Strafford

Presenting a live 90-minute webinar with interactive Q&A

Executive Compensation Tax Issues in M&A: IRS Rules for Stock Options, Deferred and Equity Comp, Golden Parachutes

WEDNESDAY, JULY 8, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Jeanie Cogill, Partner, **King & Spalding**, New York

Rami Glatt, Principal, **Semler Brossy Consulting Group**, New York

Laura McDaniels, Special Counsel, **Baker Botts**, Palo Alto, Calif.

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

Tips for Optimal Quality

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Agenda

- Background Considerations
  - Context and deal structures
  - Identifying the change in control event
- Structuring the Deal
  - Treatment and taxation of target equity awards
- Due Diligence
  - Due diligence process
  - Identifying Section 409A red flags
- Section 280G
  - Section 280G basics, CIC trends and ISS considerations
  - Exemptions and mitigation strategies
- Between Signing and Closing
  - Terminating a NQDC plan
  - Restructuring severance and transaction bonus arrangements

Background Considerations

Context/Motivations in the Deal

- Auction vs exclusive negotiations
- Form of deal consideration
  - cash vs buyer stock
- Simultaneous sign/close vs signing + delayed closing
- Identity of the parties
  - Private vs public entities
  - Strategic buyer vs private equity or other financial acquirer
  - Established target company vs “aqui-hire”

Basic Deal Structures

- Merger
- Stock purchase
- Asset purchase
- Other variations
  - Tender offer
  - Merger of equals
  - Sale of a subsidiary/division
  - Joint venture
  - PE investment + management rollover

Identifying the Change in Control (CIC) event

- **For Whom?**
  - David and Goliath: seller's stockholders hold majority of buyer stock post-closing
  - Merger of equals
    - Under Section 280G rules, only one company can have a CIC
    - BUT likely a CIC for both parties under Section 409A
  - Sale of subsidiary may be a CIC for parent
- **When?**
  - Tender offer or proxy battle: at onset of TO or proxy fight, or consummation?
  - "Option to purchase": CIC under Section 280G may be triggered earlier than closing (sometimes years before)
  - Board discretion to decide when a CIC occurs? Raises conflicts/governance issues
- **Contract vs Tax Rules**
  - Section 409A and 280G definitions differ somewhat
    - Section 280G measures a CIC on a controlled group basis; Section 409A focuses on employer/payor company
  - Transaction could be a CIC under Section 280G and/or 409A but not under equity plans/employment contracts, or vice versa

Structuring the Deal:
Treatment of Target Equity Awards

Impact of Deal Structure on Equity Awards

Merger or Stock Purchase

- Continuity of employment
- Awards may be assumed (or substituted) or cashed-out
- Subject to equity plan terms, may impose different treatment for different awards:
  - Vested vs unvested
  - Continuing employees vs others
  - Underwater vs in the money options
  - Cash-out of 409A "tainted" awards

Asset Purchase

- Generally results in a termination of continuous service *under equity plan*
  - Even in a subsidiary sale, where continuity of employment remains
- Unvested awards usually terminate at closing (or termination of employment from seller, if later)
- Vested awards treated as per plan/award terms
  - 90 day option exercise period

•Buyer less involved, but will want to know how much is received by acquired employees

Forms of Equity Awards

- Equity awards are usually an important component of an employer's compensation program. They can take various forms, including:
  - Stock options, either incentive stock options or "ISOs" or nonqualified stock options or "NQSOs"
  - Restricted stock
  - Restricted stock units or "RSUs"
  - Stock appreciation rights
  - Phantom stock and other equity-based incentives
  - For partnerships, restricted or vested capital or profits interests

Diligencing the Equity Awards

- Treatment of target equity awards is often a key focus in a transaction
- Equity awards often of paramount interest to key employees of target, who frequently hold a large biggest portion of their compensation in equity
- The parties must carefully review the terms of outstanding target equity awards, which may be found in:
  - Equity plan documents
  - Award agreements
  - Employment agreements
  - Change in control agreements
  - Severance agreements and plans
- Parties should consider:
  - Does the transaction constitute a change in control?
  - If there is a change in control, what *can* or *must* happen to outstanding awards?
  - If there is no change in control, how can the awards be treated?
  - In light of the above, how do the parties want to treat outstanding equity awards?
  - Is participant consent required and, if so, what consideration can be provided?

