

SAMPLE DOCUMENT

INELIGIBLE SECTION 457(f) PLAN

LUMP SUM DEFINED BENEFIT SUPPLEMENTAL INCOME PLAN

Nonqualified defined benefit plan with no reduction in compensation; contributions only from certain tax-exempt employers; also called a SERP (Supplemental Executive Retirement Plan)

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Background Information:

- *This sample nonqualified deferred compensation (“NQDC”) plan is an “ineligible” section 457 plan.*
- *Internal Revenue Code § 457 governs NQDC plans involving an employer that is a state or local government entity or is otherwise tax-exempt. However, such “eligible employers” do not include churches or qualified church-controlled organizations, which are specifically excluded under § 457(e)(13).*
- *A NQDC plan is essentially just an agreement between the Employer and the Executive to defer a portion of the Executive’s compensation until some specified date in the future. However, because these benefits are not treated as separate from the Employer’s general assets, the entire deferred benefit is exposed to the creditors of the Employer. The most that Executive can obtain in terms of security, without triggering constructive receipt and losing the deferral, is to bargain for the Employer to set aside money in a “rabbi trust.” A “rabbi trust” (so-called because the first IRS ruling on such an arrangement related to a congregation’s contributions to a trust for the benefit of their rabbi), may protect an Executive from a situation in which the Employer changes their mind about funding the benefit or undergoes a change of control. However, assets in a rabbi trust are still exposed to the creditors of an Employer.*
- *Section 457 divides such NQDC plans into of two (2) categories: “eligible” or “ineligible.”*
 - *Eligible plans are also called 457(b) plans. They have limits on the maximum amounts that can be contributed (generally matching 401(k) limits), but are taxed under normal timing rules (normally, when paid, rather than when merely vested).*
 - *Ineligible plans are also called 457(f) plans. This is the type of plan in this sample. These plans do not have limits on the maximum amounts that can be contributed, but impose taxation when vesting occurs, even if no payment has yet occurred. Because of that rule, virtually every 457(f) plan – including this sample – pays its benefit in a lump sum when vesting occurs.*
- *Section 457(f) provides, generally, that the deferred compensation under a subject plan will be included in the gross income of a participant or beneficiary in the first taxable year in which there is no “substantial risk of forfeiture” of the rights to the compensation. Section 457(f) provides that*

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such rights are subject to a “substantial risk of forfeiture” so long as they are conditioned upon “the future performance of substantial services.” See I.R.C. § 457(f)(3)(B).

- *Under recently proposed regulations, which may be relied upon until final regulations are adopted, “the determination of whether an amount of compensation is conditioned on the future performance of substantial services is based on the relevant fact and circumstances, such as whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation.” See Prop. Treas. Reg. § 1.457-12(e)(ii). Prior to these proposed regulations, guidance was found in the regulations under Section 83, which provide that any requirement for the performance or nonperformance of services over a period of **less** than twenty-four (24) months is typically **not** regarded as being substantial. See Treas. Reg. § 1.83-3(c)(4), Ex. 1.*
- *This Plan calls for the Executive to receive a lump sum upon his or her continuing to be an employee as of a set target date.*
- *If the Executive dies while working, this Plan calls for a lump sum payment shortly after death.*
- *This NDQC plan generally would be considered to be a “pension plan” under the Employee Retirement Income Security Act of 1974 (ERISA). Nonetheless, because this plan is designed for Executives who qualify as select management or highly paid, and because the plan is unfunded and unsecured (a so-called Top Hat plan), the ERISA requirements are generally few:*
 - *The employer must send an alternative reporting and disclosure statement (a short letter) to the Department of Labor (DOL) within 120 days of creating the plan;*
 - *The plan must contain certain “fiduciary” and “claims procedure” provisions (they are included in Section 8 of this sample document).*
- *If the Employer intends to own a life insurance policy to informally fund the benefits of this plan, the employer and employee generally should satisfy the “notice and consent” requirements of IRC § 101(j) before the policy is issued, in order to avoid income taxation of death benefit.*
- *Although 457(f) plans seem to avoid the nonqualified deferred compensation rules of Internal Revenue Code (IRC) § 409A under its “short term deferral” exception, treasury regulations under that § 409A imply that any amendment to a 457(f) plan should nonetheless obey § 409A rules.*

