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together

M&A Basics:
Executive Compensation Issues

Webinar 1 of 3

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Agenda

- M&A 101
- Change in Control Arrangements
- Dealing with Section 409A
- Say on Golden Parachutes Vote
- Golden Parachutes Under Section 280G
- Going Private Transactions – Management Representations

M&A 101

Types of Transactions

- Preliminary considerations
  - Context and motivation for the transaction
  - Profile of the parties potentially involved
  - Consideration to be paid
- Structure/types of transactions
  - Stock Purchase
  - Merger
  - Asset Purchase
  - Joint Venture and Merger of Equals

Process and Inflection Points

- Initial involvement
  - Identification of opportunity
  - Initial information sharing
  - Non-disclosure agreements
  - Management presentations
- Seller's evaluation of target company employees and contemplated transaction
- Buyer's due diligence investigations
- Negotiation of transaction documents
- Signing and announcement of transaction
- Closing and integration

Seller's Evaluation of Target Company/Employees

- Need for transaction-specific confidentiality agreements
- Potential upcoming expiration/renewal dates
- Transaction impact on any existing employee obligations
  - Change in control agreements
  - Acceleration of equity or other rights
  - Structure of 401(k) plan
- Potential transition service needs/requests
- Consideration of transaction bonus plans or agreements
  - Structure – parties; plan vs. agreement; payment mechanics
  - Disclosure to Buyer
- Potential 280G and 409A issues

Buyer's Due Diligence Investigation

- Identification of key issues and risks with the employee benefits profile of the target entity
- Detailed review of employee benefit plans and employment related obligations
- Special attention paid to:
  - Employment agreements
  - Post-employment obligations
  - Change-in-control/bonus arrangements
  - Collective bargaining agreements
  - Multiemployer obligations

Transaction Documentation

- Definitive transaction agreement (i.e., Purchase Agreement)
  - Consideration provisions
    - *Cash vs. Buyer equity*
    - *Cash-out/rollover of existing equity awards*
    - *Treatment of transaction bonuses*
  - Representations/warranties
    - *Risk allocation and disclosure*
    - *Closing conditions*
    - *Indemnification*

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Transaction Documentation (cont.)

- Definitive transaction agreement (cont.)
  - Covenants
    - *Pre-closing information sharing/communications with regard to employees*
    - *Buyer treatment of target company plans*
    - *Buyer obligations for replication/continuity of seller/target company employee/plan obligations*
    - *Buyer hiring of employees*
- Ancillary documentation and agreements
  - Employment Agreements
  - Equity Agreements
  - Employee Releases
  - Noncompete Agreements
  - Transaction Bonus Agreements

Change in Control Arrangements

Purpose of Change in Control Agreements

- Goal is to balance the legitimate interests of both the executive and the employer
  - Executive needs to be sure that there is some level of protection against a successor employer terminating the relationship or otherwise materially changing the business deal
  - Employer needs to be sure that the change in control provisions don't negatively impact its ability to effectuate a change in control at an appropriate price

Triggering Events

- Single Trigger
  - Equity vesting upon the occurrence of the change in control
  - Payment of a bonus on a change in control
- Double Trigger
  - Executive will only receive change in control benefits upon a qualifying termination in connection with or within a specified period following the change in control

Arrangements Addressing Change in Control Benefits

- Severance Plans and Agreements
  - Enhanced severance
  - Severance often paid in lump sum
  - All or part of equity accelerated
- Retention Agreements
  - Continued employment to date of change in control or specified date following change in control
- Bonus Plans
  - Payout at target or measure performance on date of change in control
  - Transaction bonus pool
- Deferred Compensation Plans
  - Accelerated vesting or payout
  - Additional service credit under executive retirement plans
- Equity Compensation Plans
  - Single-trigger or double-trigger vesting
  - Assumption or cash-out of equity awards
  - Earnout

Dealing with Section 409A

Section 409A – The Basics

- Fairly recent section of IRC provides strict rules for deferral and payment of “deferred compensation” outside of rank-and-file tax-qualified plans (like 401(k) plans) and “cafeteria” plans
- Very broad applicability:
  - Executive deferred compensation arrangements and SERPs
  - Some equity awards
  - Some severance arrangements
  - Some expense reimbursement arrangements and gross-up rights
  - Some annual bonus arrangements

Section 409A – The Basics (cont.)

