M&A Basics:
Equity Compensation Plans

Webinar 3 of 3

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Overview

- Importance of planning ahead for change in control transactions
- Alternatives for equity vesting
- Performance-based equity grants
- Due diligence issues
- Global equity grants
- Equity compensation in private equity buyouts

Planning Ahead for 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 avoid uncertainty

Effect of a Change in Control on Equity Grants

- What does equity plan permit?
  - Unilateral right to cancel and terminate equity grants, including underwater options
  - Is participant consent required to cash out equity grants?
  - Does plan require assumption by acquiror?
  - Right to amend equity plan/effect on outstanding grants

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Effect of a Change in Control on Equity Grants

- How should equity be treated in a change in control (CIC)?
  - Single trigger
  - Double trigger
    - *Time period after CIC: one or two years*
    - *Involuntary termination or Good Reason*
    - *Definition of Good Reason*
      - Material reduction in base salary
      - Relocation
      - Material adverse change in responsibilities

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Effect of a Change in Control on Equity Grants

- ISS preference for double trigger vesting
  - In ISS Equity Plan Scorecard for approval of new equity plans, plan will receive more “points” if it provides for double trigger vesting
- In ISS Equity Plan Scorecard, a “liberal” CIC provision will cause ISS to recommend a vote against the plan
  - For example, a CIC provision that provides for vesting upon shareholder approval of a transaction even if the transaction never occurs

Effect of a Change in Control on Equity Grants

Treatment of Options: Three Alternatives

- Assumption (One)
  - Options remain in place, but the underlying number of shares and the exercise price are adjusted to reflect the transaction
  - Acquiror's shares used for the exercise of the assumed options, but the shares do not count against acquiror's equity 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 (Two)
  - Old option is canceled and a new option issued under the acquiror's plan
  - Number of shares and exercise price are adjusted to reflect the transaction
  - Acquiror's shares used for option exercises are charged against the acquiror's equity plan reserve

Effect of a Change in Control on Equity Grants

- For both assumption and substitution, adjustment of options 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

- Cashout of Options (Three)
  - Old option is canceled for a payment made in cash or stock of the acquiror
  - Amount of cashout is typically equal to the intrinsic value (spread) of the option 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
  - Cashout if cash transaction
  - Conversion to acquiror shares
- Restricted Stock Units (RSUs)
  - Cashout with immediate payment or deferred payment/409A compliance
  - Conversion to RSUs of acquiror stock
- Stock Appreciation Rights
  - Same alternatives as options

Effect of a Change in Control on Equity Grants

- Performance-based Equity Grants
  - Shares earned at target at CIC, or measure performance as of CIC date
    - Alternative is to adjust performance goals
  - Payment provisions should be hardwired in advance under section 409A
  - Can be converted to cash obligation or RSUs of acquiror stock
  - Make sure equity plan has broad language allowing appropriate adjustments

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Effect of a Change in Control on Equity Grants

- Other Considerations
  - Assumed equity awards could create material liability for acquiror and result in share dilution
  - Retention effect on employees
  - Desire for employees to continue to have equity at stake
  - Earnout/escrow considerations/409A issues
  - 280G issues

Effect of a Change in Control on Equity Grants

Self-Audit of Equity Grants

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

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Effect of a Change in Control on Equity Grants

- Review CIC provisions in:
  - Equity plans
  - Equity grant agreements
  - Equity grant agreements outside the United States
  - Employment agreements
  - CIC agreements
  - “One-off” agreements
  - ESPP

Due Diligence

- Treatment of equity plans is subject to substantial negotiation
- Can represent significant liability and affect purchase price
- Due diligence highlights issues
- Allows risk allocation

Due Diligence Materials

- All equity compensation plans, arrangements, and agreements
- Lists of all participants, the number of shares, the vesting schedule, and the exercise price of options
- CIC agreements
- Employment agreements/offer letters
- List of all states, provinces, or countries where employees reside
- Board and shareholder approvals
- Valuation reports

Issues

- Plan Implementation
- Securities Compliance
  - Rule 701
  - Form S-8
- Tax
  - Incentive Stock Options
  - Restricted Stock
  - Section 409A
  - Section 280G
  - Non-U.S. Grants

Incentive Stock Options

- Did shareholders approve the equity incentive plan's share reserve and any share increases within 12 months of adoption?
- Was exercise price equal to fair market value (FMV) on grant date?
- 10% stockholder
- Other provisions

Restricted Stock

- Did holders make a section 83(b) election within 30 days after transfer?

