

Employee Benefit Issues and Equity Compensation Strategies for Technology Companies to Consider in Merger and Acquisition Transactions

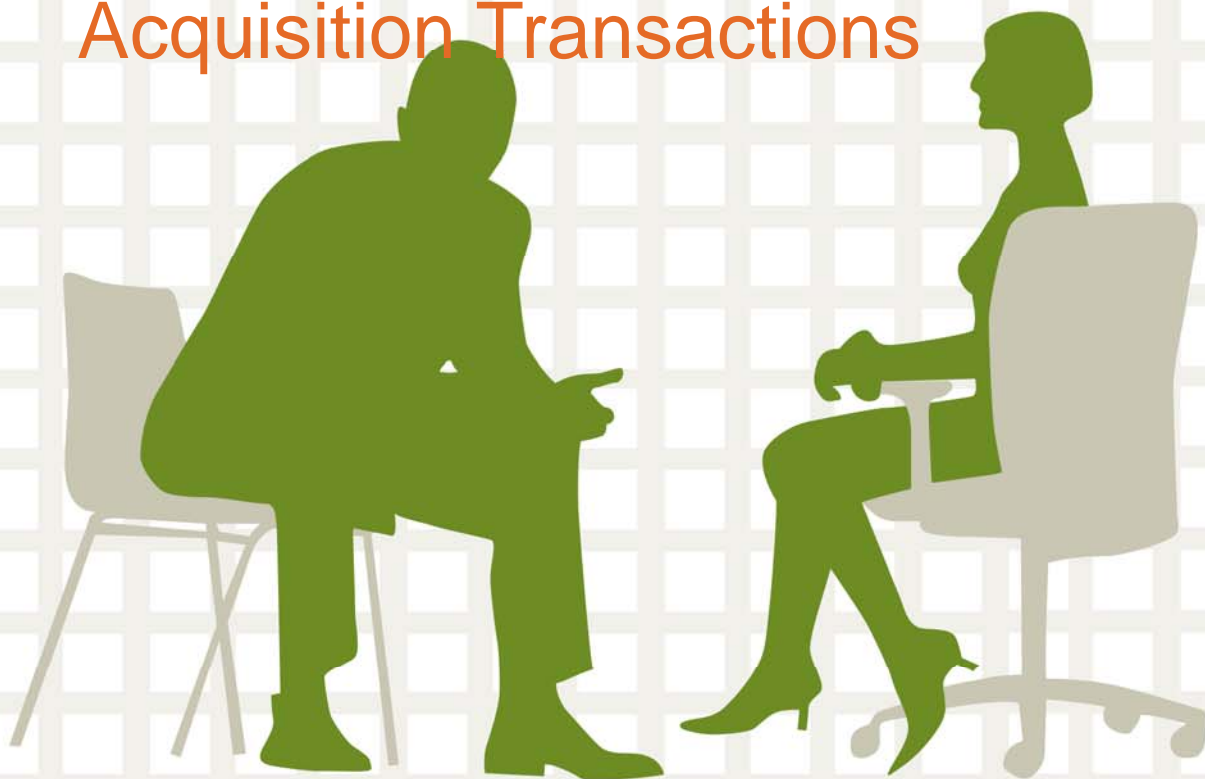
Morgan Lewis
technology
series

Presenters

Amy Pocino Kelly
Jeffrey P. Bodle

May 15, 2013

This presentation 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. These materials may be considered attorney advertising in some states. Please note that any prior results discussed in the material do not guarantee similar outcomes.



Know the Basics

- Plan Ahead
- Know the Deal Structure and Players
- Know the Language
- Know the Equity Plan/Award Structure
- Know the Hurdles under Internal Revenue Code (IRC) Section 409A
- Know the Change of Control Payments and the Issues under IRC Section 280G
- Know the Other Unfunded Liabilities

Plan Ahead

- Assess sufficiency, minute books, stock books, and other records prior to due diligence
- Use outside independent valuation firm to set fair market value exercise price for option grants to avoid IRC Section 409A issues
- Assess compliance with federal and state (“blue sky”) securities laws
- Assess terms and notice obligations, equity plan, and rights to cancel grants or rollover
- Assess management incentives – carve-out plan or other transaction bonus or retention incentive

Know the Deal Structure and Players

- What Type of Transaction?
 - Stock purchase/merger (buyer gets everything)
 - Asset deal (buyer can pick and choose)
 - Public company deal
 - Private company deal
- Considerations will vary for sell-side vs. buy-side vs. management

Know the Language

- Recognize Typical Provisions in Deal Documents
 - Provision Regarding Treatment of Equity on Change of Control
 - IRC Section 409A Representation
 - Escrow/Earnout Language for deal document (usually in section dealing with the Escrow Agreement)
 - IRC Section 280G Matters Representation
 - Shareholder Approval for Private Company Exemption Covenant
 - Language for Termination of 401(k) Plan
 - Other covenants regarding treatment of employees and benefits post-closing