Treatment of Equity Awards

- In deciding how to treat outstanding target equity awards, consider:
  - The tax consequences to the parties and to the award holders
  - The impact on the purchase price
  - The effect on employee retention and morale
- For stock transactions, the options are broadly:
  - Cashout, or
  - Assumption or substitution (rollover)
- If cashout is chosen:
  - It's easy and administratively convenient
  - Generally the award holder receives the value of the vested awards, or (for options and SARs) the excess of the deal price over the exercise price
  - Payment can be in cash or shares, the latter most frequently if part or all of the consideration for the transaction is in stock
  - Parties must determine who pays for the cashout – seller shareholders or the buyer
  - A cashout is counter-retentive; employees may do so well that they have little incentive to remain with buyer, and buyer may need to issue new equity awards following closing

Cashout of Underwater Stock Options and Worthless Equity Concerns

- Can underwater options be cancelled at the closing for no consideration and without optionee consent?
  - Look at what the plan and award agreements say. Ideally, they should unambiguously permit the cashout of underwater options without consideration, based on closing date consideration, without regard to earnouts
  - If the plan or award entitles the holder to the “value” of the option on cancellation or requires that the holder retain his or her “economic position” on the cancellation, because an underwater option will generally have some Black-Scholes-type value, a payment may need to be made to the optionee and/or the optionee’s consent obtained. *AT&T v. Lillis,* Delaware 2009
- Worthless equity:
  - *In Re: Trados, Incorporated Shareholders Litigation* case in Delaware in 2013
  - Court applied the “entire fairness” standard rather than the deferential business judgement standard to a management carve-out plan that reallocated proceeds from common stock to management
  - Buyers should be mindful of the divergent interests of preferred and common stockholders
  - Buyers should also consider the independence of boards that are composed largely of management or VC appointees

Tax Issues for Equity Award Cashouts

- Options and SARs:
  - Holders recognize ordinary income on the cashout amount
  - FICA and income tax withholding apply, including to ISOs that are cashed out
  - If the holder of an ISO exercises before the cashout, then FICA and federal income tax withholding won't apply, but the cashout amount will be taxed at ordinary income rates
  - The employer is subject to a tax deduction equal to the amount taken into ordinary income
  - Section 409A permits payout of the spread or a larger amount
  - Section 409A permits deferred payout of amounts subject to escrow (within five years) and/or subject to earnout, as long as the payments are made on the same schedule and on the same terms and conditions as they are made to the target's stockholders generally
  - Practitioners have become comfortable that payout of cash over original vesting schedule is also consistent with Section 409A
    - Should permit settlement in stock at the time of vesting as well – that is, a conversion of options into RSUS

Tax Issues for Equity Award Cashouts

- RSUs not subject to Section 409A:
  - Holders recognize ordinary income and are subject to FICA and federal income tax withholding at the time of the cashout
  - Employer is entitled to a corresponding tax deduction
- RSUs and other awards that are subject to Section 409A:
  - Generally need to pay out on the schedule determined at grant
  - Cashout at the time of the transaction may not be permitted if a change in control is not a payment event or a change in control is a payment event but the transaction is not a Section 409A compliant "change in control"
  - But a special Section 409A rule permits the termination and liquidation of nonqualified deferred compensation arrangements within 12 months of a change in control
  - Escrow and earnout delayed payments are permitted under Section 409A, as long as on the same schedule and on the same terms and conditions as for target stockholders generally
- Restricted stock:
  - If no Section 83(b) election was made at the time of grant, and the restricted stock vests on the change in control, then the holder is taxed at ordinary income rates on the excess of the consideration received over the amount (if any) paid for the shares. Amount paid will be subject to FICA and federal income tax withholding, with a corresponding deduction to the employer
  - If a Section 83(b) election was timely made, the holder will recognize either long-term or short-term capital gain or loss on the difference between the transaction price and the value on the date of grant, with no employer deduction

Equity Rollovers in Stock Transactions

- A buyer may want to rollover outstanding equity awards by either assuming the awards together with the seller's equity plan, or substituting awards under one of its own buyer equity plans
- If outstanding awards are assumed, buyer shares used to fund the issuance, settlement or exercise of the assumed awards do not deplete the buyer's equity plan reserve
- Rollover is more common when buyer is a public company than when buyer is a private equity fund or other financial buyer
- The parties should review the terms of the plan and awards to ensure that rollover is permitted without participant consent
- The vesting, expiration and other terms of the assumed or substituted awards are generally preserved, but the number of shares and exercise price will generally need to be adjusted

Option Rollovers in Stock Transactions

- For ISOs to be rolled over without adversely affecting the favorable tax treatment accorded to ISOs, a number of rules set out in Section 424 of the Internal Revenue Code must be satisfied:
  - The new option cannot provide the holder with additional benefits that the old option did not have
  - The aggregate spread value may not be higher after the rollover than before
    - The ""spread" is the excess of the aggregate fair market value of the underlying shares over the aggregate exercise price
  - The ratio of the exercise price to the fair market value of each share subject to the new option may not be **less** than (but may be **more**) than the old option. That is, the new options can't be more "in the money" than before the transaction
  - The holder of the option won't recognize any income on the rollover of the options and the employer will take no deduction
  - Vesting can be accelerated without adversely affecting the ISO treatment. But accelerating the vesting of ISOs may have the effect of disqualifying the options if the $100,000 per year limitation on the aggregate fair market value of the stock on which ISOs are exercisable for the first time during any calendar is exceeded
- For nonqualified stock options or SARs to be rolled over without loss of the exemption from Section 409A, the following requirements must be satisfied:
  - As with ISOs, the aggregate spread may not be greater after the rollover than before
  - However, there is no requirement that the ratio of exercise price to share price be maintained (or increased but not decreased). Therefore, a rolled nonqualified stock option or SAR can be:
    - over *more* shares with a smaller per share spread, or
    - over *fewer* shares with a larger per share spread (more "in the money")
  - There is no blanket requirement that the other terms of the option cannot be more favorable than the pre-transaction terms, as there is with an ISO

