Morgan Lewis

webcast

Change in Control Webinar Series

Presenters:

Mary Hevener

Amy Pocino Kelly

Randy McGeorge

David Calder

June 2011

Overview

- Current best practices in drafting change-in-control provisions for employment agreements and change-in-control agreements
- Golden parachute taxes in corporate transactions and planning for IRC Section 280G in a “no gross-up” world
- 162(m) issues
- FICA/W-2 issues

Change-in-Control Provisions in Employment Agreements and Change-in-Control Agreements

General Observations

- Goal is to balance the legitimate interest of both the executive and the employer
  - Executive needs to be sure that there is some level of protection against a successor employer’s 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

© Morgan, Lewis & Bockius LLP

General Observations (cont'd)

- Companies will often provide enhanced severance protection following a change in control
- Severance multiple is often greater for severance occurring "in connection with" a change in control (e.g., one times compensation vs. three times compensation)

Reasons Companies Are Willing to Provide Change-in-Control Payments

- Competitive executive compensation
  - Need to provide retention protection at possible target companies in consolidating industries
- Advance change-in-control protection makes top management neutral regarding acquisition offers
- Reward an executive's service in the company's "final act"

© Morgan, Lewis & Bockius LLP

Triggering Events

- Single Trigger
  - Equity vesting upon the occurrence of the change in control
  - Executive has the right to voluntarily quit on or following the change in control and still receive severance
- Double Trigger
  - Executive will only receive equity vesting and severance upon a qualifying termination after the change in control

© Morgan, Lewis & Bockius LLP

Current Trends

- Limited group of executives covered by CIC arrangements
- Lower severance multiples
  - Trending away from three times multiple
  - Severance multiples over three times base salary is considered a poor pay practice
- Shift to Double Trigger
  - Executive should only receive severance after the change in control occurs
- Elimination of 280G gross-ups/addition of 280G cutbacks
- Clawbacks
- Impact of say-on-golden parachute payments

© Morgan, Lewis & Bockius LLP

Morgan Lewis

Employer-Initiated Termination – "Cause"

- Defining "Cause" is a balancing act
  - Executive wants to remove subjectivity to be sure only specific, objective events are included
  - Employer wants to retain subjectivity to allow flexibility in light of uncertain circumstances
- Notice and cure periods
- Due-process right to Board review
- Examples of key elements of cause

© Morgan, Lewis & Bockius LLP

Executive-Initiated Termination – "Good Reason"

- "Good reason" essentially amounts to constructive termination without cause, and thus generally results in the same economics to the executive
- Successor employer should not be permitted to materially change the initial business deal (e.g., CEO becomes part of the janitorial staff)
- Notice and cure periods
- Examples of key elements of good reason

© Morgan, Lewis & Bockius LLP

Deferred Compensation – 409A

- Agreement can be structured to either be “exempt from” or “compliant with” 409A
  - Exempt agreements provide for greater flexibility to modify terms in connection with a change in control
  - Exemption provides less flexibility w/r/t compensation that can be provided and “good reason” definition
    - *Two times lesser of compensation or 401(a)(17) limit and entire amount must be paid by end of 2nd year*
    - *“Good reason” trigger must be material negative change*

© Morgan, Lewis & Bockius LLP

Deferred Compensation – 409A (cont'd)

- Six-month delay provision for public companies
- Release provision
- Limited ability to change 409A-compliant agreement in connection with change in control
  - Prohibition on accelerating or delaying payment, but:
    - *Plan termination and distribution*
    - *Earn-out provisions and transaction-based payments*
    - *Extension of vesting or substantial risk of forfeiture*

Golden-Parachute Taxes in Corporate Transactions

What Is the "Golden-Parachute Tax"?

- 20% excise tax imposed by IRC Sections 280G and 4999
  - on 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)*
  - that are "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)

How Is the Excise Tax Calculated?

- If an executive receives a payment on a change in control that equals or exceeds three times the executive's "base amount," then
  - 20% excise tax on all amounts in excess of one times the executive's "base amount"
    - *Base amount is the executive's average annual W-2 compensation for the most recent five years (or period worked, if less) ending before the change in control*

© Morgan, Lewis & Bockius LLP

Who Cares About This Tax?

