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COMPENSATION

Stockholder Appraisal Actions Present an Attractive Litigation-Based Strategy for Hedge Fund Managers

By Kara Bingham

The Hedge Fund Law Report

Hedge fund managers have always been keen to retain investment professionals who are successful at delivering alpha, but portfolio managers are only one piece of the puzzle that drives a manager's success. The search for desirable talent is arduous and costly, and management teams intent on building robust asset management firms know that in order to meet legal, regulatory and investor demands, they need to surround themselves with the best and brightest professionals in the business.

Finding talented individuals who perform at a high level and fit well into the adviser's culture is only the first step, as retaining these individuals often requires the manager to employ a variety of methods to dissuade each individual from jumping ship if a more lucrative offer comes his or her way. One tool used by many hedge fund managers to retain key employees is the deferred compensation plan, which, in its simplest form, defers the receipt of a portion of an individual's compensation until a later point in time. See "*Greenwich Associates and Johnson Associates Issue Report on Asset Management Compensation Trends in 2012*" (Dec. 13, 2012).

This two-part series provides an overview of the use of deferred compensation plans in the hedge fund industry, including the different forms these plans can take and certain tax matters to consider. This first article explores the intended goals of these programs and tax consequences associated with pre- and post-tax deferral programs. The second article will examine how commonly these plans are adopted in the hedge fund industry; discuss technical aspects of these plans, such as vesting schedules and forfeiture events; and identify categories of employees who are likely to participate in deferred compensation plans.

For analysis of trends in compensation at hedge fund managers, see "*How Much Are Hedge Fund Manager General Counsels and Chief Compliance Officers Paid?*" (Jul. 24, 2014); and our two-part series on the market for in-house compensation at hedge fund managers: "What Is the Value of Legal and Compliance Staff?" (Mar. 12, 2015); and "Trends in Legal and Compliance Hiring and Staffing" (Mar. 19, 2015).

Evolution of Deferred Compensation Plans

Current Goals of Deferred Compensation Plans

"One of the primary reasons that managers elect to adopt deferred compensation plans is to retain top performers on the investment team and other individuals who are critical to running the firm's daily operations," explained Schulte Roth & Zabel partner Holly Weiss. The theory is that an individual will more seriously weigh employment decisions if he or she is required to forfeit unvested deferred compensation.

Founder and president of Parks Legal Placement, David Claypoole, concurred with Weiss that retention is a key driver. He also observed, however, that in some cases, these plans are not particularly effective at meeting this goal. A future employer is frequently willing to make up the deferred compensation that the employee is leaving, Claypoole explained. "This is especially true if the total amount of deferred compensation is less than half of the total compensation package being offered by the new employer."

"Another fundamental feature of these plans is that they align the employees' interests with the interests of fund investors," noted Kleinberg Kaplan partner Kelly Zelezen.

"This is due to the fact that in many cases, the deferred compensation is tied to the performance of one or more of the manager's private funds."

These plans can also be used to discourage employees from engaging in bad behavior once they have left the firm, Weiss explained. "In order to receive deferred compensation, the terms of the plan often require the individual to be an employee in good standing at the time the deferred compensation vests and is paid. But there is nothing legally prohibiting the manager from agreeing to permit a departing employee to continue to vest and be paid deferred compensation. Managers may offer this in exchange for the individual executing a separation agreement, which will likely include non-compete and non-solicitation provisions," noted Weiss. See "*New York Court Assesses the Validity of a Former Portfolio Manager's Claim Against a Fund Management Company for Unvested Performance Compensation*" (May 7, 2015).

Deferred compensation plans may also be offered as perks to highly compensated employees, explained Sadis & Goldberg tax partner Alex Gelinas. While many employers may elect to apply a vesting schedule to deferred compensation, there is no requirement that they do so. Alternatively, managers may subject a certain amount of deferred compensation to a vesting schedule but otherwise permit individuals to defer additional compensation beyond what is required under the plan, without those amounts being subject to a vesting schedule, noted Claypoole. In either case, the employee is able to defer the receipt of compensation until future periods that may be more advantageous from a tax perspective, while potentially earning a return on compensation that would have otherwise gone to pay taxes on the income, noted Gelinas.