IRC Section 409A

- Incentive stock options are generally exempt unless modified
- Nonstatutory stock options to purchase service recipient stock are exempt if:
  – The exercise price of the options can never be less than the FMV of the underlying stock on the grant date and
  – There are no deferral features that would delay the recognition of income beyond the exercise date (other than the receipt of unvested stock)

Stock of Service Recipient

- Common stock of the service recipient
  - Stock cannot be subject to any preferences as to dividends or liquidation rights or nonlapse put or call rights or mandatory repurchase obligations based on a value other than the FMV of the stock
- Common stock of a parent corporation may qualify as service recipient stock with respect to individuals who perform services for a subsidiary

Determination of Fair Market Value

- Stock readily tradable on established securities market
- Stock not readily tradable on established securities market
  - A value determined by the reasonable application of a reasonable valuation method

Determination of Fair Market Value

- Presumption of reasonableness
  - A valuation established by an independent appraisal as of a date not more than 12 months prior to the relevant grant date;
  - a valuation formula based on the tax principles governing the valuation of shares subject to nonlapse restrictions, and used for all compensatory and noncompensatory valuations of the stock; or
  - for an illiquid stock not subject to any nonlapse put or call right or obligation (other than a first refusal right) and issued by a start-up corporation that has no trade or business that it has conducted for a period of 10 years or more, a written valuation report that takes into account the valuation factors listed above
    - *prepared by a person with significant knowledge and experience or training in performing similar valuations;*
    - *however, this valuation method will not be permissible if a CIC or initial public offering (IPO) of the stock is reasonably anticipated to occur within the succeeding 12 months*

Modifications

- Reduction in price
- Extension of post-service exercise period

Restricted Stock, Restricted Stock Units

- Issuance of restricted stock will not be subject to section 409A, whether or not the recipient makes a section 83(b) election with respect to that stock
- RSUs that entitle the recipient to receive stock following the satisfaction of a specified service or vesting condition will not be subject to section 409A if the stock will be issued in compliance with the short-term deferral exception
- Deferrals may be permitted

IRC Section 280G

- 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, a 1% or more shareholder, or a "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)
- Accelerated equity
  - Favorable valuation rules
- Presumption re: equity awards granted within 12 months
- Shareholder cleansing vote for privately held companies

Non-U.S. Grants

- Were awards granted in compliance with local law?
  - Approvals
  - Registrations
  - Filings
- Any qualified/approved grants
  - Terms may be different
  - Treatment in CIC may result in loss of beneficial treatment
- Treatment in CIC may need approval

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Non-U.S. Grants

- Tax compliance
  - Withholding/reporting
- Cross-border issues
- Data privacy in data transfer
- Section 457A

Equity Compensation in Private Equity Buyouts

- Management compensation structures in private equity (PE) buyouts rely heavily on equity-based incentives and have lower cash-based compensation than public company peers
- Understanding these structures is important for both a PE firm taking a public company private and a strategic buyer buying a PE-backed company (or selling off a division to a PE buyer)
- Raise the same issues as with any use of equity (section 280G, section 409A, securities laws, etc.)
- Critically important to the transaction; negotiate early and consider a management equity term sheet

Equity Compensation in Private Equity Buyouts

- PE buyers are very concerned with retaining and incentivizing management, since they will not run the business day to day (unlike strategic buyers)
- They want quality management teams that will build stockholder value; management is key to success
- These concerns influence the compensation structure – goals are to further:
  - Incentivize management to stay
  - Align management's economic interests with PE firm's desire to increase the value of its investment

Equity Compensation in Private Equity Buyouts

- Management may hold a significant stake – up to 20% of post-buyout company
- Equity is provided to a relatively large group of key management with CEO/CFO holding largest portions
- Prohibitions on transfer and forfeiture and repurchase (i.e., put/call) provisions are common
  - PE firms want to recycle equity upon management departure
  - Desire to limit unaffiliated stockholders at an exit
  - Risk of future disputes with former management stockholder

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Equity Compensation in Private Equity Buyouts

- Categories of Management Equity Incentives:
  - Exchange or “rollover” of management equity in existing entity into post-buyout portfolio company
  - Management co-investment equity – the purchase of new equity by management in the post-buyout portfolio company
  - Management promote equity – the grant of compensatory equity awards to management in the post-buyout portfolio company