- Executives care because they could owe the 20% excise tax
- Corporations care because parachute payments are not deductible and they are required to report parachute payments on Form W-2 and appropriately withhold them
- If the corporation fails to withhold and the executive does not pay, the government may try to collect the tax from the corporation
  - If the company pays on audit, the payments aren't considered income to the employee, but are deductible by the company

© Morgan, Lewis & Bockius LLP

Exemptions

- Payments made by tax-exempts, partnerships, or S corps
- Payments made by privately held company when shareholder approval requirements are met
  - Payment approved by more than 75% of shareholders (SHs) entitled to vote immediately before the change in control
  - "Adequate disclosure" of all material facts regarding all material pay is provided to ALL persons entitled to vote
  - Payments must be contingent on the vote
- Compensation reasonably believed to be tax exempt at the time of payment

© Morgan, Lewis & Bockius LLP

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, that a payment would be made, it is not contingent on the change in control
- Payment that occurs as a result of an event that occurs within one year of a change in control is presumed to be contingent upon a change in control, but the presumption is rebuttable

Which Transactions Trigger Parachute Payment Taxes?

- 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, which presumption may be rebutted
- Transfer of a substantial portion of assets
  - Assets with value of at least one-third of the value of all assets

© Morgan, Lewis & Bockius LLP

Parachute Payments

- Payments in the nature of compensation
  - Cash severance
  - Continued health and welfare benefits
  - Outplacement services
  - Option and restricted stock vesting
  - Accelerated payment of deferred compensation
  - Special valuation rules under the 280G regulations can minimize the amount included

"Reasonable Compensation" Before a Change in Control

- Included in the base amount, but reduces the excess parachute component
- Salary, bonuses, payments for restrictive covenants (e.g., noncompetition/nonsolicitation)
  - Enforceability of a noncompete is required
- The IRS has strongly opposed excessive values attributable to reasonable compensation, especially where noncompetes are adopted shortly before a change in control, and has even required amortization (not deduction)

© Morgan, Lewis & Bockius LLP

“Reasonable Compensation” After a Change in Control

- If compensation is reasonable in amount for services to be rendered after the change in control, such amount is subtracted from the payments (i.e., essentially treated as an exempt payment) for all purposes of Section 280G
  - Payments may only be made for the period the individual actually performs services
  - If duties don’t substantially change, compensation should not be significantly greater than it was prior to the change in control
  - If duties substantially change, compensation should not be significantly greater than that paid in the market

© Morgan, Lewis & Bockius LLP

Strategies to Avoid Excise Taxes

- "Gross-up" provision for excise taxes
  - Most companies no longer provide gross-ups
- "Hair-cut" provision for parachute payments
  - Reduce payments to avoid excise tax or to provide "best of" provisions
- 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

© Morgan, Lewis & Bockius LLP

162(m) Issues

Overview of Internal Revenue Code Section 162(m)

- Generally disallows a federal income tax deduction for compensation in excess of $1 million per taxable year paid to a "covered employee" of a "publicly held corporation"
- Commissions and qualified "performance-based compensation" do not count toward the $1 million limit
- Important determinations:
  - Publicly held corporation
  - Covered employee

Identifying the "Publicly Held Corporation"

- Any corporation issuing common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act")
- Includes affiliated corporations (other than any subsidiary that is itself a publicly held corporation subject to Section 162(m))
- Not "publicly held" unless subject to the reporting obligations of Section 12 of the Exchange Act, determined as of the close of the taxable year

Identifying "Covered Employees"

- Includes the "principal executive officer" and the three highest-compensated officers (other than the principal executive officer *and the principal financial officer*)
- Determined pursuant to the executive compensation disclosure rules under the Exchange Act
- Determined as of the close of the taxable year
- Potential statutory revisions

© Morgan, Lewis & Bockius LLP

Coordination with Excess Parachute Payments

- $1 million deductible compensation limit is reduced by excess parachute payments made to covered employees

© Morgan, Lewis & Bockius LLP

Morgan Lewis

Example

Acme pays its CEO $1,500,000 during a taxable year, none of which satisfies the exception for commissions or the exception for qualified performance-based compensation. Of the $1,500,000, $600,000 is an excess parachute payment. The $1 million deductible compensation limit is reduced by $600,000. Acme may only deduct $400,000 of the compensation paid to its CEO. The remaining portion is disallowed pursuant to Section 162(m) ($500,000) or Section 280G ($600,000).

© Morgan, Lewis & Bockius LLP

Potential Planning Opportunities

- Delay payments
  - Section 409A considerations
- Ask executives to resign (or, at a minimum, resign their officer positions) before the last day of the corporation's taxable year
- Work to complete the transaction before the target corporation's fiscal year end (or very early in the target corporation's subsequent fiscal year so that the target is not required to file a Form 10-K or proxy statement for the preceding fiscal year)
  - The determination of who is a "covered employee" is determined by reference to the summary compensation table. If a summary compensation table is not required to be filed for a particular fiscal year, then Section 162(m) arguably does not apply for that taxable year.