Special Tax Issues for Equity Awards

- Escrows and earnouts raise special issues:
  - If there is an option rollover, how does one treat an amount put into escrow?
  - For example, if the target shares are being acquired for $10 a share, and $1 of that is being put into an escrow for twelve months to indemnify the buyer for any breaches of target representations, what price should be used for the option spread and ratio? $10, $9, or something in between?
- Aqui-hiring and cash payments for vested equity subjected to a new service requirement:
  - Cash payments for management equity that was vested at the time of the transaction but that is subjected to a new vesting condition at closing at the request of the buyer, usually the requirement to continue in service for an additional period of time
  - Does this turn what would be installment payments for the sale of capital stock taxable at capital gains rates into compensation for services taxable at ordinary income rates?
  - Helpful if the same price is being received by other non-management shareholders
  - State the intended tax treatment in the documentation
- Who gets the deduction – buyer or seller group – for equity award cashouts?
  - Section 83 and Section 162 of the Internal Revenue Code
  - Next day rule
  - Can the parties agree as to who will get the deductions?
- Imposing a post-change in control risk of forfeiture on vested management equity
  - Rev. Rul. 2007-49
  - No tax consequences if there is no change in the stock
  - Taxable versus nontaxable transactions

Due Diligence

Due Diligence Process

- Detailed review of employee benefit plans and employment related obligations
- Pay special attention to:
  - Equity plans and forms of award agreements
  - Target's equity grantmaking practices
  - Employment agreements
  - Post-employment obligations
  - Change-in-control/retention bonus arrangements
  - Annual bonus and commission plans
  - Supplemental retirement and excess benefit plans
- Identify key issues and risks to Buyer
- Determine how to address in definitive agreements
  - Representations and warranties: risk allocation and disclosure
  - Alterations to deal structure/terms/price
  - Closing conditions
  - Indemnification

Due Diligence: Equity-Linked Plans

- Determine whether stock options and stock appreciation rights (SARs) are exempt from Section 409A (especially if they will be assumed)
  - Exercise price must be at least FMV at grant date
  - Awards must be granted on “service recipient stock”
    - Means common stock of the award recipient’s employer or a parent company
    - Watch out for: awards granted “up” the corporate chain by a subsidiary, to service providers of a sister company, or covering preferred stock
- Verify that RSUs and phantom equity are either exempt from Section 409A as “short term deferrals” or have compliant payment terms
  - Watch out for:
    - Retirement eligible vesting acceleration
    - “Liquidity event” RSUs
    - Phantom equity with non-409A compliant payment triggers (e.g., ROI hurdles) where terminated employee remains eligible for payout
- If cash-out is contemplated, verify that plan/award terms permit this, and will not cause an impermissible acceleration under Section 409A

Due Diligence: Severance Plans and Employment Agreements

- Review payment provisions
  - Look out for differences in severance payment timing (installments before CIC and lump sum on/after CIC)
  - Do vesting acceleration rights in employment agreement conflict with equity award terms?
- Cause and Good reason triggers
  - "Walk right" -- e.g., a very employee favorable Good Reason definition
    - Usually results in severance being deferred compensation subject to Section 409A
  - Consider need to harmonize definitions post-closing, and potential for Good Reason trigger to be implicated in post-closing integration/restructuring
- 6-month delay of payment of deferred compensation (for public company)
  - Must be in writing for public company specified employee
  - Hard wired 6-month delay even for payments that would otherwise be exempt means they are deferred compensation
- Release timing issues
  - Can the employee impermissibly control which tax year the deferred compensation payment occurs based on when release is delivered?

Due Diligence: Nonqualified deferred compensation (NQDC) Plans

- Determine whether plans/arrangements provide for accelerated vesting or payment on a CIC
  - If plan provides for payout on CIC, then CIC definition must comply with Section 409A
- Has there been a trust established, and does the CIC trigger funding?
- Consider whether desirable to terminate plan in reliance on Section 409A plan termination rules (to be discussed later)

Section 409A and Due Diligence Red Flags

- Option exercise price issues (private company target)
  - Scenarios:
    - Options granted in the gap period after expiration of 12-month safe harbor and prior to receipt of new valuation. New valuation report when received has an "as of date" that is before the grant date of an option, and FMV in higher than exercise price used for options granted during gap period.
    - Approval of option grant delayed for a year, and when granted the company set strike price at FMV when employee was originally hired, not the FMV as of the grant date.
    - Options granted at 11th hour before receipt of term sheet using 409A valuation that does not take into account the deal.
  - Key questions:
    - Can options be fixed through an uppricing in reliance on correction under IRS Notice 2008-113?
    - Can we take position that award was voidable under terms of the Plan?
  - Takeaways:
    - Due diligence review should include review of Section 409A valuation reports (including as of date) against option grant dates and strike prices to uncover potential discounted options early in process.
    - Section 409A corrections can be handled as a condition to closing.