Original Goals of Deferred Compensation Plans

Regardless of whether these plans are currently adopted for corporate objectives or competitive purposes, they were originally developed as tax-planning tools. Prior to the effectiveness of Section 457A of the Internal Revenue Code (Code) in 2009, explained Gelinas, managers sought to obtain significant tax benefits by entering into deferred compensation agreements with their offshore funds that were:

- structured as foreign corporations in a zero-tax jurisdiction (e.g., the Cayman Islands or British Virgin Islands);
- not engaged in a U.S. trade or business; and
- owned almost entirely by foreign persons and/or U.S. tax-exempt investors (collectively, tax-indifferent parties).

The deferred fees owed by these tax-indifferent parties to the investment manager were indexed to the performance of the respective offshore fund; therefore, they grew on a pre-tax basis until the end of the deferral period, which could continue for many years, explained Kleinberg Kaplan tax partner Jim McCann. Twenty-year deferrals were not uncommon.

At the same time that the investment manager deferred fees from tax-indifferent parties, McCann elaborated, the investment manager could elect to award employee compensation on a deferred basis. This benefit was offered not only to key employees, but often to analysts and back-office personnel. By deferring part of an employee's compensation, the individual was also able to obtain pre-tax growth on the amount of compensation that was indexed to the performance of the offshore fund.

By enacting Section 457A of the Code, Congress sought to curb this practice. Generally, Section 457A requires the manager of the offshore fund to report as taxable income the fees derived from providing services to tax-indifferent parties when those amounts are earned and not subject to a substantial risk of forfeiture, explained Gelinas. "Therefore, a deferral agreement for earned fees is not effective to postpone the manager's U.S. income tax on such fees." Following the adoption of Section 457A, managers have had to be more thoughtful about structuring their deferred compensation plans, as they no longer are able to receive the same sort of tax benefits when deferring their own fees or employee compensation.

For more on how Section 457A affected the hedge fund industry, see "*IRS Releases Further Guidance Affecting Offshore Hedge Fund and Other Pooled Investment Vehicle Deferrals*" (Feb. 12, 2009); and "*The End of Deferral As We Know It: The New Rules Prohibiting the Deferral of Compensation Paid to U.S. Managers by Off-Shore Hedge Funds*" (Oct. 28, 2008).

How Hedge Fund Managers Structure Deferred Compensation Plans

"Deferred compensation plans can be structured to defer the compensation of both employees who receive a salary and bonus, as well as individuals admitted as members of the investment manager or its affiliated entities in order to receive a portion of future allocated profits and management fees," explained Weiss.

When individuals participate in deferred compensation plans, a portion of their compensation – typically a percentage of their bonuses – is paid to them at a date after the compensation was earned. The deferred compensation is generally paid out subject to a vesting schedule. One of the key aspects for a manager to consider when structuring a deferred compensation plan is whether compensation will be deferred on a pre- or post-tax basis.

Pre-Tax Deferred Compensation Plans

Structural Elements of Pre-Tax Plans

With a pre-tax plan, the individual is generally not required to pay taxes on compensation until he or she is paid that compensation, explained Weiss. The deferred compensation is often indexed to the performance of one or more of the manager's private funds during the vesting period, meaning that the manager applies the performance of the fund, whether up or down, to the deferred compensation, explained Zelezen. As the gross amount of the deferred compensation is indexed to the performance of the fund, the individual is able to receive pre-tax growth.

While the manager often indexes deferred compensation to the performance of its flagship fund product, noted Zelezen, it may index the compensation to the performance of another fund, or a sub-strategy or carved out portfolio within a fund, particularly where the employee is more involved in or has duties with respect to the fund, strategy or portfolio. In all of these cases, indexing the deferred compensation to the performance of a fund, strategy or portfolio meets the goal of aligning an employee's interests with those of fund investors. When indexing deferred compensation to performance, the manager often elects to invest a corresponding amount directly into the fund in order to hedge its exposure.

Benefits and Disadvantages of Pre-Tax Plans

One of the key benefits to individuals of pre-tax plans is that they can earn pre-tax growth on the deferred compensation, explained McCann. Individuals are also able to defer their taxes to future years.