- Sectio 409A issues in transactions:
  - Do the target's deferred compensation arrangements comply?
  - What changes to arrangements subject to Section 409A do the parties want to make in connection with the transaction, and can the proposed changes be made in a way that complies with Section 409A?

Section 409A – Compliance of Existing Arrangements

- Equity plans
  - Determining whether “stock rights” are exempt from Section 409A is key in private company transactions (especially if stock rights will be assumed)
  - Stock rights are options and stock appreciation rights
  - Exercise price must be at least stock’s fair market value at grant date
  - Stock rights must be granted on “service recipient stock”
    - *Common stock of the company that employs the grantee or a parent company*
  - RSUs and phantom stock awards must have Section 409A–compliant payment terms, or must meet an exemption from Section 409A
  - Can equity grants be terminated/cashed out under Section 409A?

Section 409A – Compliance of Existing Arrangements (cont.)

- Severance Plans/Employment Agreements
  - Review payment provisions
    - *Look out for differing forms of payment (installments before change in control and lump sum after change in control)*
  - Good reason trigger
    - *Look out for weak "good reason" definitions and walk rights*
  - Six-month delay for "specified employees" in public companies
  - Release timing issues

Section 409A – Amounts Payable on or Following a Change in Control

- Amounts subject to Section 409A can only be paid on a change in control if the change in control meets the requirements of a 409A-compliant change in control
  - Requires change in control of employer (or payor) corporation or any corporation up the chain linked by majority ownership – note distinction from Section 280G, which looks to the entire controlled group in determining whether a change in control has occurred
    - *Change in ownership – acquisition of more than 50%*
    - *Change in effective control – acquisition of 30% or more or turnover of a majority of the board of directors within 12 months*
    - *Change in ownership of a substantial portion of assets – more than 40% within 12 months*
  - Note that spinoffs and IPOs typically do not satisfy the requirements for a change in control
- Does time or form of payment vary after a change in control?

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Section 409A – Separation from Service

- Amounts subject to Section 409A can only be paid on an employment termination or reduction in service level that meets the definition of “separation from service”:
  - Generally requires substantial, permanent reduction in service level with direct employer and its controlled group
  - In stock sale, there is continuity of employment with direct employer, and generally no separation from service (even though there may be a change in control)
  - In asset sale transactions, default is that there would be a separation from service for transferring employees
    - *Parties may agree to not treat as separation from service, but must be consistent*

Section 409A – Amounts Subject to Earn-Out

- Earn-out Consideration
  - Earn-out consideration will be subject to Section 409A if not payable within the short-term deferral period
  - Short-term deferral period is generally payment within 2-1/2 months after the year in which the compensation vests

Section 409A – Amounts Subject to Earn-Out (cont.)

- Earn-out will satisfy Section 409A if:
  - Earn-out is paid on the same schedule and under the same terms and conditions as apply to the shareholder payments, and must be paid within five years after the change in control, or
  - Earn-out constitutes a substantial risk of forfeiture and is payable upon the same terms and conditions as apply to the payments made to the shareholders
    - in such event the legally binding right to the earn-out is treated for purposes of the short-term deferral exception as arising on the date it became subject to the substantial risk of forfeiture

Section 409A – Extension of Vesting

- Extension of vesting of awards or other compensation that otherwise would vest on the change in control:
  - Extended vesting condition must constitute a substantial risk of forfeiture
  - Extension must occur before and in connection with the change in control

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Section 409A – Plan Termination

- Change in control plan termination
  - Regulations provide special opportunities to terminate Section 409A arrangements pursuant to a change in control
  - Must terminate all plans of the same type for all participants experiencing a change in control
  - Note plan aggregation categories
  - Termination must occur within 30 days before or within 12 months following a change in control
  - All payments must be made within 12 months following the date of the action to terminate

Section 409A – Noncompliance

- Correct before year of vesting
- IRS correction programs
- Seller special indemnity?