Equity Compensation in Private Equity Buyouts

- Exchange or “Rollover” Equity
  - Amount will vary, but typically 50% or more of senior management holdings in pre-buyout company may be rolled over
    - *Depends on tax treatment, other forms of equity compensation, and the PE firm and the dilution it is willing to accept*
  - Same class(es) of equity as the PE buyer; subject to same contractual restrictions and receives same rights
    - *Liquidation preference, rights of first refusal, restrictions on transfer, registration rights, and tag-along and/or drag-along*

Equity Compensation in Private Equity Buyouts

- Exchange or "Rollover" Equity (cont'd)
  - Tax-free a must, or else management will expect to be grossed up
  - Tax analysis can be complex and tax-free is not always feasible
  - Rolled over equity is often subject to a new vesting requirement (time and/or performance); more to come on vesting later

Equity Compensation in Private Equity Buyouts

- Management Co-Investment Equity
  - Limited to top 1 or 2 executives
  - May be used when a rollover is not feasible or insufficient
  - Often used if PE firm brings in new management
  - Requires up-front cash from management
  - May be more effective in aligning management's and PE firm's economic interests

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Equity Compensation in Private Equity Buyouts

- Management Co-Investment Equity (cont'd)
  - Same class(es) of equity, purchased alongside the PE firm
  - Subject to the same contractual restrictions and receives same rights
  - Typically not subject to vesting, since purchased by management
  - Funded with management cash on hand or after-tax proceeds from sale of existing equity in the pre-buyout company, or by a loan from the portfolio company
    - *Loans can raise tax and securities law issues*

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Equity Compensation in Private Equity Buyouts

- Management Promote Equity
  - Compensatory equity awards to management
  - The heart of the equity-based compensation model – a true equity incentive providing upside gain without downside risk
  - No up-front cash or rollover required
  - PE firm sets up an executive compensation program for a wide group of management and reserves a promote pool of 5%-20% of company's fully diluted equity

Equity Compensation in Private Equity Buyouts

- Management Promote Equity Forms
  - Options
    - *Granted with an exercise price equal to FMV on grant date; no value until exercised and no rights as stockholder*
  - Stock appreciation rights (SARs)
    - *Right to receive stock or cash equal to appreciation of the underlying common stock's FMV from grant date to exercise date; contractual only and no rights as stockholder*
  - Restricted stock
    - *Provides immediate value on grant date; provides rights as stockholder*

Equity Compensation in Private Equity Buyouts

- Management Promote Equity (cont'd)
  - Restricted stock units
    - *Right to receive FMV of a share in cash or stock; provides immediate value on grant date; no rights as stockholder*
  - Profits interests – increasingly popular
    - *Awards of LLC interests that give management the right to receive a share of future profits of the portfolio company (but not capital or assets)*
    - *Tax-free at grant, and may provide capital gains treatment upon sale*

Equity Compensation in Private Equity Buyouts

- Vesting Provisions for Management Equity
  - Typically apply to management promote equity
  - Often apply to rollover equity
- Time-based Vesting:
  - 3 to 5 years
  - Vesting can be prorated daily over the full period
  - Cliff vesting (monthly, quarterly, or annually)
    - *pro rata (straight line)*
    - *front loaded or back loaded*

Equity Compensation in Private Equity Buyouts

- Vesting Provisions for Management Equity (cont'd)
- Performance Vesting:
  - Ties key operating goals to building stockholder value
  - Also typically 3 to 5 years
  - Annual operating vesting
    - *Based on annual revenue, net income, and EBITDA*
    - *Can include a cumulative or catch-up component*
  - Return on investment (ROI) vesting
    - *All or a portion of the award cliff vests at liquidity event based on the PE firm's return on invested capital*

Equity Compensation in Private Equity Buyouts

- Vesting Provisions for Management Equity (cont'd)
- Acceleration of Vesting – always heavily negotiated
  - Upon termination or resignation?
    - *Uncommon, but may be partial vesting upon termination without Cause or resignation for Good Reason*
  - Upon death or disability?
  - Upon IPO?
    - *Uncommon, but may be partial vesting to incentivize management to achieve successful IPO*

Equity Compensation in Private Equity Buyouts

- Vesting Provisions for Management Equity (cont'd)
  - Upon sale
    - *No standard market practice, but a portion may accelerate*
      - Single trigger acceleration more common for unvested time-based awards than performance-based awards
      - Double trigger keeps management in place through the sale
    - *PE firm wants to limit acceleration*
      - Award was not earned (unless based on PE firm's ROI)
      - PE firm's portion of purchase price is diluted
      - Ability to roll unvested awards makes portfolio company more appealing to purchasers

Questions?