A benefit to managers of pre-tax structures, noted Zelezen, is that the manager retains control over the deferred compensation. In the event that the employee forfeits his or her right to receive the deferred compensation, the manager can retain the compensation and refuse to pay it out to the employee. This is significantly easier than the manager trying to recover compensation that has already been paid to the employee, as is the case with post-tax plans.

The biggest challenge from a tax perspective with pre-tax plans is that they create a tax mismatch for the investment manager, explained McCann. Generally speaking, salary and bonus payments paid to an employee are tax-deductible expenses for the employer. For these types of deferred compensation plans, explained Gelinas, the general rule is that the employer is not entitled to claim a deduction for the compensation until the time that the employee is required to take into income the deferred compensation (e.g., the year of the scheduled payment date). For managers that follow the accrual basis of accounting, this leads to the manager having a tax liability in the year that the individual earns the deferred compensation, but not taking a corresponding deduction until the year(s) that the employee receives as income the deferred compensation. "There is a cost to employers, therefore, of deferring employee compensation on a pre-tax basis, as the net result of these plans is that they reduce the amount of deductions that the employer would otherwise take in the year in which the compensation was earned," stated Gelinas.

McCann illustrated the tax mismatch issue with the following example. Assume that an investment manager is subject to a 40 percent tax rate and the manager is deferring $1,000,000 of employee compensation. For the year in which the compensation otherwise would have been paid, the manager will have to pay an extra $400,000 in taxes, as it cannot take a deduction for the deferred compensation amount until that amount is paid to the employee. The additional $400,000, therefore, will have to come out of the manager's pocket when it comes time to pay the $1,000,000 of deferred compensation. Typically, this out-of-pocket cost would be recovered through deducting this compensation in the year of the payment.

If the deferred compensation plan calls for the manager to index the deferred compensation amount to the performance of one of the manager's funds in order for the manager to hedge its exposure, the manager now has only $600,000 to invest in the fund.

Furthermore, performance returns earned on the amount invested in the fund may create an additional layer of tax mismatch for the manager, elaborated McCann, as the manager will owe taxes on the returns of the amount invested and will only be able to take a deduction for that amount when it is paid to the employee.

Prior to the enactment of Section 457A of the Code, this mismatch did not exist because managers were deferring fees from their offshore funds that were structured as tax-indifferent parties. Tax-indifferent parties are not subject to U.S. income taxation (except for certain withholding taxes); therefore, they do not need the deduction for the compensation, explained Gelinas.

"One option to minimize the impact of the tax mismatch to the employer is to adjust downwards the amount that the employee actually receives, to try and compensate the company for what it is losing by not being able to take a current deduction," stated Gelinas.

This concept was illustrated by McCann with the following example: assume that an investment manager defers $1,000,000, which earns a 10 percent return. Rather than paying out the full 10 percent return to the plan participants, the terms of the plan may dictate that the manager will only pay out the after-tax return on the deferred amounts. If the manager is subject to a 40 percent tax rate, only $60,000 of the return would be distributed. "This middle-of-the-road approach negates some of the tax benefits to the plan participants. They are no longer receiving pre-tax growth on deferred amounts, but they are still receiving returns on pre-tax amounts," explained McCann.

Post-Tax Deferred Compensation Plans

Investment managers that are not comfortable with the tax mismatch issues associated with pre-tax plans may opt for a post-tax mandatory reinvestment structure. With post-tax plans, the deferred compensation is paid out to the employee and is then generally required to be reinvested in one of the funds by the individual for the duration of the vesting period, explained Weiss. The deferred compensation is taxable to the person at the time it is paid; therefore, the individual is investing after-tax dollars.

Benefits and Disadvantages of Post-Tax Plans

From an economic perspective, post-tax plans are less advantageous to the employee, as the individual is investing after-tax dollars into the fund and thus not receiving the benefits of pre-tax growth, noted McCann. To assist the employee with meeting the tax liabilities associated with the deferred compensation, these plans are typically structured to allow the employee to retain a certain amount of the deferred compensation to cover tax liabilities, explained Weiss. Distributions in future years are generally made to cover tax liabilities associated with those periods.