Say on Golden Parachutes Vote

Say on Golden Parachutes

- “Say on golden parachute” provisions apply where:
  - Seeking shareholder approval of an acquisition, merger, consolidation, or proposed sale or disposition of all or substantially all of a public company’s assets
  - Disclosure also required in connection with going-private transactions and third-party tender offers
- Requirements:
  - Disclosure
  - Nonbinding shareholder advisory vote

Say on Golden Parachutes (cont.)

- A separate shareholder advisory vote is not required on golden parachute compensation if disclosure of that compensation was included in the executive compensation disclosure subject to a prior advisory vote of the shareholders (say on pay)
  - Rare that previous say on pay disclosure is sufficient for this purpose
- Companies are not required to use any specific language or form resolution for the say on golden parachute vote

Say on Golden Parachutes (cont.)

- Disclosure requirements:
  - Disclosure must be in a “clear and simple form in accordance with the regulations” and must include “the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of [named executive officers].”
  - Disclosure of the “golden parachute” arrangements required for all agreements and understandings that the acquiring and target companies have with named executive officers of both companies.
  - Rules require a narrative and a table for disclosing “golden parachute” compensation.

Say on Golden Parachutes (cont.)

Golden Parachute Compensation

Name (a)	Cash ($) (b)	Equity ($) (c)	Pension/ NQDC ($) (d)	Perquisites/ Benefits ($) (e)	Tax Reim burse ment ($) (f)	Other ($) (g)	Total ($) (h)
PEO							
PFO							
A							
B							
C							

Elements that are separately quantified and included in the total are any cash severance payments (e.g., base salary, bonus, and pro-rated non-equity incentive compensation plan payments) (column (b)); the dollar value of accelerated stock awards, in-the-money option awards for which vesting would be accelerated, and payments in cancellation of stock and option awards (column (c)); pension and nonqualified deferred compensation benefit enhancements (column (d)); perquisites and other personal benefits and health and welfare benefits (column (e)); and tax reimbursements (e.g., Internal Revenue Code Section 280G tax gross-ups) (column (f)). The "Other" column of the table includes any additional elements of compensation not specifically includable in the other columns of the table (column (g)). The table requires footnote identification of each separate form of compensation that is reported in the aggregate. The table also requires separate footnote identification of amounts attributable to "single-trigger" arrangements and amounts attributable to "double-trigger" arrangements, so that shareholders can readily discern these amounts.

Golden Parachutes Under Section 280G

The “Golden-Parachute” Tax

- 20% excise tax on the employee/independent contractor
- Loss of tax deduction to employer – could be buyer
- Imposed by IRC Sections 280G and 4999 on “excess parachute payments”

The “Golden-Parachute” Tax (cont.)

- Parachute payments:
  - Payments “in the nature of compensation”
  - Made to certain “disqualified individuals”
    - *Company service provider who is an officer, 1% or more shareholder, or “highly compensated employee” (highest-paid 1%, not to exceed 250 employees)*
  - “Contingent” on a “change in control” (i.e., change in the ownership or control of a corporation or in the ownership of a substantial portion of its assets)

The Golden Parachute Tax – Calculation of the Excise Tax

- If an executive receives parachute payments on a change in control that equal or exceed three times the executive's "base amount," then
  - A 20% excise tax on all amounts in excess of one times the executive's "base amount," except to the extent those payments represent reasonable compensation
  - Base amount is the executive's average annual W-2 compensation for the most recent five calendar years (or period worked, if less) ending before the change in control

The Golden Parachute Tax – Impact of the Excise Tax

- Executives care because they could owe a 20% excise tax
- Corporations care because parachute payments are not deductible, and corporations are required to report parachute payments on Form W-2 and withhold taxes correctly
- If a corporation fails to withhold and an executive does not pay, the government may try to collect the tax from the corporation

