

The background of the slide is a dark green with various financial market data. It includes candlestick charts, line graphs, and bar charts. Currency codes such as ITL, DEM, BEF, FRF, MLG, RUS, JPY, EUR, CHF, GBR, SEK, CAD, RMY, and DTR are visible, along with their respective values and percentage changes. A large, stylized green arrow points from the left towards the right, passing behind the main title.

Morgan Lewis

GLOBAL PUBLIC COMPANY ACADEMY

PREPARING FOR A CHANGE IN CONTROL

PLANS AND AGREEMENTS AFFECTED BY A CHANGE IN CONTROL

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Overview

- Importance of planning ahead for potential change in control transactions
- Say-on-Golden-Parachute shareholder vote
- Conduct self-audit of all change in control arrangements
- Review change in control issues to be addressed and solutions
- Effect of change in control on third party contracts
- Disclosure and communications considerations

Importance of Planning Ahead for Potential Change in Control Transactions

- Planning is key
- Identify goals, strategy, and potential issues
- Tough to implement changes after transaction has started
- Don't create surprise diligence issues
- Strive for clarity and not uncertainty
- Considerations apply to compensation arrangements as well as commercial and contractual

Conduct Self-Audit of All Change in Control Arrangements

- Identify change in control arrangements
- Review change in control definitions
- Change in control planning considerations

Identify Change in Control Arrangements

- Executive severance agreements and employment agreements
- Employee severance plan or policy
- Other arrangements
- Annual bonus or incentive plans

Identify Change in Control Arrangements

- Long-term incentive plans
- Deferred compensation plans (SERPs, rabbi trust, other supplemental plans)
- Equity compensation plans
- Other arrangements (401(k), ESPP, ESOP)

Review Change in Control Definitions

- What is the trigger event?
 - Board change
 - Sale of stock (40/50/80%)
 - Asset sale
 - Merger
- Are definitions consistent/will all agreements be triggered?

Review Change in Control Definitions

- Can definitions be amended to be consistent?
- Is consent required for amendment or disclosure?
- Payment triggers
 - Change in control itself (single trigger)
 - Without cause/good reason termination (double trigger)
 - Look to see if good reason will be triggered in deal or if change in control is built into good reason definition
 - Good reason trigger (walk right, safe harbor, cure period)

Change in Control Planning Considerations

- CIC provisions
 - Do they accomplish your goals?
 - Are they flexible enough?
 - Are they consistent?

Change in Control Planning Considerations

- What type of change in control protection period (# of months) is desired?
- If pro rata bonus awards are paid, are they based on actual or target?
- Restrictive covenant provisions
- Are payments subject to earnout/escrow? (409A/SRF considerations)

Change in Control Planning Considerations

- ERISA fiduciary issues for ESOPs and 401(k) plans that hold stock (trustee)
- Special rules for ESOPs
 - Pass-through voting (direct the trustee)
 - Is ESOP leveraged? (allocated vs. unallocated accounts)

Change in Control Planning Considerations

- Section 409A of the Code
 - Is CIC definition 409A compliant?
 - If not, does arrangement have continued service requirement?
 - Can reasonable substantial risk of forfeiture argument be made?
 - Payment subject to a release (timing issues)
 - Toggle issues
 - Payment date issues
 - General Section 409A compliance issues – is pre-CIC correction feasible?

Change in Control Planning Considerations: Internal Revenue Code Section 280G Issues

- Will the transaction be a CIC under Section 280G?
- Adverse consequences of excess parachute payments:
 - Not deductible to the corporation
 - Subject to 20% excise tax to executive
- Inventory all arrangements with potential parachute payments
- Might parachute payments to any disqualified individual equal or exceed 3x base amount?

Change in Control Planning Considerations: Internal Revenue Code Section 280G Issues

- What terms do the executive arrangements have in connection with Section 280G?
 - Cutback
 - Modified cut-back (“better of” approach)
 - Legacy gross-up

Change in Control Planning Considerations: Internal Revenue Code Section 280G Issues

- Pre-CIC planning to avoid or minimize excess parachute payments for corporation:
 - Cutback/modified/net best approach
 - Increase current year compensation if CIC will close in subsequent year to increase base amount
 - Acceleration of payments or vesting into pre-closing year
 - Clear and convincing evidence that part of the compensation is reasonable compensation for post-CIC services
 - Assign value to non-compete to offset severance value
 - Post-CIC continued service conditions (retention awards)
 - Accelerate service-based equity and extend performance-based equity

Change in Control Planning Considerations: Internal Revenue Code Section 280G Issues

- May be possible that lower-tier corporations in group separated by partnerships that are not wholly-owned will be able to take advantage of shareholder “cleansing” vote for private companies

Effect of a Change in Control on Equity Grants

- What does plan permit?
 - Unilateral right to cancel and terminate (even if no spread or underwater)?
 - Assumption required?
 - Is participant consent required to cash out awards?
 - Right to amend equity plan/effect on outstanding awards

Effect of a Change in Control on Equity Grants

- How does the company want equity to be treated in a change in control?
 - Single trigger/double trigger
 - ISS/shareholder preference