From the manager's perspective, however, this eliminates the tax mismatch concern identified for pre-tax plans. As the deferred compensation is paid out to the employee, the manager is eligible to take a current deduction on its own taxes, clarified McCann.

Structural and Regulatory Considerations

From a structural perspective, McCann explained, individuals who are required to reinvest their deferred compensation do not generally invest directly into the fund. Rather, the manager typically forms an entity into which the employees invest, and that entity in turn invests in the manager's fund(s). In the event that there is a dispute between the employee and the manager regarding the deferred compensation, managers would not want this conflict to be visible to other fund investors; interposing an entity between the fund and employee can help minimize this risk.

Other considerations include whether the employees, as direct or indirect investors in one of the manager's funds, are subject to the fund's fees and expenses, as well as how the other investment terms, such as restrictions on redemptions, apply to deferred compensation that is invested in the fund.

From a regulatory perspective, the manager will need to consider whether all employees that are required to reinvest deferred compensation in the fund meet the investor eligibility requirements of the fund, noted Zelezen. Investors in private funds relying upon Rule 506(b) of Regulation D to avoid registration under the Securities Act of 1933 and Section 3(c)7 of the Investment Company Act of 1940 to avoid registration as an investment company typically have to meet the "accredited investor" and "qualified purchaser" thresholds. Employees that do not otherwise meet the qualified purchaser criteria may still invest in the fund (or indirectly invest in the fund) if they qualify as "knowledgeable employees." In light of the fact that the SEC took steps in 2014 to broaden the scope of employees that qualify as knowledgeable employees, this is less of a concern than it used to be. See "*SEC Clarifies Scope of the 'Knowledgeable Employee' Exception for Section 3(c)(1) and 3(c)(7) Funds*" (Feb. 28, 2014); and "*Are the General Counsel and Chief Compliance Officer of a Hedge Fund Manager Considered 'Knowledgeable Employees' of the Manager?*" (Sep. 13, 2012).

Choosing Between Pre- and Post-Tax Plans

Assuming that the manager is adopting a deferred compensation plan with the goal of retaining employees, whether to proceed on a pre- or post-tax basis will be a decision of critical importance. Historically, pre-tax programs were more prevalent at hedge fund managers, noted Weiss. "In recent years, however, the industry has trended away from these plans toward post-tax mandatory reinvestment programs."

"In some cases, the post-tax mandatory reinvestment option is cleaner, because the employee pays the tax and there is no mismatch for the employer," explained McCann, "but this option requires more documentation, which can complicate the arrangement." For example, post-tax mandatory reinvestment structures may require the manager to form an entity to invest in one or more of its funds; arrange for employees with deferred compensation to become partners in such entity; and plan for that entity to deliver K-1s to the partners. Additional documentation will also be required to address the right to withdraw money to cover tax liabilities. Whereas, with pre-tax plans, all of the terms can typically be documented in a bonus agreement.

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COMPENSATION

Practical Considerations for Hedge Fund Managers Establishing Deferred Compensation Plans: Vesting Schedules, Deferral Amounts and Compliance With Section 409A (Part Two of Two)

By Kara Bingham

The Hedge Fund Law Report

When designing programs and incentives to attract and retain critical employees, deferred compensation plans warrant thoughtful consideration by hedge fund managers. Individuals who plan to remain with a firm for the long term often welcome these plans as a way to invest a portion of their income on a pre-tax basis and allow it to grow on a tax-deferred basis. Conversely, others who are more junior or fluid in their careers may prefer to receive cash compensation at the time it is earned to ensure sufficient means to address life events or avoid forfeiting a portion of the deferred compensation when joining a new firm.

This two-part series provides an overview of deferred compensation plans in the hedge fund industry and key factors managers should consider when developing these plans. This second article examines how commonly these plans are adopted; discusses technical aspects of these plans, such as vesting schedules and forfeiture events; identifies categories of employees who are likely to participate in these plans; and reviews Section 409A of the Internal Revenue Code (Code) as it relates to the sorts of plans adopted by hedge fund managers. The first article explored the intended goals of these programs and tax consequences associated with pre- and post-tax deferral plans.

