

The background of the slide is a photograph of a chessboard. A vertical line down the center of the board divides the image into two halves. The left half is in grayscale, while the right half is in color. Chess pieces are visible on the board, including a king, queen, and knight on the right side, and several pawns on the left side.

Morgan Lewis

# **M&A ACADEMY EXECUTIVE COMPENSATION AND EMPLOYEE BENEFIT PLAN ISSUES IN M&A TRANSACTIONS**

Presenters: Colby Smith and David Zelikoff  
February 14, 2017

# General Introduction

- Why focus on executive compensation and employee benefit plan issues in M&A transactions?
- Agenda
  - Executive compensation and employee benefit issues in a M&A transaction
  - M&A focus on Sections 409A and 280G of the Internal Revenue Code (the “Code”)
  - Unique issues in asset transactions
  - Specific considerations in change-in-control arrangements

# Background Considerations to Keep in Mind as EC/EB Issues Arise

- Context and motivation for the transaction; for example:
  - Auction vs. exclusive negotiations
  - Carve-out divestiture
  - Timing issues (i.e., year-end tax planning)
  - Simultaneous sign/close vs. signing with delayed closing
  - Profile of the parties potentially involved (private vs. public entities, private equity or VC backed companies vs. strategic parties)
  - Form of deal consideration (cash vs. buyer stock)
- Structure of transaction
  - Stock purchase
  - Merger
  - Asset purchase
  - Joint venture

# **EC/EB ISSUES AS PRESENTED WITHIN THE CHRONOLOGY OF A TRANSACTION**

# **Seller's Self-Evaluation of Impact of Transaction on Employees and Benefit Plans**

- Inventory of benefit plans/agreements and impacted employees
- Transaction's impact on existing employee obligations; for example:
  - Change-in-control agreements
  - Equity
  - Pension and health and welfare plans
- Upcoming expiration/renewal
- Change-in-control plans or agreements
  - Existing vs. new
  - When to put in place
  - Disclosure to buyer
- Identify potential Sections 280G and 409A of the Code issues
- Structural issues (e.g., anti-assignment provisions in employment agreements)

# Preliminary Agreements

- Transaction-based Non-Disclosure Agreement
  - Often contains employee related non-solicitation/no-hire covenants
  - Process-related restrictions (e.g., no direct contact by buyer to target employees)
- Term sheet / Letter of Intent
  - Perhaps address any significant EB/EC issues that should be agreed upon at the outset; for example:
    - Conditioning deal on key employee agreements
    - Collective bargaining obligations/Pension plan liabilities
  - Perhaps address “rules of the road” for any employment-related due diligence (e.g., employee names and salary information)
- Consider need for transaction-specific confidentiality agreements with target company or buyer employees

# 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:
  - Equity rights
  - Single trigger/double trigger
  - Employment agreements/change-in-control agreements
  - Severance and post-employment obligations
  - Bonus/retention arrangements
  - Collective bargaining agreements
  - Pension plan liabilities
  - Historic plan non-compliance
  - Documentation gaps

# Transaction Documentation

- Definitive transaction agreement (i.e., Purchase Agreement)
  - Consideration provisions
    - Cash vs. equity
    - Cash-out/rollover of existing equity awards
    - Treatment of transaction/retention bonuses
    - Severance
  - Representations/warranties
    - Purposes of EC/EB reps/warranties
      - Disclosure and risk allocation
      - Closing condition
      - Indemnification
    - Examples of heavily negotiated reps/warranties
      - Scope of disclosure
      - Responsibility of historic noncompliance with law and plan documentation
      - Materiality vs. knowledge vs. absolute

# Transaction Documentation (cont.)

- Definitive transaction agreement (cont.)
  - Covenants
    - Continuation of benefits
      - Comparable benefits
      - Crediting of service
      - Eligibility to participate in buyer plans/mirror plans
    - Pension plans
      - Termination vs. assumption
    - Health and welfare plans
      - COBRA obligations
    - Buyer hiring of employees
      - Stock deal vs. asset deal
  - Indemnification obligations (private company transaction)
  - Closing conditions (private company transaction)
    - Employment agreements
    - Waivers and releases
    - “Bring-down” standard

# Transaction Documentation (cont.)

- Ancillary Agreements
  - Employment Agreements
  - Equity Agreements
  - Noncompete Agreements
  - Transaction Bonus Agreements
  - Retention Agreements

# **SECTION 409A OF THE CODE**

# Section 409A – The Basics

- Section of the Code that generally applies to any arrangement that provides for compensation to be earned in one tax year, but not paid until a subsequent tax year
- Very broad applicability:
  - Executive deferred compensation arrangements and SERPs
  - Certain equity awards
  - Severance arrangements
  - Annual bonus arrangements
- Failure to comply with requirements results in
  - Immediate taxation
  - 20% penalty tax
  - Interest penalty

## Section 409A – The Basics (cont.)

- Section 409A of the Code issues in transactions:
  - Equity grants
  - Earn-outs
  - Severance plans/employment agreements
  - Payment on a change-in-control