1. Establishment and Purpose of Plan

1.1 **Establishment and Duration of Plan.** The Board of Directors of [Name of Employer], a [Form of Entity] organized under the laws of [State of Employer] (“Employer”), hereby establishes this defined benefit Supplemental Income Plan of [Name of Employer] and its successors, effective as of the _____ day of _____, 20____. By executing a Participation Agreement, an Executive agrees to the terms of the Plan. The Plan shall continue until terminated by the Board of Directors of the Employer.

1.2 **Purpose of Plan.** The purpose of this defined benefit Supplemental Income Plan is to incentivize the Executive to remain an employee of Employer by providing the Executive with a lump sum payment upon fulfillment of certain conditions, as provided herein.

2. Definitions

2.1 “Beneficiary” means the person or persons who are designated by the Executive, in his or her Participation Agreement, to receive payments under the Plan.

2.2 “Death Benefit” means, with respect to any Executive, a lump sum cash payment equal to \$_____. Nevertheless, if the Executive dies as a result of suicide within [one (1) year] of his or her Entry Date, the amount of the Executive’s Death Benefit shall be zero (0).

Comment: *The Death Benefit is zero if the Executive commits suicide within 1 year of entering into the Plan because, to the extent the Employer purchases a life insurance policy to informally fund the benefits provided by this Plan, the policy’s “suicide clause” will likely prevent it from paying its death benefit if the insured commits suicide within 1 year of policy issuance. It is generally not desirable to give the Employer a legal obligation to pay a death benefit unless death benefits are receivable by the Employer from an insurance policy. The practitioner should make sure that this provision is coordinated with the insurance policy.*

2.3 “Deferred Benefit Amount” means a lump sum cash payment equal to \$_____.

2.4 “Employer” means [Name of Employer], a [Form of Entity] organized under the laws of [State of Employer], or any successor thereto and its subsidiaries.

2.5 “Entry Date” means the effective date as of which an Executive first executes a Participation Agreement under the Plan.

2.6 “Executive” means ___[name of employee participating in this plan]___. Executive is among the Employer’s management and highly paid employees within the meaning of the Employee Retirement Income and Security Act of 1974 (ERISA).

2.7 “Fiscal Year” shall mean the twelve-month period beginning on January 1 of each year.

2.8 “Participation Agreement” means the agreement executed by the Executive upon being admitted to the Plan. The Participation Agreement shall be an integral part of the Plan with respect to the Executive who executes such Participation Agreement.

2.9 “Plan” means this Supplemental Income Plan of the Employer and its successors as described herein as the same may hereafter from time to time be amended.

2.10 “Target Date” means _____, 20___.

3. Payment of Benefits

- 3.1 If the Executive is actively and continuously employed by the Employer on a full-time basis from his or her Entry Date through and until the Target Date, then the Employer will make a lump sum cash payment to the Executive no later than the first day of the calendar month immediately following the Target Date, or thirty-one (31) days after the Target Date. The amount of such lump sum payment shall be equal to the value of the Executive's Deferred Benefit Account. If the Executive dies after the Target Date but before the lump sum payment due has been made, the lump sum payment shall be made to the Executive's Beneficiary.