For discussion of other methods used by hedge fund managers to incentivize employees, see "*Use by Hedge Fund Managers of Profits Interests and Other Equity Stakes for Incentive Compensation*" (Apr. 18, 2014); "*How Can Hedge Fund Managers Use Profits Interests, Capital Interests, Options and Phantom Income to Incentivize Top Portfolio Management and Other Talent?*" (Aug. 22, 2013); and "*Key Considerations for Hedge Fund Managers in Developing a Succession Plan (Part Two of Two)*" (Feb. 23, 2012).

Key Characteristics of Deferred Compensation Plans

Vesting Schedules

When deferred compensation plans are deployed to retain employees, they will include a vesting period – a length of time that participants must wait before they are entitled to receive the compensation. Vesting schedules generally take one of two forms, noted Schulte Roth & Zabel partner Holly H. Weiss: cliff or graded vesting.

Under a cliff vesting schedule, compensation that is deferred at any one point in time vests all at once at the end of the vesting period, Weiss explained. With graded vesting schedules, portions of the deferred compensation – usually equal portions – vest over a prescribed period. For example, with a three-year graded vesting schedule, one-third may vest and be paid out 12 months after being deferred; another third would vest and be paid out 24 months after being deferred; and the final third would vest and be paid out 36 months after being deferred.

Graded vesting schedules tend to be more common in the hedge fund industry, noted Weiss, but she has also seen cliff vesting.

When it comes to the length of time of the vesting period, Kleinberg Kaplan partner Kelly Zelezen explained that one- to two-year periods are fairly standard in the hedge fund business. David Claypoole, founder and president of Parks Legal Placement, noted that he typically sees three to five years as the norm.

Forfeiture Conditions

Most plans are structured such that to receive the deferred compensation, the individual must be an employee in good standing at the time the deferred compensation vests and is paid, explained Weiss.

Some managers, noted Zelezen, elect to distinguish between a good-leave scenario and a bad-leave scenario. In a good-leave scenario – commonly defined as death, disability or termination without cause – individuals continue to vest in and receive deferred compensation as it is paid, notwithstanding the fact that they are no longer employed by the firm. Conversely, in bad-leave scenarios – generally defined as termination for cause or resignation by the employee – employees forfeit any unvested deferred compensation.

Most plans as written, therefore, state that resignation by the employee will cause the individual to forfeit unvested deferred compensation. Some individuals, however, are successful in negotiating the right to continue to vest and be paid deferred compensation despite his or her resignation. Vesting and payment is usually conditioned on the employee refraining from competing with the employer or engaging in other conduct, such as soliciting investors. These forfeiture-for-competition provisions are readily enforceable under the law by the employer, explained Weiss.

It is also possible to have a forfeiture of vested compensation that has not yet been paid, noted Weiss. "This is more common in the private equity world, however, where compensation vests in accordance with the vesting schedule but is often paid out at a later point in time after the general partner receives its carried interest from the partnership. This is less of a concern in the hedge fund context, as managers (or their affiliates) tend to receive their incentive compensation on an annual basis; therefore, vesting typically occurs at the same time as payment."

While the forfeiture of unvested and unpaid compensation is often referred to as a clawback, Weiss clarified that a true clawback is a contractual right by an employer to recover from an employee compensation that was earned by the employee and vested. This contrasts with forfeiture conditions in the deferred compensation context, which concern the loss of unvested compensation. The distinction is important from a labor law perspective, explained Weiss, as many states, including New York, strictly regulate an employer's ability to claw back compensation once it is earned. Forfeiture of unvested compensation, however, is typically seen as beyond the scope of these rules and consequently less problematic from a legal perspective.

See "*New York Federal District Court, Applying 'Faithless Servant' Doctrine, Allows Morgan Stanley to Recoup Entire Compensation Paid to a Former Hedge Fund Portfolio Manager Who Admitted to Insider Trading*" (Feb. 6, 2014); and our two-part series "*Structuring, Drafting and Enforcement Recommendations for Hedge Fund Managers Considering Employee Compensation Clawbacks": Part One* (Aug. 7, 2013); and *Part Two* (Aug. 15, 2013).