Section 409A and Due Diligence Red Flags

- NQDC plan errors
  - Scenarios:
    - Plan requires payout on a CIC, but CIC definition is not Section 409A compliant
    - Deferral elections failures (for example, allowing deferrals made after December 31 of year prior to the year earned amounts are deferred)
      - See Wilson v. Safelite Group, Inc., 930 F.3d 429 (6^{th} Cir. 2019)
    - Failure to comply with Code involving FICA tax payments arising on retirement
      - See Davidson v. Henkel, 115 AFTR 2015-396 (E.D. Mich. Mar. 24, 2015)
    - Termination of NQDC plan (prior and unrelated to CIC) where company accelerates payout in mistaken belief the arrangement was a "short term deferral"
  - Takeaways:
    - Verify (in diligence and through reps/warranties) that seller is in operational as well as documentary compliance
    - Check whether NQDC plans are drafted as ERISA-covered plans (to preempt state law claims), and whether include waivers of Section 409A liability to plan participants
    - Depending on risk and exposure, may need to consider special indemnities or other Buyer protections

Section 409A and Due Diligence Red Flags

- Incomplete equity grants
  - Scenario:
    - Offer letter includes promise to grant stock option, but no awards formally approved by Board or issued to employee.
    - Transaction contemplates assumption of options
  - Key questions:
    - Did offer letter include enough terms to reflect an actual grant (e.g., number of shares, exercise price, vesting schedule, incorporation of plan terms)?
    - If yes, did the board approve the offer letter, or is there evidence that the Board delegated grantmaking authority?
  - Takeaways:
    - Taking the position that options were granted via offer letter could place Buyer at risk of Section 409A liability for a discounted grant if assumed
    - Ideally treat awards as ungranted, and pay CIC bonus in exchange for release of claims

Section 280G

Overview of 280G and Section 4999

Sections 280G and 4999 of the tax code were enacted to discourage large payments to executives upon change in control (CIC) transactions.

- Section 280G relates to 'Golden Parachute Payments' pursuant to a Change-In-Control (CIC) that denies corporations a tax deduction for the 'excess' payment, while Section 4999 imposes a 20% excise tax on the 'excess' payment
- The rationale for CIC agreements is generally to provide enhanced severance under specific circumstances to encourage key employees to stay with the company despite knowing in advance that their positions could be modified or eliminated post-transaction
- These programs free executives from their concern for future employment and:
  - Encourage focus on achieving maximum transaction value
  - Maintain attention on the successful completion of the transaction
  - Enhance the company's recruitment ability during periods of uncertainty
- The result is that 'excess' golden parachute payments are an inefficient way to deliver compensation as the tax penalties can eliminate much of any gain
- Historically, many companies adjusted for an executive's tax penalties by 'grossing-up' for the excise tax paid, thus ignoring the loss of the deductibility for the company…but shareholder pressure has all but halted the practice of gross-ups to avoid excessive compensation and maintain deductibility for the company

Definition of CIC and 'Disqualified Individuals'