Comment: *Ineligible 457 Plans – also called 457(f) Plans – impose income tax as soon as the benefits are no longer subject to a substantial risk of forfeiture (viz. upon vesting). Accordingly, this (and virtually any) Ineligible 457 Plan pays the Executive as soon as he or she vests, as opposed to paying a stream of payments. Additionally, the above provision makes it so that the Executive receives no benefits unless he or she remains employed by the Employer until some “target date” sufficiently far out to ensure the performance of “substantial” services. An Executive might find this riskier than he or she likes, so the parties might instead agree to have a vest (and pay) date that is not any further into the future than necessary.*

Comment: *Internal Revenue Code § 409A also allows for payments to be made upon disability, change of ownership or control of the Employer, at a specified time, or upon the occurrence of an unforeseeable emergency. If a plan includes any of these allowable distribution triggers, the plan document should incorporate the specifications set forth in the Internal Revenue Code § 409A and its corresponding regulations.*

- 3.2 If the Executive's employment with the Employer is terminated on account of Executive's death before the Target Date, then the Employer shall make a lump sum payment to the Executive's Beneficiary. The amount of such lump sum payment shall be equal to the Executive's Death Benefit. Such payment shall be made no later than the date that is sixty (60) days after the date of the Executive's death.

Comment: *When the benefit is triggered by the Executive's death, this agreement calls for the payment in a lump sum of a “Death Benefit” amount, expressed as a dollar amount chosen by the parties and put forth in the definitional section at 2.3, above.*

Comment: *If the employer also provides a separate split dollar plan to the Executive through an Employer-owned life insurance policy, this supplemental income plan might want to provide a smaller amount, or no amount, payable at death. This is particularly*

true if the life insurance policy is meant to informally fund the death benefit under this supplemental income plan, as the Employer likely will not want to be obligated to pay total benefits under the two plans that exceed the total death benefit provided by the life insurance policy.

Comment: *To the extent the parties choose to treat this Plan as subject to Internal Revenue Section 409A (foregoing the argument that any Ineligible 457 Plan meets the “short term deferral” exception of 409A) the Employer should generally also make sure that it’s not the case that any taxable benefit owed under this supplemental income plan is being reduced in exchange for the providing of a welfare benefit – which generally includes a split dollar plan – as Treasury Regulation § 1.409A-2(b)(2) states that doing so would be treated as a taxable payment under the deferred compensation plan anyway.*

Comment: *In the event that a NQDC plan fails to satisfy the requirements of § 409A, the Executive sustains a number of adverse consequences, namely: (i) inclusion of the deferred compensation is accelerated into the earliest open year, (ii) a 20% penalty tax is payable, and (iii) penalty interest (an additional 1% over the underpayment rate) is payable. Against this background, a sophisticated Executive is likely to negotiate for some sort of indemnification—especially if the Employer retains broad power to amend the Plan in a manner that could cause a failure. Below is a sample tax indemnity provision.*

[3. **Special Tax Indemnity.** *The Employer shall pay over to Executive an additional amount such that, when such additional amount is taken into account, the net amount retained by the Executive from the payments under this Agreement, after taking into account the Executive’s obligation to pay all taxes attributable thereto under section 4999 of the Code or 409A(a)(1)(B) of the Internal Revenue Code (the “Special Taxes”) and the additional federal and state income taxes attributable to the inclusion of the additional amount itself (together with interest and penalties thereon), shall be equal to what such net amount retained would have been if none of the Special Taxes had been applicable. In calculation the additional amount payable under this subsection (g), the Executive shall be deemed to pay federal and state income taxes at the highest marginal rates.]*

Comment: *While the consequences of a § 409A problem appear to fall almost entirely on the Executive, there are some consequences for the practice that are less obvious, but still very important. Specifically: If and when there is acceleration of the compensation into the earliest open year, the Employer would be regarded as having had a withholding obligation on the entire present value of the stream of payments for that year. Since this withholding would not have occurred, the Service would look to collect this amount — plus interest (and, perhaps, penalties)—from the Employer. The Employer would then be*

left to its remedies to recover the later year withholding that it did pay by filing a Form 941X. However, there are other subtleties having to do with FICA and possible use of IRC § 3121(v)(2) which may also help.