Whose – and How Much – Compensation is Deferred?

Subject to compliance with Section 409A of the Code, managers generally retain wide latitude when designing the mechanics of deferred compensation plans. Aspects to consider include identifying who will participate in the plan; whether the plan will include a threshold as well as a floor; and critically, what portion of an individual's compensation will be deferred.

Identifying Plan Participants

In the hedge fund industry, the practice of deferring a portion of compensation was first applied to investment professionals, noted Claypoole. This is not surprising considering the twin goals of retaining top performers and aligning interests with investors.

"The boom for in-house legal and compliance staff started around 2004," explained Claypoole, "when the SEC first attempted to narrow the 'private adviser' exemption relied upon by many hedge fund managers to avoid registration with the SEC." As the market had not yet developed for what these professionals should be paid, compensation figures were widespread but had one common element: almost all in-house legal and compliance staff received 100% of their compensation in cash.

Since then, the deferral programs that started with investment professionals have expanded to other senior professionals that are crucial for continuity at the firm, such as members of the C-suite, heads of business development and general counsels. While it is certainly possible to draft a deferred compensation plan that would apply to all employees, managers usually reserve these plans for their highest earners.

"I typically see two schools of thought on this issue when managers are deciding which categories of employees should have a portion of their compensation deferred: some managers set a dollar threshold to determine which individuals will have a portion of their compensation deferred, while other managers specify in the plan that it only applies to certain categories of employees that are expected to be highly compensated," explained Zelezen.

Plan Thresholds

When it comes to setting a threshold, the figures are manager specific, vary widely across the industry and can take into account different compensation components. For example, some managers set the threshold and then look at which employees received total compensation over that threshold, noted Zelezen, while others only consider whether the bonus compensation exceeded the threshold. Once the threshold is crossed, the manager can elect to defer a portion of the individual's bonus compensation or an amount of the employee's compensation that exceeds a floor (described below).

Deferral Amounts

Regardless of which approach a manager elects to take, it will need to determine how much of the plan participants' compensation to defer. "For individuals who are swept into deferral programs, on average, I generally see about 25% or 33% of compensation above their base salary subject to the firm's deferral program," explained Zelezen.

With respect to legal and compliance professionals, Claypoole provided specific details from his firm's 2016 compensation survey on the frequency with which individuals in these roles have some portion of their compensation deferred, as well as average amounts of deferrals. A total of 269 individuals – comprising general counsels, assistant general counsels and chief compliance officers – participated in the survey. Compensation figures related to the 2015 calendar year.

"Of the entire sample, 36% had a portion of their compensation deferred," Claypoole reported. The median total compensation figure of survey participants that were not subject to deferral plans was $500,000, while the same statistic for participants that had a portion of their compensation deferred was nearly $700,000.

"The amount of the deferrals ranged from 3% of total compensation, on the low end, to 50% of total compensation, on the high end, with a median of 15% of total compensation being deferred," reported Claypoole. "The top quartile of survey participants had, on average, 21% of their total compensation deferred. From this, we can discern that the highest-paid individuals, on average, have a larger portion of their compensation deferred."

Claypoole noted that the participation of legal and compliance staff in deferred compensation programs appears to be on the rise. "Since 2004, I have seen a steady uptick in the number of legal and compliance professionals working in-house at hedge fund managers that have a portion of their compensation deferred, and I expect this trend to continue," he added.

See our two-part interview with Claypoole on in-house compensation at fund managers: "*How Have Industry Developments Affected the Value of Legal and Compliance Staff?*" (Feb. 2, 2017); and "*Will Industry Deregulation Affect the Value of Legal and Compliance Staff?*" (Feb. 16, 2017).

Deferral Floors

Another consideration is whether the plan includes a floor, noted Weiss. A floor represents an amount of compensation below which the manager cannot defer. "For example, if the firm adopts a plan that has a floor of $500,000, and an individual earns a base salary of $250,000 and a $500,000 bonus, only the portion of the individual's compensation that exceeds the floor is eligible for deferral."