The Golden Parachute Tax – Exemptions

- Payments made by privately held companies when shareholder approval requirements are met
  - Payments must be approved by more than 75% of the disinterested shareholders entitled to vote immediately before the change in control
  - "Adequate disclosure" of all material facts regarding all material payments that otherwise would be parachute payments is provided to ALL persons entitled to vote
  - Payments must be contingent on the vote
    - *"Waiver" of legal right to payments generally sought*

The Golden Parachute Tax – Contingent on a Change in Control

- When is a payment “contingent on a change in control”?
  - Payment would not have been made absent the change in control
  - If it is substantially certain at the time of the change in control that a payment would be made regardless of whether a change in control occurs, it is not contingent on a change in control
  - A payment made as a result of an event that occurs within one year before or after a change in control is presumed to be contingent on a change in control, but the presumption is rebuttable

The Golden Parachute Tax – Transactions That Trigger Parachute Payments

- What is a change in control under Section 280G?
  - Change in the ownership of a corporation
    - *Acquisition of more than 50% of the vote or value*
  - Change in the effective control of a corporation
    - *Presumption upon acquisition of more than 20% of the voting power or replacement of a majority of directors during a 12-month period, which presumption may be rebutted*
  - Transfer of a substantial portion of assets
    - *Assets with a value of at least one-third of the value of all assets, determined without regard to any liabilities*
  - Determined on a controlled group basis
    - *Acquisition of subsidiary won't trigger a Section 280G change in control for its employees, unless the value of the subsidiary meets or exceeds the one-third threshold for entire corporate group*

The Golden Parachute Tax – Parachute Payments

- What is a parachute payment?
  - Payment in the nature of compensation, such as
    - *Transaction bonus*
    - *Cash severance*
    - *Continued health and welfare benefits*
    - *Outplacement services*
    - *Option and restricted stock vesting*
    - *Accelerated payment of deferred compensation*
    - *Added years of service or compensation under SERP*

The Golden Parachute Tax – “Reasonable Compensation” After a Change in Control

- Restrictive covenants
  - Compensation paid for a noncompete covenant may be considered reasonable compensation for services rendered after a change in control
  - Enforceability of a noncompete covenant is required
  - The IRS has opposed excessive values attributable to reasonable compensation, especially where noncompetes are adopted shortly before a change in control

The Golden Parachute Tax – Strategies to Avoid Excise Taxes

- “Gross-up” provision for excise taxes
  - Most companies no longer provide gross-ups
- “Best-net” provision for parachute payments
  - Reduce payments to avoid excise tax if it puts an executive in a better net-tax position
  - If paying excess parachute payments is better for the executive, the company loses the deduction
- Parachute cap

The Golden Parachute Tax – Strategies to Avoid Excise Taxes (cont.)

- Increase the executive's "base amount"
- Attach a valid, enforceable noncompete to parachute payments (but note the audit risk previously discussed)
- Waiver and shareholder approval for private company

Going Private Transactions – Management Representations

Equity Considerations – Existing Equity

- Existing Equity
  - Consequence of Change of Control
  - Rollover
  - Invested

Equity – Incentive Equity

- Incentive Equity
  - Type
    - *Stock options*
    - *Restricted stock*
    - *Profits interest*
  - Pool
  - Initial allocation
  - Hold back
  - Forfeitures
  - Eligible employees

Equity – Incentive Equity (cont.)

- Terms
  - Vesting schedule
    - *Time-based*
    - *Performance-based*
  - Acceleration triggers
    - *IPO*
    - *Change in control*
  - Consequence of employment termination
  - Restrictive covenants
  - Other terms – depends on type of equity

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Equity – Rights as a Shareholder

- Shareholder terms
  - Tag-along rights
  - Drag-along provisions
  - Registration rights
  - Call rights/put rights
    - *Determination of Fair Market Value*

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Other Considerations

- Employment agreement
- 409A considerations for existing arrangements
- 280G implications
- Other entitlements

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Join us for the next webinar in our M&A Basics series:

Pension, Savings, and Welfare Plan Issues

February 4, 2015 | 12–1 pm ET

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February 26, 2015 | 12–1 pm ET

Register at https://morganlewis.webex.com/

Questions?