- 3.3 If, at the death of the Executive, there is no properly designated living Beneficiary, or, if the Beneficiary is an entity (e.g., a trust) and such entity is not then in existence, then any payments due under this Plan shall be made to the Executive's estate.
- 3.4 Sections 3.1, 3.2, and 3.3, above, constitute the only conditions under which benefits are payable under the plan

4. Rights and Duties of Executives and Beneficiaries

- 4.1 No Executive or any other person shall have any interest in any fund or in any specific asset or assets of the Employer by reason of this Plan, or for any other reason, or have any right to receive any distributions under the Plan except as and to the extent expressly provided under the Plan. Any person entitled to a payment under the Plan is a general unsecured creditor of the Employer.
- 4.2 Each Executive shall receive an updated copy of the Plan and shall receive copies of any amendments to the Plan within ten (10) days after their adoption.
- 4.3 No right of any Executive or any Beneficiary or any other person to receive payment hereunder shall be subject to alienation, transfer, sale, assignment, pledge, attachment, garnishment, or encumbrance of any kind. Any attempt to alienate, transfer, sell, assign, pledge, attach, or otherwise encumber any such payments whether presently or hereafter payable shall be void. No payment under this Plan shall be subject to debts or liabilities of any Executive or Beneficiary.
- 4.4 Every person receiving or claiming payments under the Plan shall be presumed to be mentally competent until the date on which the Employer receives a written notice in a form and manner acceptable to the Employer that such person is incompetent and that a guardian, conservator or other person legally vested with the interest of his or her estate has been appointed. If guardian or conservator of the estate or any person receiving or claiming payments under the Plan is appointed, payments under this Plan may be made to such guardian or conservator provided that the proper proof of appointment and continuing qualification is furnished in a form and manner acceptable to the Employer. Any payments so made shall be a discharge of any liability of the Employer for such payments.
- 4.5 Each person entitled to receive a payment under this Plan, whether an Executive, Beneficiary, a guardian or otherwise, shall provide the Employer with such information it

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may from time to time deem necessary or in its best interest in administering the Plan. Any such person shall also furnish the Employer with such documents, evidence, data or other information as the Employer may from time to time deem necessary or advisable.

5. Duties of the Plan Administrator

- 5.1 The Plan shall be administered by the Plan Administrator.
- 5.2 The Plan Administrator may from time to time establish rules and regulations for the administration of the Plan and adopt standard forms for such matters as elections, beneficiary designations and applications for benefits, provided such rules and forms are not inconsistent with the provisions of the Plan.
- 5.3 All determinations of the Plan Administrator shall be binding on all parties. In construing or applying the provisions of the Plan, the Employer shall have the right to rely upon a written opinion of legal counsel, which may be independent legal counsel or legal counsel regularly employed by the Employer, whether or not any question or dispute has arisen as to any distribution from the Plan.
- 5.4 The Plan Administrator shall be responsible for maintaining books and records for the Plan.

6. Amendment or Termination

- 6.1 The Employer may not amend, modify, terminate, or discontinue the Plan without the written consent of the Executive.

Comment: Although 457(f) plans (like this sample) seems like it should avoid the application of Internal Revenue Code § 409A due to its “short term deferral” exception – generally referring to plans that vest and pay in the same year – Treasury Regulations imply that such plans are subject to many of the same limits on amending plans that normally apply. Section 409A generally prohibits payments to occur earlier than originally called for in the plan, and permits the postponement of payments only if certain requirements are met (generally, any amendment or election to delay payment must occur at least 1 year before the first payment is scheduled to be made, and the new payment date must be at least 5 years later than that which was originally scheduled). There are exceptions to the rules against accelerating payments, including those under the “termination and liquidation” exception or in the event of an unforeseen financial hardship suffered by the Employee, but only if several technical requirements are met. Interested readers should particularly consult IRC § 409A(a)(2) and (4); Treas. Reg. §§ 1.409A-1(c)(3)(iii), -2(b)(1), and -3(j)(4)(ix)(C).

