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409A Basics | A Webinar Series

# Managing 409A Issues in Change of Control Transactions

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# Overview

- Section 409A overview
- Transaction structure (due diligence, representations and warranties, business risks, and section 409A compliance)
- Typical 409A arrangements (equity, severance, change of control, and deferred compensation)
- Stock rights consideration (assumptions, adjustments, and exchanges for other compensation)
- Restructuring deferred compensation arrangements (key terms, payment acceleration, and delay limitations)

# Section 409A – Basic Provisions

- Final regulations became effective January 1, 2009 (good-faith compliance through December 31, 2008)
- Section 409A provides strict timing rules for deferral elections, distributions, and funding of nonqualified deferred compensation
- Section 409A applies to amounts "deferred" after 2004; amounts generally "grandfathered" if vested at December 31, 2004
- Noncompliance triggers inclusion of all amounts deferred under plans of same type, including amounts subject to a 20% additional tax, plus an additional "interest tax" (IRS underpayment rate plus 1%)

# Section 409A – Basic Provisions

- Broad applicability – starting point is any legally binding right to taxable compensation in a future year
- Statutory exclusions for qualified retirement plans and bona fide vacation, sick, and compensatory time arrangements as well as disability and death benefit plans
- Relatively broad exclusions apply for “vest and pay” (short-term deferral) arrangements, certain nondiscounted stock rights, and limited involuntary separation pay amounts

# Short-Term Deferral Rule

- Amounts that are paid shortly after vesting are not subject to section 409A – sometimes called the “vest and pay” exception
- Important exception for bonus, phantom equity, and long-term incentive plans
- Includes an amount received by the service provider by the later of
  - i. 2½ months from the end of the service provider’s taxable year when vesting occurred; or
  - ii. 2½ months after the end of the service recipient’s tax year when vesting occurred.

# Definition of Change of Control

- Keys off of employer (or payor) corporation or any corporation up the chain, linked by majority ownership
- Change in Ownership – acquisition of more than 50%
- Change in Effective Control – acquisition of 30% or more, or turnover of majority of board of directors within 12 months
- Change in Ownership of Substantial Portion of Assets – more than 40% within 12 months
- Note that spin-offs and IPOs typically are not changes of control

# Separation from Service

- Generally requires substantial, permanent reduction in service level with direct employer
- If there is continuity of employment with direct employer, there is generally no separation from service (but there may be a change of control)
- In an asset sale, default is that there is a separation from service for transferring employees. Parties may agree to not treat as separation, but must be consistent

# Six-Month Delay Requirement

- Payments of deferred compensation to “specified employees” on account of separation from service must be delayed six months
- Specified employees are generally the top 50 officers at a public company
- Regulations specify how to combine or split specified employee lists in connection with a corporate transaction



# Change of Control Plan Termination

- Regulations provide special opportunities to terminate arrangements in connection with a change of control
- Must terminate all plans of the same type for all participants experiencing a change of control
- Note plan aggregation categories

# The Transaction Structure and Players

- What type of transaction?
  - Stock purchase/asset sale
  - Public company deal
  - Private company deal
- Section 409A considerations will vary for sell-side vs. buy-side vs. management

# Understanding the 409A Hurdles

- Frequently encounter a lack of compliance—especially private companies
- Can require careful and creative arguments
- Must consider business risks (excise tax, reporting and withholding obligations, potential gross-up)
- Employer has tax reporting and withholding obligations and may incur penalties if it does not properly report and withhold
- Correction opportunities are available

# Correction Opportunities

- Operational failures – Notice 2008-113
- Documentary failures – Notice 2010-6 and Notice 2010-80
- Unvested amounts that will not vest until a later year
- Limitations – generally cannot correct beyond two prior years

# Identifying Key Arrangements

- Deferred compensation arrangements include, but are not limited to:
  - Deferred compensation and supplemental retirement plans
  - Severance promises, including those in employment agreements (walk-rights)
  - Guaranteed bonuses
  - Discounted stock options or SARs
  - Phantom stock, restricted stock units, and other equity rights
  - Long-term incentive plans
  - Annual bonus plans
  - Management carve-out plans
  - Split-dollar life insurance

# Know the Change of Control Payment Timing

- Payment triggers
  - Consummation of transaction (is change of control definition 409A compliant)
  - Without cause/good reason termination (409A compliant, facts and circumstances)
  - Toggle issues
  - Payment subject to release (timing concerns)

# Equity Compensation Highlights

- Stock rights
  - Relatively broad exclusion for nondiscounted options and SARs
  - Exclusion has detailed requirements
- Incentive stock options excluded (but watch out for changes that could eliminate ISO status)
- Restricted stock
- Phantom stock and RSUs – vest and pay? Early vesting (e.g., for retirement-eligible, involuntary termination with delayed settlement)?