Know the Equity Plan/Award Structure

- What does Plan Permit?
 - Unilateral right to cancel and terminate
 - Consent requirements; timing issues if notice is required
- What are Deal Terms Regarding Equity Awards?
- What are the Business Risks?
 - *Lillis v. AT&T Corp.* No. 717-N (Del. Ch. July 20, 2007) (Lamb, V.C.) (officers and directors whose underwater options were canceled without consideration in a cash acquisition argued that the acquiring corporation should have provided cash consideration based on the Black-Scholes value of the canceled options)

Know the Equity Plan/Award Structure

1. Assumption

- Options remain in place but the underlying shares and the exercise price are adjusted to reflect the transaction
- Buyer's shares are 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

2. Substitution of Options

- Old option is cancelled and new option is 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 the Buyer's plan

3. 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 at the closing of the transaction

Know the Equity Plan/Award Structure

- Determination of Fair Market Value
 - Need good IRC Section 409A representation
 - Assumed options could create material liability for buyer
- Withholding Taxes
- Earnout/Escrow Considerations (IRC Section 409A/Substantial risk of forfeiture issues)
- Other Equity Awards (SARs, restricted stock, RSUs)
 - IRC Section 409A hurdles

Know the Hurdles under IRC Section 409A

- Final regulations effective January 1, 2009
- Frequently encounter a lack of compliance
- Requires some careful and creative arguments when advising clients on potential acquisitions
- Must lay out business-deal risks for client (excise tax, reporting and withholding obligations, potential gross-up)
- Individuals in noncompliant plans are subject to tax at the time of vesting in addition to 20% penalty tax and to interest at the underpayment rate plus 1%
- Employer has tax-reporting obligations and may incur penalties if it does not properly report

Know the Hurdles under IRC Section 409A

- Equity Plans
 - Exemptions for restricted property under IRC Section 83, ISOs, ESPPs, stock options and SARs (granted at fair market value)
 - Phantom stock and RSUs
 - Fair market value documentation is key in private company deal (especially if options are assumed)
 - Stock right granted on “Service Recipient Stock”
- Change in Control Plans (e.g. Management Carve Out Plan)
 - Is CIC definition compliant with IRC Section 409A?
 - Does plan have continued service requirement?
 - Can reasonable substantial risk of forfeiture argument be made?
 - Short-term deferral rule includes the “vest and pay” exception

Know the Hurdles under IRC Section 409A

- Severance Plan/Employment Agreement
 - Review payment provisions
 - Good reason trigger (walk right, safe harbor, cure period)
 - Six-month delay for specified employees in public companies (generally the top 50 employees)
 - Timing of release (if there is one!)

Know the Change of Control Payments and the IRC Section 280G Issues

- Employment Agreements, Severance Plans and Agreements, CIC Plans, Bonus Plans and Equity Plans
- Payment Triggers
 - Consummation of Deal (single trigger)
 - Without cause/good reason termination (double trigger)
 - *Look to see if good reason will be triggered (business point)*
- Protection Period (6 or 12 months)

Know the Change of Control Payments and the Section 280G Issues

- Excess Parachute Payments
 - Equals or Exceeds 3x Base Amount
- IRC Section 280G/Gross-Ups
- One-Year Presumption
- Shareholder Approval for Nonpublic Companies
 - Approval of 75% of disinterested shareholders (must actually waive and have the payments at risk!)
- Lost Tax Deduction to Buyer (1x Base Amount)

Know About Other Unfunded Liabilities

- Supplemental Executive Retirement Plans
- Excess Plans
- Other Nonqualified Deferred Compensation Plans
- Incentive Plans (annual or long-term incentive plans)

Know About Other Unfunded Liabilities

- Unfunded Nature of Liabilities
- Payment Triggers
 - Does plan/agreement provide for payment upon CIC?
 - Is payment hard wired into deal document?

Know About Other Unfunded Liabilities

- Who will be on the hook for unfunded liabilities?
 - **Nonqualified Plans/SERPs:**
 - *Buyer assumes plans and all liabilities (or just those with respect to transferring employees)*
 - *Buyer establishes mirror plans*
 - *In an asset deal, transferring employees will have termination of employment triggering payment*
 - **Incentive Plans:**
 - *Seller pays pro rata bonuses (employees may or may not then be eligible to participate in Buyer's incentive plans)*
 - *Buyer pays bonuses for full year (difficult if bonuses are based on Seller's performance)*
 - *Retention Concerns*

Presenters


- Amy Pocino Kelly
 - 215.963.5042
 - akelly@morganlewis.com
- Jeffrey P. Bodle
 - 215.963.5417
 - jbodle@morganlewis.com

Technology Series

- For additional information on Morgan Lewis's Technology Series, visit www.morganlewis.com/topics/technology or join the conversation on Twitter using #MLTech.

IRS CIRCULAR 230 DISCLOSURE

- To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see <http://www.morganlewis.com/circular230>.



This material is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It does not constitute, and should not be construed as, legal advice on any specific matter, nor does it create an attorney-client relationship. You should not act or refrain from acting on the basis of this information. This material may be considered Attorney Advertising in some states. Any prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change.

© 2013 Morgan, Lewis & Bockius LLP. All Rights Reserved.