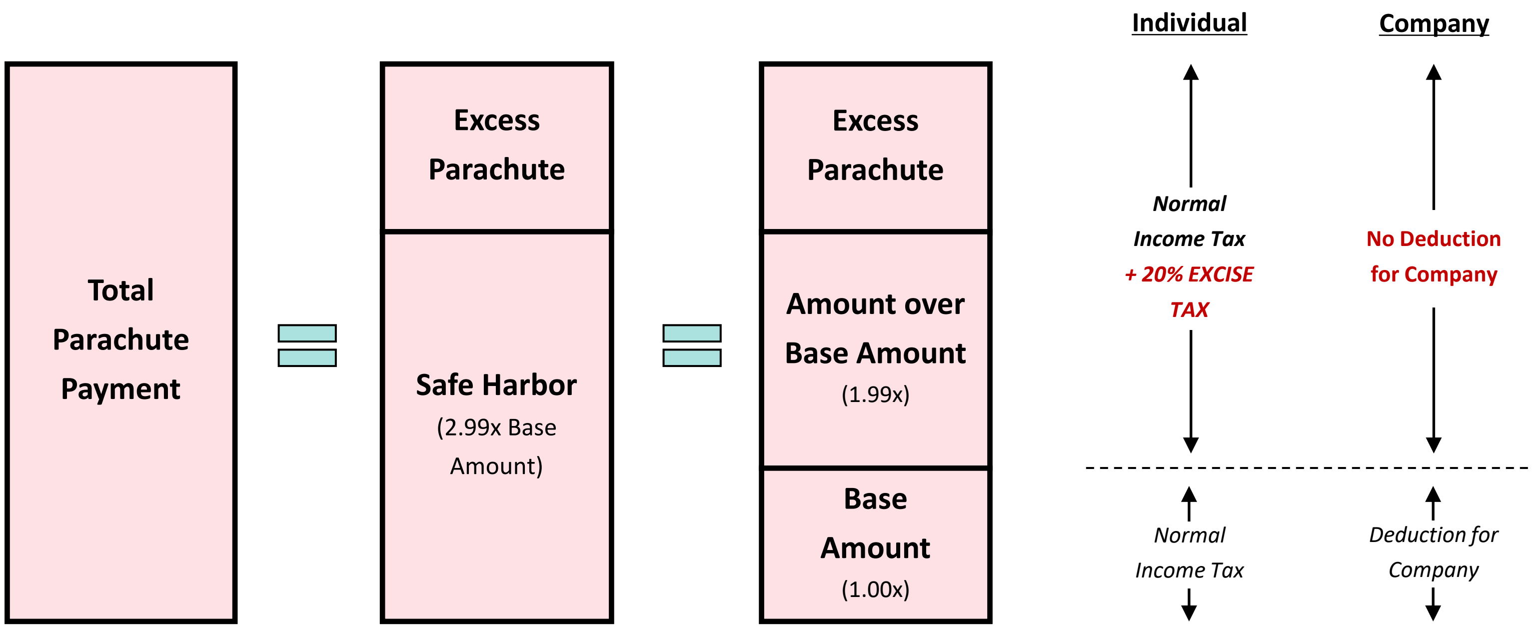
The statute defines 'Change-in-Control' and 'Disqualified Individual' as follows:

- **Change-in-Control** can result for any one of the following reasons, as outlined in the statute:
  - A change in ownership or control
  - A change in effective control
  - A change in the ownership of a substantial portion of a corporation's assets
  - However, companies may make payments for scenarios that may not necessarily trigger a 280G liability
- Those that are subject to review are called **'Disqualified Individuals'** and are defined as:
  - *An officer*: no more than 50 employees or, if less, the greater of 3 employees, or 10% of the employees (rounded up to the nearest integer) of the corporation are treated as disqualified individuals for purposes of this definition
  - *A 1% or more shareholder*: owning stock with a value exceeding 1% of the total fair market value of outstanding stock
  - *A highly compensated individual*: earning at least $120,000, limited to the lesser of (1) the highest paid 1% of the employees, or (2) the highest paid 250 employees

Definition of ‘Excess’ Parachute Payment

‘Excess’ payments result in tax penalties for both the company and the executive. An illustration of how 280G works is shown below:

- **Base amount:** an amount equal to the average of the executive’s preceding five years of W-2 income (partial years may be annualized)
- **Safe Harbor:** an amount equal to 2.99x the executive’s base amount
- **Excess Parachute:** the amount by which any parachute payments *exceeds* the Safe Harbor



Steps for a 280G Analysis

At a high level, there are generally seven key steps to conducting a formal 280G analysis:

1
- Determine each disqualified individual's 'safe harbor amount' from W2s

2
- Determine what payments or compensation are made to each disqualified individual (i.e. wages, bonuses, severance pay, fringe benefits, equity compensation, etc.)

3
- Determine whether any of the parachute payments can have the contingent portion reduced under Q/A-24
- Generally, a payment is contingent unless it is substantially certain, at the time of the change, that it would have been made whether or not the change in control occurred

4
- Reduce each parachute payment by whatever portion may be established as reasonable compensation with 'clear and convincing evidence' (i.e., compensation for services after a CIC)

5
- Determine the present value of the parachute payments as of the date of CIC (almost always the case, but can be earlier if payment made prior)
- Present value generally determined by using a discount rate equal to 120% of the Applicable Federal Rate (AFR) compounded semiannually

6
- Calculate the 'excess parachute payments' by subtracting the base amount from the aggregate parachute value
- If the aggregate present value equals or exceeds the 'safe harbor amount,' it gives rise to an 'excess parachute payment' subject to the 20% excise tax under Section 4999 and disallowance of deduction under Section 280G
- The value of 'excess parachute payments' equals the excess of the aggregate parachute value over one times the base amount

7
- Determine how the 'excess parachute payment' will be treated and the extent of such treatment
- Alternative approaches include gross up, cutback, 'best after tax'