Presenters

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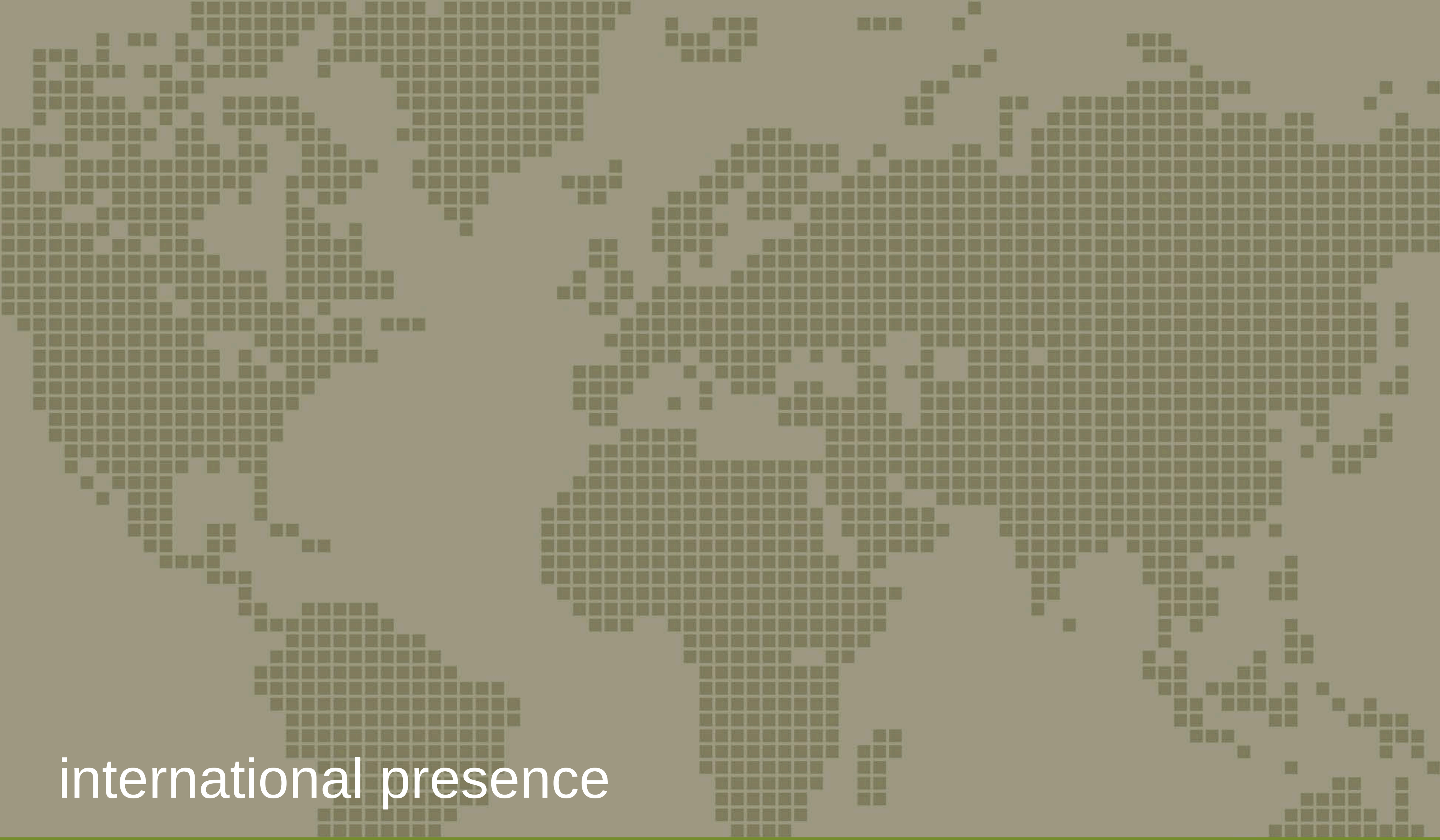

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