# Stock-Based Compensation

- Stock options and SARs are not deferred compensation subject to section 409A if:
  - Exercise price can never be less than the fair market value (FMV) of the underlying stock on the grant date
  - Stock right is granted on “service recipient stock”
  - Stock right does not include any deferral feature other than the deferral of income from the grant date until the option exercise date



# Modification of Stock Rights

- Modification generally results in a new grant
- Modification is any change in the terms of the stock right that may give the holder a direct or indirect reduction in the exercise price of the right
- Changes that would meet requirements under section 424 rules for ISOs generally are not treated as new grants of rights
- Exercise period may be extended to the earlier of when the right would have originally expired or 10 years from original grant
- Can extend term of underwater options (treated as new grant)

# Extension of Stock Rights

- Extension beyond the LESSER of the original term or 10 years is generally treated as an “additional deferral feature” for the ORIGINAL grant date (for in-the-money stock rights)
- Effect generally will be to cause an automatic section 409A violation
- Most option extensions do not go beyond the lesser of the original term or 10 years, and extensions within that time frame do not cause a violation or treatment as a new grant

# Permitted Distributions

- Must be paid upon one of the following:
  - Fixed date or schedule
  - Death or disability
  - Separation from service
  - Change of control
  - Unforeseeable emergency
- Acceleration of payment timing is generally prohibited
- Deferral of payment timing is very restricted

# Accelerating Payments: Plan Termination

- General restrictions on acceleration of payments pursuant to plan termination
  - All plans of the same type must be terminated
  - All distributions must occur at least one year but not more than two years following termination
  - Similar plan cannot be adopted for three years

# Accelerating Payments: Plan Termination

- Special rule for change of control
  - Within 30 days prior or 12 months following
  - Plans of same type are terminated with respect to the participants who experienced the change of control
  - All distributions must occur within 12 months of plan termination
  - Affected participants must not have the right to make plan termination decision
  - No post-termination prohibition on maintaining a plan of the same type

# Accelerating Payments: Amounts not Subject to Section 409A

- Amounts not subject to section 409A are not subject to antiacceleration prohibitions
  - Short-term deferral amount
  - Exempt involuntary separation pay amounts
- Requires making difficult distinctions between exempt and nonexempt amounts

# Delaying Payments: Earn-out Provisions

- Transaction-based compensation can generally be paid out on the same schedule and under the same conditions applicable to shareholders
  - Earn-out period must not be more than five years
  - If the earn-out is for a period of more than five years, a different exception may also provide relief where applicable contingencies may qualify as a substantial risk of forfeiture
- Relief extends to amounts that “relate to” the stock of the target (e.g., cash awards based on stock price)

# Delaying Payments: New Vesting Conditions

- Imposing new vesting conditions is permitted in connection with a change of control event without additional compensation being awarded if:
  - Compensation is subject to the new condition at or before the change of control
  - Condition is to be added in connection with the change of control
  - Condition constitutes a substantial risk of forfeiture
  - Compensation is payable under the same terms applicable to shareholders of the target



# Delaying Payment: Extension of Substantial Risk of Forfeiture

- Addition of a substantial risk of forfeiture after a legally binding right arises is generally disregarded, unless supported by reasonable compensation
- In a change of control circumstance, the vesting period may be extended beyond the change of control as long as the added conditions would otherwise qualify as a substantial risk of forfeiture
  - Requirement to perform services (e.g., two years)
  - Requirement to satisfy a performance goal
  - Otherwise forfeited

# Delaying Payment: Extension of Substantial Risk of Forfeiture

- Vesting periods changed for single-trigger payments
- Short-term deferral to short-term deferral
- Double-trigger severance subject to section 409A restructured into retention/other payments
- Double-trigger severance triggered by multiple events restructured into retention/other payments
  - Not clear that subsequent election rule can be disregarded
  - Safest approach is to retain separation from service trigger
  - More aggressive approach to permit change in payment trigger



# Questions?

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