Parachute Payment Valuation Methods

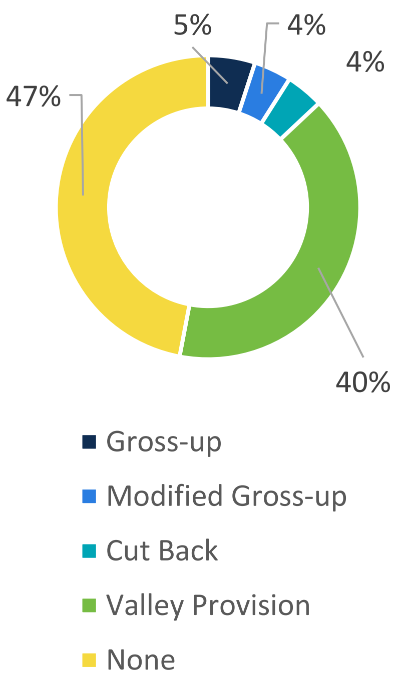
The parachute payment values from an IRS perspective may differ from actual cash value being received by the executive

		Parachute Valuation
Cash Payments	Severance Payment	• Valued at full amount
	Prorated STI or Cash LTI	• If within the performance period, valued at the full actual amount • If on the last day of period and no requirement to be employed on the payment date, then not included
Equity	Stock Options & SARs	• Assessed a value (interest rate) of receiving the 'in-the-money' value earlier than the vesting date, plus a value associated with the lapse of vesting (1% per month) • Typically a very small portion of the value of the options
	RSUs	• Assessed a value (interest rate) of receiving the award value earlier than the vesting date, plus a value associated with the lapse of vesting (1% per month) • Typically a very small portion of the face value of the shares
	PSUs	• If performance criteria have not been satisfied or the performance period is not complete, the full 'in-the-money' value at the time of the transaction will be included as a parachute value • If there are discrete performance criteria or performance period within one grant, then each tranche may be treated separately (e.g., Revenue, TSR)
Other Benefits	Benefits	• The present value of the benefits to be received which results in an amount just slightly less than the value received
	Tax Gross-up	• The full value of the excise tax and the tax gross-up will be included in the parachute payment

CIC Market Practices *(Page 1 of 2)*

The "Golden Parachute" rules impose a 20% excise tax on an executive if the executive receives a parachute payment greater than the "safe harbor" limit. Companies may address the excise tax issue in one of the following ways:

Prevalence of Excise Tax Protection Provisions for CEOs



Triggers

- **Single trigger** – Benefits become payable automatically upon a change in control
- **Modified single trigger** – In addition to benefits becoming payable pursuant to a double trigger, the executive may trigger payment by voluntarily terminating employment for any reason during a specified "window period" – usually the 30-day period following the one-year anniversary of the change in control
- **Double trigger** – Benefits become payable after both a change in control and the termination of the executive. The termination can be either by the company without "cause" or by the executive for "good reason" (that is, a "constructive termination"), within a specified period following the change in control

Gross-ups

- **Gross-up:** Company pays the full amount of the excise tax, making the executive "whole" on an after-tax basis
- **Modified Gross-up:** Gross-up of an executive if payments exceed "safe harbor" limit by a certain amount or percentage
- **Cut Back:** Company cuts back parachute payments to the "safe harbor" limit to avoid excise tax
- **Valley Provision:** Company cuts back parachute payments to the "safe harbor" if financially advantageous to the executive. Otherwise, no adjustments to payments and the executive is responsible for the excise tax
- **None:** Some companies do not address the excise tax and executives are solely responsible for its payment

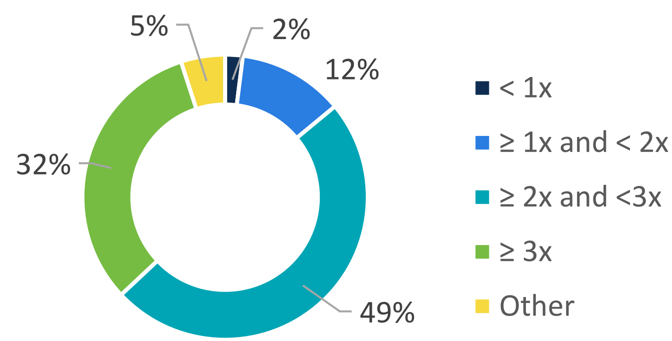
Note: Survey data and exhibits from Alvarez & Marsal "Executive Change in Control Report – Analysis of Executive Change in Control Arrangements of the Top 200 Companies"

CIC Market Practices *(Page 2 of 2)*

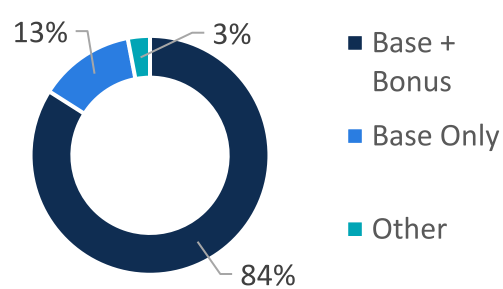
Key Takeaways

- ~75% of CEOs and CFOs receive cash severance payment upon termination in connection with a CIC
- Most common multiple: 2x – 2.99x
- No observed severance multiples greater than 3x
- 84% of companies surveyed define compensation for purposes of determining the cash severance amount as base salary plus annual bonus
- ~65% of CEOs and CFOs receive an extension of health and welfare benefits upon termination in connection with a CIC
- Most CIC payout triggers (97%) are categorized as double-trigger