FICA/W-2 Issues

Federal Insurance Contributions Act (FICA)

- Old-age, survivor, and disability insurance (OASDI)
  - Employee Rates:
    - *4.2% for FICA wages received in 2011*
    - *6.2% for FICA wages received in 2012 or later*
  - Employer Rate:
    - *6.2% for FICA wages paid*
  - 2011 Wage Base: $106,800
- Hospital insurance (HI)
  - Employers and employees currently taxed at the same rate
    - *1.45% for FICA wages paid/received in 2011 and 2012*
  - For tax years beginning in 2013 or later, employees will pay an additional 0.9% HI tax on FICA wages in excess of $200,000 ($250,000 for married taxpayers filing a joint return and $125,000 for married taxpayers filing separately)
  - No wage base

© Morgan, Lewis & Bockius LLP

FICA – Wage Base

- Wage limitation applies to FICA wages paid/received in a calendar year
- Generally applies separately to wages paid by each employer
- Employee may be entitled to a credit against income tax for the excess of the employee FICA tax over the limitation amount

© Morgan, Lewis & Bockius LLP

FICA – Examples

- *Example 1*: In 2011, Employee receives FICA wages of $140,000 from Employer A. The FICA tax rate on Employee's wages up to $106,800 is 5.65% (4.2% OASDI + 1.45% HI). On wages in excess of $106,800, the rate is 1.45%. Employee pays an aggregate of $6,515.60 in FICA taxes ([5.65% x $106,800] + [1.45% x [$140,000 - $106,800]).

- *Example 2*: In 2011, Employee receives FICA wages of $80,000 from Employer A and $60,000 from Employer B. Neither Employer A nor Employer B is considered a successor to the other. The annual wage limitation will apply separately to the wages paid by Employer A and Employer B. Employee did not receive FICA wages from either employer that exceeded the 2011 annual wage limitation ($106,800). The FICA tax rate for Employee's entire wages will be 5.65% (4.2% OASDI + 1.45% HI). Employee pays an aggregate of $7,910 in FICA taxes (5.65% x $140,000).

Total difference equals $1,394.40 ($7,910 - $6,515.60)

Change-in-Control Issues – Statutory Merger or Consolidation

- Successor corporation is regarded as the same employer for FICA tax purposes
  - Successor employer furnishes Forms W-2 to the acquired employees
  - Successor and predecessor employers must explain the differences between Form W-2 amounts and Form(s) 941 amounts using Schedule D to Form 941

© Morgan, Lewis & Bockius LLP

Change-in-Control Issues – Acquisition of Property

- Wages paid by a predecessor (i.e., target) during the calendar year in which an acquisition occurs and before the acquisition date may be treated as wages paid by the successor employer (i.e., acquiror)
- Only permitted if:
  - the successor acquired substantially all of the property used in the trade or business, or a separate unit of a trade or business, of a predecessor during the calendar year; and
  - the employee was employed in the acquired business immediately before and immediately after the acquisition.
    - *Not necessary to acquire the entire separate trade or business*
- Interesting issues are presented by the acquisition of LLCs

© Morgan, Lewis & Bockius LLP

Morgan Lewis

Change-in-Control Issues – Acquisition of Property (cont'd)

- Method of acquisition is immaterial
- Property acquired may consist of either of the following
  - substantially all of the property used in the performance of an essential operation of the business; or
  - substantially all of the property used in a relatively self-sustaining entity that is part of the business
- Property need not be "acquired" as long as substantially all of the property of the predecessor is available for use by the employees of the successor

Change-in-Control Issues – Acquisition of Property (cont'd)

- "Standard Procedure"
  - Predecessor and successor each file a Form W-2 and Form(s) 941 for wages and other compensation that it paid
  - Predecessor may file its final Form 941
- "Alternate Procedure"
  - Successor employer assumes the predecessor's obligation to furnish Form W-2 to the acquired employees
  - Each of the predecessor and successor must explain the differences between Form W-2 amounts and Form(s) 941 amounts using Schedule D to Form 941
  - Use of the alternate procedure must be agreed to by the parties

© Morgan, Lewis & Bockius LLP

Questions?

Contact Information

- Mary Hevener, mhevener@morganlewis.com
- Amy Pocino Kelly, akelly@morganlewis.com
- Randy McGeorge, rmcgeorge@morganlewis.com
- David Calder, dcalder@morganlewis.com

© Morgan, Lewis & Bockius LLP

Disclaimer

- This communication is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship

© Morgan, Lewis & Bockius LLP