# Section 409A – Equity

- Equity grants
  - Determining whether “stock rights” are exempt from Section 409A of the Code is key in private company transactions (especially if options and/or stock appreciation rights will be assumed)
  - 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 of such employing entity
  - RSUs and phantom stock awards must have Section 409A of the Code compliant payment terms or meet an exemption from Section 409A of the Code

## Section 409A – Earn Outs

- Earn out consideration will be subject to Section 409A if not payable within the short-term deferral period (generally payment within 2-1/2 months after the year in which the compensation vests.)
- Earn out will comply with Section 409A if:
  - Paid on the same schedule and under the same terms and conditions as apply to the shareholder payments, and
  - Paid within five years after the change-in-control

## Section 409A – Severance

- Severance plans/employment agreements
  - Review payment provisions
    - Look for differing forms of payment (installments before change-in-control and lump sum after change-in-control)
  - Good reason trigger
    - Look for weak “good reason” definitions and walk rights
  - Six-month delay for “specified employees” in public companies
  - Release timing issues

## Section 409A – Change-in-Control Payments

- Payment on a 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
  - Irrevocable action to terminate 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 280G OF THE CODE**

## Section 280G – The Basics

- Code provision that applies to payments in the nature of “compensation” that are “contingent” on a “change-in-control” paid to a “disqualified individual”
  - 20% excise tax on the “excess parachute payment”
  - Loss of tax deduction to the employer

## Section 280G – Key Terms

- “Compensation”
- “Disqualified individuals”
  - Officer (no more than 50 employees, or, if less, the greater of 3 employees or 10% of the employees),
  - More than 1% shareholder, or
  - “highly compensated employee” (highest-paid 1%, not to exceed 250 employees)
- “Contingent” on a “change-in-control”
  - Payment would not have been made absent the change-in-control
  - Arrangement entered into within one year prior to a change-in-control is presumed to be contingent on a change-in-control

## Section 280G – Calculation of the Excise Tax

- “Excess parachute payment”
  - If a disqualified individual receives payments on a change-in-control that equal, or exceed, three times such individual’s “base amount,” then
  - A 20% excise tax on all amounts in excess of one times the disqualified individual’s “base amount”
  - Base amount is the disqualified individual’s average annual W-2 compensation for the most recent five calendar years (or period worked, if less) ending in the calendar year prior to the year in which the change-in-control occurs

## Section 280G – 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
- Section 280G of the Code does not apply to Subchapter S corporations

# **UNIQUE ISSUES IN ASSET TRANSACTIONS**

# Asset Transactions

- Employment
  - Termination of employment by seller and rehire by buyer
  - “Assignment” of contracts, including employment agreements
  - Hiring by buyer may trigger buyer’s traditional new-hire obligations (e.g., background testing, signature of new hire packet)
- Liabilities
  - Often all pre-closing liabilities (including employment-related liabilities) are retained by seller
- Target company benefit plans
  - 401(k) plans
  - Multi-employer plans
  - Defined benefit pension plans
  - Health and welfare plans

# **CHANGE-IN-CONTROL ARRANGEMENTS**

# Triggering Events

- Single Trigger
  - Equity vesting upon the occurrence of the change-in-control
  - Payment of a bonus on the 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
- Equity Compensation Plans
  - Single-trigger or double-trigger vesting
  - Assumption or cashout of equity awards
  - Earnout
- 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
- Rabbi Trust

# Morgan Lewis



# QUESTIONS?

# Biography



## **Colby W. Smith**

Philadelphia

T +1.215.963.5496

[colby.smith@morganlewis.com](mailto:colby.smith@morganlewis.com)

Colby W. Smith counsels clients in business law matters, with an emphasis on public and private merger and acquisition transactions and securities offerings. He represents buyers and sellers in carve-out transactions, and helps clients understand and resolve the unique issues presented in those transactions. He also focuses on counseling public and private Pennsylvania companies on corporate governance and transactional matters. Colby represents clients in a variety of industries, including technology, healthcare, manufacturing, aerospace and defense, and consumer products.



## **David B. Zelikoff**

Philadelphia

T +1.215.963.5360

[david.zelikoff@morganlewis.com](mailto:david.zelikoff@morganlewis.com)

David B. Zelikoff represents and counsels clients in a range of matters related to employee benefit plans and executive compensation agreements. He advises on the design and implementation of tax-qualified, nonqualified deferred compensation, equity compensation, and health and welfare plans, and he helps clients draft and negotiate executive employment agreements, severance arrangements, and change-in-control arrangements. David's clients include tax-exempt organizations, and public/private Fortune 500 and emerging growth companies in the technology and life sciences fields.

## Our Global Reach

Africa  
Asia Pacific  
Europe  
Latin America  
Middle East  
North America

## Our Locations

Almaty	Dallas	Los Angeles	Philadelphia	Silicon Valley
Astana	Dubai	Miami	Pittsburgh	Singapore
Beijing	Frankfurt	Moscow	Princeton	Tokyo
Boston	Hartford	New York	San Francisco	Washington, DC
Brussels	Houston	Orange County	Santa Monica	Wilmington
Chicago	London	Paris	Shanghai	



**Morgan Lewis**

# THANK YOU

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. Attorney Advertising.

© 2016 Morgan, Lewis & Bockius LLP

**Morgan Lewis**