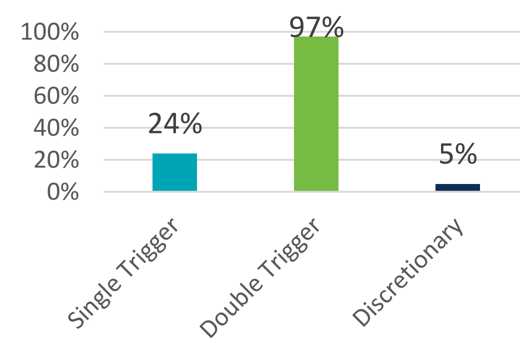
Most Common Severance Multiples Provided to CEO Upon Termination With CIC Across All Industries



Compensation Definition for Cash Severance Payments



Prevalence of CIC Triggers for Outstanding Equity Awards[1]



Note: Survey data and exhibits from Alvarez & Marsal "Executive Change in Control Report – Analysis of Executive Change in Control Arrangements of the Top 200 Companies"

[1] Because some companies have multiple equity awards outstanding with different equity triggers, the prevalence adds up to more than 100%

ISS Views on Golden Parachutes

- **Double-trigger vesting** for CIC equity awards is considered best practice; vesting acceleration should require both (1) CIC and (2) qualifying involuntary termination event
- ISS evaluates **excessiveness** of CIC payouts taking into consideration the value of payouts on an absolute basis and one or total payouts relative to the transaction's equity value
- New and existing **problematic** CIC severance features are evaluated by ISS evaluations, with greater scrutiny against recent amendments and presence of multiple legacy problematic features

ISS has high levels of scrutiny for plans with single-trigger vesting. It also evaluates the excessiveness of CIC payouts and problematic CIC severance features, including a liberal CIC definition

- A plan that contains a **liberal CIC definition** that could result in vesting of awards by any trigger other than a full double trigger is considered a negative overriding factor
  - A liberal CIC definition typically includes:
    - Shareholder approval of a transaction, rather than its consummation
    - A change in less than a half of the board; an acquisition of a low percentage of outstanding common stock (15% or less)
    - An announcement or commencement of a tender or exchange offer
    - Any other trigger that could result in windfall compensation without the occurrence of an actual CIC of the company
- To remedy equity plans containing a liberal CIC definition:
  - Qualify the problematic CIC definition to be preconditioned on determinate events that effectively constitute a non-liberal CIC definition
  - For an existing plan that is being amended, specify that a non-liberal CIC definition will be effective for grants made after the plan amendment date

Note: Sourced from Institutional Shareholder Services

Section 280G Exemptions

- Section 280G applies to corporations → not applicable to partnerships
  - BUT Section 280G does apply to: publicly traded partnership, Section 856(a) real estate investment trust
  - 280G *may* apply to:
    - Sale by partnership parent of stock held in a corporate subsidiary
    - Sale by corporate parent of interests in a partnership subsidiary
- "Small business corporation" exemption if company is an S corporation under IRC 1361 (or is eligible to make an S-corporation election)
  - Section 280G rules waives prohibition on nonresident alien shareholders
- Certain tax exempt corporations under IRC 501 or 529
- **BUT** foreign corporations are not exempt from Section 280G
  - IRC 4999 20% penalty tax can apply to disqualified individual who is a US taxpayer, even if loss of US corporate tax deduction under Section 280G is not relevant (or material) to the corporation
- Special rules apply to CIC in context of bankruptcy proceeding
  - See IRS Revenue Ruling 2004-87

When is a payment contingent on a CIC?

- Payment would not have been made absent the CIC (“but for” test)
  - If it is substantially certain at the time of the CIC that a payment would be made regardless of whether the CIC occurs, it is not contingent on a change in control
- Payment vests early or is paid early due to the CIC
- Also includes payments contingent on an event closely associated with the CIC – such as termination of employment
- One year presumption: Payment made as a result of an event that occurs within one year before or after a CIC is <u>presumed</u> to be contingent on a CIC, but the presumption is rebuttable
  - *Presumption more likely to be rebutted*: CEO receives salary increase through normal review process, and is in line with similar increases given to her in last 3 years.
  - *Presumption likely not rebuttable*: CEO is concerned that company is a potential hostile takeover target, and negotiates new equity grants. 6 months later, the company is subject to a proxy battle and a CIC occurs. Value of accelerated vesting is likely to be entire award rather than merely 1.280G-1, Q/A 24 acceleration value.