Comment: *In this sample, the Employer cannot amend the Plan unilaterally. Accordingly, the Executive has less leverage to negotiate an indemnification for any adverse tax consequences resulting from an amendment—given that the Employee had the discretion to reject such amendment.*

7. Not a Contract of Employment

7.1 This Plan is not a contract of employment between the Executive and the Employer. No provision of this Plan restricts the right of the Employer to discharge an Executive or restricts the right of an Executive to terminate his or her employment.

8. Claims Procedure

8.1 If for any reason a claim for benefits under this Plan is denied by the Employer, the Plan Administrator shall deliver to the Claimant a written explanation setting forth the specific reasons for the adverse benefit determination; specific references to the Plan section on which the adverse benefit determination is based; a description of any additional material or information necessary for the Claimant to perfect the claim and an explanation of why such material or information is necessary; and a description of the Plan's review procedure including a statement of the Claimant's rights to bring a civil action under Section 502 of ERISA following an adverse determination on review, all written in a manner calculated to be understood by the Claimant. For this purpose:

- (a) The Claimant's claim shall be deemed filed when presented orally or in writing to the Plan Administrator.
- (b) The Plan Administrator's explanation shall be in writing delivered to the Claimant within 90 days of the date the claim is filed unless the Plan Administrator determines that special circumstances require an extension of time for processing the claim. If such an extension of time for processing is required, written notice of the extension shall be furnished to the Claimant prior to the termination of the initial 90-day period. In no event shall such extension exceed a period of 90 days from the end of such initial period. The extension notice shall indicate the special circumstances requiring an extension of time and the date by which the Plan Administrator expects to render the benefit determination. If the period of time is extended because the Claimant has failed to provide necessary information to decide the claim, the period for making the benefit determination shall be tolled from the date on which the notification of the extension is sent to the Claimant, until the date on which the Claimant provides the information. Failure to provide notice of decision in the time specified is the same as denial of the claim and the Claimant is entitled to require a review of the denial under the review procedures.

- 8.2 The Claimant (or his or her duly authorized representative) shall have 60 days following the receipt of the denial of the claim to file with the Plan Administrator a written request for review of the denial. For such review, Claimant shall have the opportunity to submit written comments, documents, records, and other information relating to the claim for benefits. Claimant shall be provided, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the claim for benefits. The review of the claim shall take into account all comments, documents, records, and other information submitted by the Claimant relating to the claim, without regard to whether such information was submitted or considered in the initial benefit determination.
- 8.3 In the case of a request for review of an adverse benefit determination, the Plan Administrator is designated, solely for purposes of this claims procedure, as the appropriately Named Fiduciary for a full and fair review. On review, the Plan Administrator shall notify the Claimant not later than 60 days after the Company's receipt of the request for review, unless the Plan Administrator determines that special circumstances require an extension of time for processing the claim, in which case a decision shall be rendered as soon as possible, but not later than 120 days after receipt of the request for review. If such an extension of time for review is required because of special circumstances, written notice of the extension shall be furnished to the Claimant prior to the termination of the initial 60-day period. In no event shall any such extension exceed a period of 60 days from the end of the initial period. The extension notice shall indicate the special circumstances requiring an extension of time and the date by which the Plan expects to render the determination on review. If the period of time is extended because the Claimant has failed to provide necessary information to decide the claim, the period for making the benefit determination shall be tolled from the date on which the notification of the extension is sent to the Claimant, until the date on which the Claimant provides the information. The decision on review shall be in writing and in the case of an adverse benefit determination shall include: (i) the specific reason or reasons for the decision; (ii) references to the specific Plan provisions on which the benefit determination is based; (iii) a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records and other information relevant to the Claimant's claim for benefits; and (iv) a statement of the Claimant's right to bring an action under Section 502(a) of ERISA, all written in a manner calculated to be understood by the Claimant. If the decision on review is not furnished within such time, the claim shall be deemed denied on review.
- 8.4 The Secretary of the Employer is hereby designated as the Named Fiduciary and Plan Administrator of this Plan.