Effect of a Change in Control on Equity Grants

Treatment of Options: Three Alternatives

- Assumption
 - Options remain in place, but the underlying number of shares and the exercise price are adjusted to reflect the transaction
 - Buyer's shares used to fund the exercise of the assumed options but do not count against buyer's plan reserve
 - May require S-8 registration for shares issuable under assumed options

Effect of a Change in Control on Equity Grants

Treatment of Options: Three Alternatives

- Substitution of Options
 - Old option is cancelled and new option issued under buyer's plan
 - Number of shares and exercise price in effect under new option are based on the number of shares and exercise price in effect under old option
 - Buyer's shares used to fund option exercises are charged against buyer's plan
 - Adjustment of options upon assumption or substitution must meet section 409A requirements for nonqualified options and section 424 requirements for incentive stock options

Effect of a Change in Control on Equity Grants

Treatment of Options: Three Alternatives

- Cash-Out of Options
 - Old option is cancelled for a payment made in cash (if any) or stock of the acquiror
 - Amount of cash-out is typically equal to the intrinsic value of the option (spread) at the closing of the transaction
 - No payment with respect to cancellation of underwater options (assuming consistent with plan terms)

Effect of a Change in Control on Equity Grants

Other Equity Awards

- Restricted Stock
 - Cash-out if cash transaction
 - Conversion to buyer shares
- Restricted Stock Units
 - Cash-out with immediate payment or deferred payment/409A compliance
 - Conversion to RSU of buyer stock
- Stock Appreciation Rights
 - Same alternatives as options

Effect of a Change in Control on Equity Grants

- Performance Stock Units
 - Shares earned at target at change in control?
 - Payment provisions need to be hardwired in advance under section 409A
 - Can be converted to cash obligation or RSU of buyer stock

Effect of a Change in Control on Equity Grants

Other Considerations

- 409A compliance
- Assumed options and other equity awards could create material liability for buyer
- Retention effect on employees
- Section 280G effect of vesting
 - Acceleration of performance-based vesting has higher cost under 280G than does time-based vesting
 - Buyer should not communicate new grants before closing
- Determination of fair market value
- Earnout/escrow considerations (409A/SROF issues)

Non-Compensation Considerations

- Due diligence preparation
 - Data room
 - Disclosure schedules
- Third party contracts/arrangements
 - Customers
 - Suppliers
 - Joint venture partners

Non-Compensation Considerations

- Business continuation
 - Distraction preparedness
- Fiduciary duty
- Messaging
- Integration

Disclosure Considerations

- Proxy/information statement
- Tender offer materials
- Form 8-K
- Financial statement requirements
 - Where target may not have audited financial statements (e.g., carve out), plan ahead or seek SEC relief
- Special situations
 - e.g., shell companies

Say-on-Golden-Parachutes Shareholder Vote

- In proxies and information statements, companies must provide additional information about the compensation arrangements with named executive officers
 - Applies in any instance seeking shareholder approval of an acquisition, merger, consolidation, or proposed sale or disposition of all or substantially all of a company's assets
 - Also required in connection with going-private transactions and third-party tender offers
 - Disclosures of the “golden parachute” arrangements required of all agreements and understandings that the acquiring and target companies have with named executive officers of both companies

Say-on-Golden-Parachutes Shareholder Vote

- A separate shareholder advisory vote is not required on golden parachute compensation if disclosure of that compensation has been included in the executive compensation disclosure subject to a prior advisory vote of the shareholders (e.g., “say on pay”)
 - In practice very unusual
- Most modifications to existing arrangements will result in a new shareholder advisory vote

Say-on-Golden-Parachutes Shareholder Vote

- 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]”
 - Companies are not required to use any specific language or form resolution for the “golden parachute” arrangement vote
 - Regulations require a table for disclosing “golden parachute” compensation

Shareholder Vote on Executive Compensation – Golden Parachute Arrangements

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							

Shareholder Vote on Executive Compensation – Golden Parachute Arrangements

- Elements to be separately quantified and included in the total are:
 - cash severance payment (e.g., base salary, bonus, and pro rata nonequity incentive plan compensation 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))
 - tax reimbursements (e.g., Internal Revenue Code Section 280G tax gross-ups) (column (f))

Shareholder Vote on Executive Compensation – Golden Parachute Arrangements

- The “Other” column of the table includes any additional elements of compensation not specifically includable in the other columns of the table (column (g)) and requires footnote identification of each separate form of compensation reported
- The table 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

ISS Issues

- ISS recommendation is on a case-by-case basis, consistent with problematic pay practices relating to severance
- Does pay practice provide a windfall to executives?
- Monitor ISS existing policy on problematic pay practices (i.e., features that may lead to a negative vote)

Practical Effect of Golden Parachute Vote

- Golden parachute vote is an advisory vote and is separate from the vote on the transaction
- Target has contractual obligation to pay the executive benefits without regard to the golden parachute vote
- Effect on shareholder litigation
- Concern about “optics”
- Business-judgment rule

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QUESTIONS?

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