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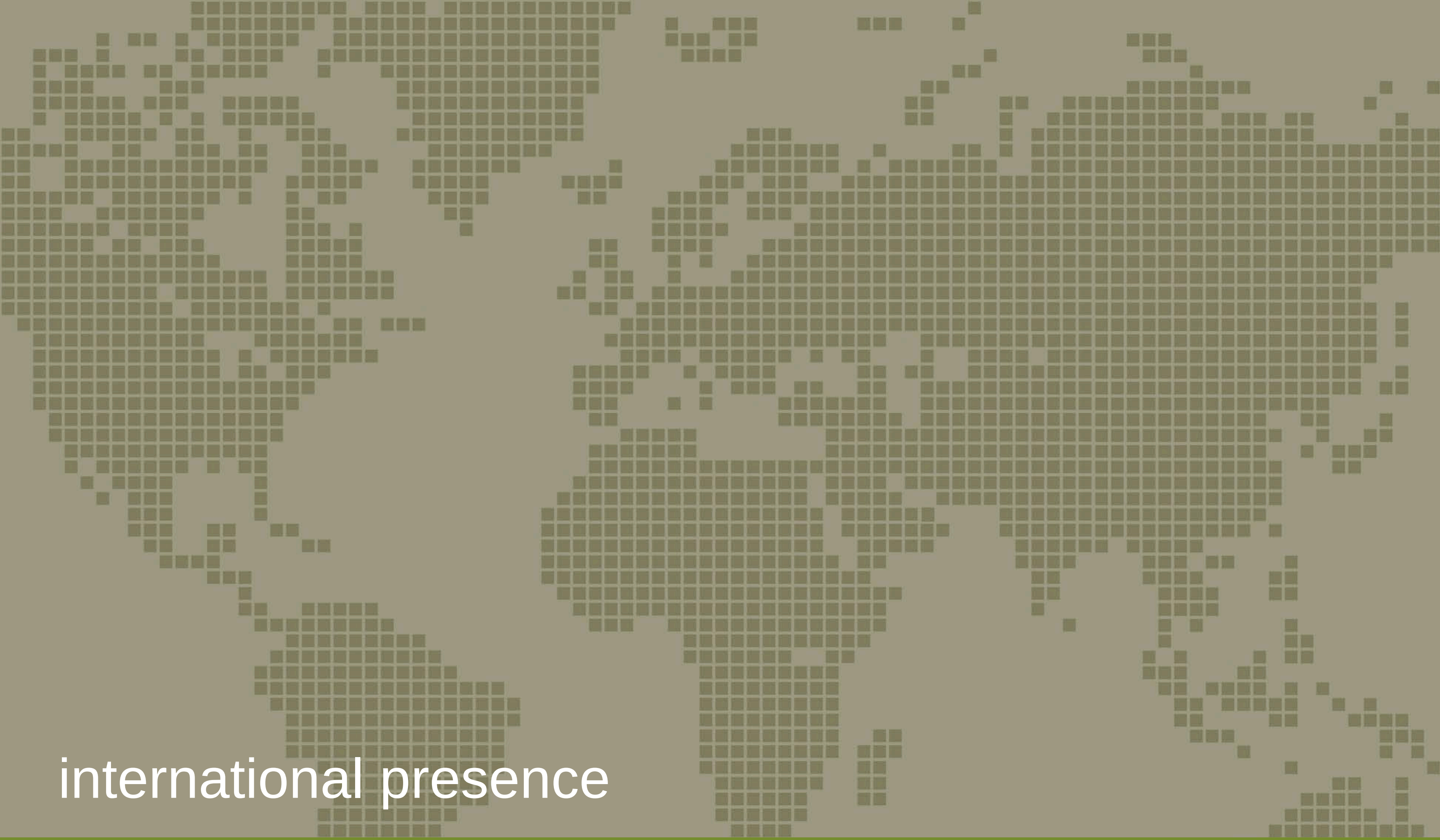

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