9. Construction and Expense

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9.1 **Notices.** Any and all notices required or permitted hereunder shall be in writing and shall be delivered to the individual designated below for the recipient thereof or for such individual's attention during normal business hours to a receptionist or other person available to receive incoming deliveries at the address designated below for such recipient or sent to such recipient via facsimile or electronic mail to the facsimile number/e-mail address designated below for such recipient or by registered or certified mail, return receipt requested and postage prepaid, to the address designated below for such recipient:

To Employer: _____
Address _____

Facsimile: (____) _____
Electronic Mail: _____

To Executive: _____
Address _____

Facsimile: (____) _____
Electronic Mail: _____

Notices delivered as provided above shall be deemed given upon such delivery. Notices sent via facsimile or electronic mail as provided above shall be deemed given upon their successful transmission. Notices mailed as provided above shall be deemed given on the date of their deposit in the United States mail. Any party hereto may change the individual, facsimile number, e-mail address and/or street address to which notices thereto should be given hereunder by giving notice of such change to the other party hereto in accordance with the provisions of this Section.

9.2 **Further Assurance.** Each of the parties hereby agrees to execute and deliver such documents and to take such other actions at any time and from time to time hereafter as may be reasonably requested by the other party to carry out the provisions or purposes of this Plan.

9.3 **Governing Law.** This Plan is being delivered and is intended to be performed in [*Name of State*] and shall be construed and enforced in accordance with the laws of [*Name of State*].

9.4 **Interpretation.** The headings in this Plan are intended for convenience only and shall not affect the meaning or interpretation hereof. In interpreting this Plan, whenever the context so permits, (a) the singular shall include the plural and the plural shall include the singular,

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(b) any gender shall include all genders and (c) the term "including" shall mean "including, without limitation." The word "including" shall mean "including, without limitation," and any exhibit, schedule or other document referred to herein is incorporated in this Plan and made a part hereof.

- 9.5 **Counterparts.** This Plan may be executed in two (2) or more counterparts, each of which shall be deemed an original and all of which together shall constitute one and the same instrument, or with multiple signature pages which may be delivered electronically.
- 9.6 **Expenses.** All expenses of administering the Plan shall be paid by the Employer unless the Plan provides to the contrary.
- 9.7 **Integration.** This Plan constitutes the entire agreement of the parties with respect to the subject matter hereof, and supersedes any and all oral, written or other negotiations, warranties, representations, agreements or other understandings in regard thereto.

[SIGNATURE PAGE FOLLOWS]

SAMPLE DOCUMENT

IN WITNESS WHEREOF, this Plan has been signed, entered into, and executed as of _____,
20____.

EMPLOYER: [NAME OF EMPLOYER]

By: _____
[Print Name]

Title: _____

EXECUTIVE: _____
[Print Name of Executive/Participant]

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PARTICIPATION AGREEMENT
INELIGIBLE SECTION 457 PLAN
LUMP SUM DEFINED BENEFIT SUPPLEMENTAL INCOME PLAN

As provided in the above referenced Plan dated _____, 20____, you, [Name of Executive/Participant], are hereby invited to participate. By accepting this invitation, you acknowledge that you have read the Plan, understand its terms, understand that benefits will be paid pursuant to the Plan only under the specific circumstances described therein, understand that you are a general unsecured creditor of [Name of Employer], and that you have no interest in specific assets owned by [Name of Employer].

Today's date is _____, 20_____.

[NAME OF EMPLOYER]

By: _____
[Signature Above; Print Name Here]

Title: _____

I hereby accept the invitation of [Name of Employer] to participate in its Lump Sum Defined Benefit Supplemental Income Plan upon the terms and conditions set forth therein and in this Participation Agreement.

[Signature of Executive/Participant Above; Print Name Here]

For purposes of the plan, I hereby designate the following Beneficiary or Beneficiaries (if none named, the beneficiary will be the personal representative of my estate):

_____ Date of Birth: _____
(Beneficiary)

If the above-named beneficiary is not alive when payments are first due to be made under the Plan, I hereby designate the following Beneficiary or Beneficiaries:

_____ Date of Birth: _____
(Contingent Beneficiary)

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