Prevalence of Deferred Compensation Plans in the Hedge Fund Industry

Deferred compensation plans are becoming fairly standard across the hedge fund industry. Even new fund launches with sizeable assets at launch will frequently adopt these plans when setting up their businesses, noted Weiss. Principals launching new funds typically come from large institutions that have implemented their own deferred compensation plans; accordingly, new fund managers are familiar with these structures.

Terms of these plans – such as deferral amounts and vesting schedules – are generally seen as non-negotiable by the manager, particularly in the case of established managers, explained Zelezen. Start-up managers may be more flexible in these negotiations, as prospective employees are taking a risk in joining an unproven venture.

One consideration that arises from time to time, noted Weiss, relates to individuals who have negotiated a guaranteed bonus for their first year of employment at the manager. In these cases, the manager may agree that the guaranteed compensation is not subject to a deferral.

Compliance With Section 409A of the Tax Code

Another aspect that managers need to consider when structuring and documenting deferred compensation plans is compliance with Section 409A of the Code, that regulates nonqualified deferred compensation plans, which generally include the types of pre-tax plans adopted at hedge funds that provide for the deferral of compensation.

Sadis & Goldberg partner Alex Gelinas explained that Section 409A generally governs:

- when the election to defer income must be made;
- when distributions of deferred compensation may be made; and
- the conditions under which the deferral period may be shortened or extended.

This provision of the Code was adopted by Congress in 2004 in response to corporate scandals, such as that involving Enron, where company executives accelerated payments of deferred compensation to receive their compensation prior to the company's bankruptcy. To address this concern, Gelinas explained, Section 409A generally restricts payments of deferred compensation to the agreed-upon payment dates, subject to certain exceptions such as separation from service, death and disability. Accordingly, Section 409A makes it more difficult to accelerate payments of deferred compensation.

If the deferred compensation plan complies with Section 409A, then there is no effect from a tax perspective on the individual for whom the deferral relates. In other words, the compensation is taxed in the same way that it would be taxed if not covered by Section 409A.

Plans that fail to comply with Section 409A, however, have significant consequences for the recipient of the deferred compensation, explained Kleinberg Kaplan partner Jim McCann. "Very generally, if the plan violates Section 409A, all compensation deferred under the plan is subject to tax plus a 20% penalty, even if the compensation has not yet been paid."

The penalties for non-compliance to the individual, therefore, are quite severe, while the employer that established the plan generally avoids negative consequences. While compliance with Section 409A of the Code is of critical importance, noted McCann, the types of plans established by hedge fund managers are generally permitted under the rules and in most cases do not prevent managers from accomplishing their goals.

See "*IRS Issues Guidance on Compliance With Section 409A Requirements Applicable to Deferred Compensation Plans of Hedge Fund Managers*" (Jan. 20, 2010).

Documentation of Deferred Compensation Plans

Documentation of the terms of these plans can take a variety of forms. Post-tax mandatory reinvestment plans are often documented through a supplement to the firm's limited partnership agreement or limited liability company agreement that sets forth the terms of the reinvestment, vesting schedule and forfeiture conditions, explained Weiss. Conversely, the terms of pre-tax plans are frequently documented in a standalone plan document, which would include terms such as vesting schedules, forfeiture conditions and a description of plan participants. For deferred compensation plans governed by standalone plan documents, award letters are typically used to announce the issuance of deferred compensation.

Deferred compensation arrangements can also be set forth in an individual's employment agreement, noted Weiss. When this approach is taken, the terms such as the amount of the deferral, vesting schedule and forfeiture conditions are included within the agreement.

Multi-National Firms

For multi-national firms, designing and implementing a deferred compensation plan presents additional challenges. "It is possible to have a firm-wide deferred compensation plan that seeks to achieve similar goals and incentivize the same kind of behavior across the firm, but there will not be a one-size-fits-all when it comes to the plan documentation," explained Weiss.

The tax regimes in each country where the firm has employees that will participate in the plan will need to be reviewed in light their treatment of deferred compensation. The plan structure and documentation will also need to be adjusted across various offices so as not to run afoul of local law.