Section 280G and Private Company Cleansing Vote

- Available to companies without publicly traded stock
  - Delisted company traded on the "pink sheets" is still deemed a public company
- Approval by shareholders holding more than 75% of voting power of all outstanding voting stock as of immediately before CIC
  - Special voting rules for entity shareholders; exclusion of shareholders related to disqualified individuals receiving parachute payments
  - Compliance with corporate law approval requirements is not enough
- Before the vote, there is <u>adequate</u> disclosure of all <u>material</u> facts to <u>ALL</u> eligible voting stockholders
- The vote must determine the disqualified individual's right to receive or retain the payments subject to the vote
  - Often accomplished through irrevocable waivers signed prior to vote solicitation
- Conducted on slate basis or separately for each disqualified individual, and cover all or only a portion of parachute payments
- Shareholder approval of CIC cannot be tied to favorable Section 280G vote

Section 280G and Reasonable Compensation

- "Reasonable compensation" for services actually rendered after the CIC is not a parachute payment
  - May cover payments under agreements entered into prior to CIC (equity awards that vest post-closing; post-closing consulting fees)
  - Also includes holding oneself out as available (consulting arrangement), or refraining from performing services -- i.e., through a non-compete
- Standard of proof is "**clear and convincing**" evidence
  - Very fact intensive; IRS may challenge overly aggressive value
  - Square D Co. v. Commissioner, 121 T.C. 168 (2003) provides some guidance on "clear and convincing" evidence standard
    - Use of historical compensation paid to similarly situated employees of the Buyer and other comparable employers
      - Peer group used by acquirer as starting point for comparable employers
      - Court limited evidence to compensation data in non-CIC context
      - Court disfavored broad, off-the-shelf market surveys in favor of customized studies
    - Annual compensation may consider value of equity awards and non-cash benefits
    - Allocation of multi-year payments over the period in which earned

Section 280G and Reasonable Compensation

- Whether compensation tied to a non-compete qualifies as reasonable compensation turns on:
  - Enforceability of non-compete under applicable state laws
  - Likelihood of enforcement by the employer/payor
- Value placed on non-compete generally determined by third party valuation
  - Historical compensation approach: the amount the executive would have earned if employed
  - "Damage" value: potential economic loss or competitive damage executive could inflict if breached a non-compete
  - "Lesser of" or hybrid approach

Other Section 280G Mitigation Strategies

- Increase the executive's 280G base amount
  - Exercise options and avoid deferring compensation
  - Accelerate income into year prior to closing
    - Pay annual bonuses early
    - Vest equity awards (and exercise options)
    - Pre-pay severance (may not be possible due to Section 409A)
- Delay entering into certain agreements until after closing
  - Arrangements negotiated and made post-closing are not subject to Section 280G
    - Downside is that executive does not have certainty of arrangements pre-closing
    - Unlikely that arrangement which has been negotiated pre-closing but not documented until after closing would qualify
  - *But* payment rights granted post-closing intended to economically replace forfeited pre-closing payments may not escape Section 280G (see *Square D*)

Between Signing and Closing

Termination of Deferred Compensation Arrangements

- If the target company has a deferred compensation plan subject to Section 409A, can you require payout of deferred amounts on the change of control if the document does not include a CIC as a payment trigger?
- Section 409A permits the termination of a nonqualified deferred compensation plan within the 30 days preceding or the twelve months following a change in control event
- However, all nonqualified deferred compensation plans treated as the same sort of plan under Section 409A that are sponsored by the company immediately after the change in control event that apply to each participant experiencing the change in control event must also be terminated and paid out
- Action to be taken by the service recipient that is primarily liable immediately after the transaction for the payment of the NQDC
- Balances must be paid under all aggregated plans within twelve months of the date the service recipient takes the action to terminate the plan
- For example, if the target has outstanding RSUs that are subject to Section 409A and that are not payable on a change in control, and a nonqualified deferred compensation plan that permits both employee and employer contributions, then, if the parties wish to pay out the RSUs on the transaction, the employer portion of the DCP must also be terminated and liquidated (although the employee elective deferral portion need not)

Restructuring Severance Arrangements

- Hypothetical 1: Buyer desires to replace a severance arrangement with a new consulting, retention or non-competition arrangement
  - Substitution rule: an amount that replaces or substitutes an NQDC also constitutes NQDC – it cannot be converted into a Section 409A exempt short term deferral to change payment timing
  - May still be able to do this (or something similar):
    - For severance that fits within short term deferral exemption (but be careful of Good Reason definition)
    - Rely on Treas. Reg. §1.409A-3(i)(5)(iv)(B) to modify vesting triggers on a CIC to extend vesting beyond the CIC if new vesting would be a substantial risk of forfeiture
- Hypothetical 2: Seller and Buyer desire to accelerate and pay severance (that is deferred compensation) at closing to employee who is continuing post-closing
  - Section 409A plan termination rule? May work if this is a one-off agreement
  - Asset sale – may permit treatment as a separation from service
  - Rely on Treas. Reg. §1.409A-3(i)(5)(iv)(B) to modify certain nonvested compensation

Thank You

Jeanie Cogill

King & Spalding

jcogill@kslaw.com

Rami Glatt

Semler Brossy Consulting Group

rglatt@semlerbrossy.com

Laura McDaniels

Baker Botts

laura.mcdaniels@bakerbotts.com