on the date of his retirement, rather than on the date of payment. It appears that the company's confusion was a consequence of needing, for the first time, to impose a six month payment delay under the Section 409A rules. The company needed to impose this delay because the CEO was a "specified employee" receiving payment upon his retirement (presumably, a "separation from service" under Section 409A).

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By way of background, the CEO had received a number of RSU awards over the years. By the time the CEO retired, all of his RSUs had vested. Those RSUs were to be paid half in cash and half in company stock. Although the CEO's RSUs were vested by the time of his retirement, the RSU awards provided that vested benefits would not become payable until the expiration of a "mandatory holding period." The mandatory holding period could expire upon any of several different events, one of which was the participant's retirement. But as a specified employee under the 409A rules, the plan's mandatory holding period extended for six additional months beyond the CEO's date of retirement.

The company made payment of roughly $1.2 million for the cash portion of the CEO's RSUs. Again, this was based on the value of the company's stock as of the date of the CEO's retirement. Company representatives had told the CEO in a number of communications prior to payment (and after his retirement) that this was the date that would be used to value the cash-settled RSUs. But shortly after payment was made, the company concluded that it had overpaid the CEO by roughly $540,000, thinking that it should have instead used the price of the stock on the date the six month delay expired (and when payment was made). Importantly, the value of the company's stock had dropped substantially during the intervening six months.

The company demanded repayment of the excess, but the executive demurred. The company then submitted the issue to its Board of Directors' Compensation and Benefits Committee. That committee had responsibility for administering the plan and, under the plan's terms, had the authority to interpret the plan. The committee, like others at the company, concluded that the executive had been overpaid.

The court concluded that the company failed to bear its burden of producing evidence that had paid the wrong amount. Both the omnibus stock plan under which the RSUs were granted and the specific award agreements themselves were silent as to whether the value of the cash-settled RSUs should be determined at the conclusion of the Section 409A six month delay, or instead at another time – for example, at the time of the CEO's retirement. The company argued that under its past practice all RSUs had been paid based on the value of the company's stock on the date the RSUs became payable, regardless of the participant's vesting date. The court noted, though, that there had been no prior instance in which there had been a six month delay in making payment (the CEO was apparently the first specified employee receiving a payment subject to the Section 409A six month delay). This meant that in the past an executive's date of retirement was, in fact, the very date when the RSUs became payable, so there was no mismatch in those dates giving rise to the question at hand. Because the company did not produce evidence that it paid the wrong amount, the court refused to require the CEO to repay any of the amounts he received.

<u>Lessons</u>. If one thinks hard about this result, several conclusions come quickly to mind. The first is that here is another point to add to our 409A drafting checklist – making clear as of what date cash-settled RSUs will be valued where there is a delay in payment due to the Section 409A specified employee rules.

The second conclusion is that the result in the case is kind of curious. The half of the RSUs settled in stock would, of course, have a value that would inevitably move with changes in the company's stock price. So, by the time the cash payment was made for the other half of the RSUs, the value of the CEO's stock-settled RSUs would have dropped to the then value of the company's stock. The result in the case, though, was that the cash portion of the RSUs had a value based on an earlier stock price. So, on the date of payment, the cash-settled half was worth substantially more than the stock-settled half.

Utz, Miller & Eickman, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

www.utzmiller.com

One gets the sense that if the company had initially paid based on the (lower) stock value on the date of payment, the court would have upheld that decision in the face of a challenge by the CEO, particularly if the company had consistently communicated to the CEO that this would be the result. In other words, it didn't seem like either party had evidence that would cause the court to upset the status quo. This leads to a third conclusion: it helps a lot to get a decision right initially. That is because it is easier to defend an interpretation on which action has been taken than to argue for changing the status quo.

Note: This article has been published in the *NASPP Advisor*, a publication of the National Association of Stock Plan Professionals (NASPP).

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Suite 320
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Phone: 913.685.0970
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

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