

Structuring Management Carve-Out and Change-in-Control Plans

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About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
 - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
 - Obtained his LL.M. (Taxation) from New York University
 - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
 - Editor-in-Chief, Journal of Medicine and Law
 - President, Tax and Estate Planning Society

Upcoming 2018 Webinars

- Upcoming 2018 webinars:
 - Effective Compensation Governance – The A-Z Course (4/12/2018)
 - Accounting Considerations that Impact Equity Compensation Design (5/17/2018)
 - Training Course on Forms 3, 4 and 5 (6/14/2018)
 - Pay Ratio: Developments from Last Proxy Season (7/12/2018)
 - Preparing for Proxy Season: Start Now (Annual Program) (8/9/2018)
 - Planning for an IPO: Compensation Considerations (Part 1 of 2) (9/13/2018)
 - Compensation Changes Due to Loss of EGC Status (Part 2 of 2) (10/11/2018)
 - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
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- Upcoming 2019 webinars:
 - List will be created around September 2018

- Sign up here: <https://www.andrewskurth.com/ExecCompWebinar>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
 - Tax,
 - Securities,
 - Accounting,
 - Governance,
 - Surveys, and
 - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
 - Tax lawyers,
 - Securities/corporate lawyers,
 - Labor & employment lawyers,
 - Accountants, and
 - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- The purpose of this presentation is to address various design considerations when structuring a management carve-out bonus plan or a change-in-control bonus plan for key employees

- To that end, this presentation covers:
 - Terminology,
 - Preliminary considerations,
 - Identifying the key employees,
 - Determine the type of funding trigger,
 - Determine the value of the award,
 - Vesting conditions & forfeitures,
 - Form and timing of payment,
 - Taxation, and
 - Ability to amend or terminate

Terminology: Change-in-Control v. Management Carve-Out

- A management carve-out plan and a change-in-control plan are both cash bonus plans that provide cash liquidity to certain key employees upon a change-in-control transaction (“**CIC Transaction**”) of the Company
 - Both accomplish the same end result but for different purposes
- A purpose of a management carve-out plan, and for that matter a change-in-control plan, is to motivate key employees to “do their best” and remain incentivized through the CIC Transaction
- The term “management carve-out plan” is typically used in the following situation (or similar situation):
 - The Company has two classes of stock (*i.e.*, common stock and preferred stock)
 - The key employees hold common stock
 - The preferred stock holds all or most of the value of the Company and the common stock has nominal or no value
 - A contractual obligation to pay cash is a debt obligation of the Company, and as a result, should be paid prior to any payments to the holders of preferred stock
 - Result: through a management carve-out plan, key employees otherwise holding worthless (or near worthless) common stock can be paid prior to the preferred stockholders (*i.e.*, the key employees become first in line by jumping over the preferred stockholders)

Pointer No. 1 – Preliminary Considerations

- Determine the primary goal
 - Motivate the key employee to increase the Company's value and incentivize the key employee to remain employed through consummation of the CIC Transaction?
 - Same as above but also incentivize the key employee to remain employed after the CIC Transaction?
 - Same as directly above, but also to motivate the key employee to, on a post-CIC Transaction basis, work hard to maximize the earn-out that otherwise could be paid to the selling stockholders?

- Identify which key employees should participate and the approximate values

- Review applicable corporate documents to determine whether any corporate formalities must be satisfied
 - Review the stockholders' agreement, if any
 - Review the Corporate Charter or Bylaws
 - Approval by the Board of Directors should be required. But is it required to have stockholder approval or is such approval warranted under the applicable facts?

Pointer No. 2 – Identify the Key Employees

- Determining which key employees should receive an award depends upon highly specific facts. Typical thoughts to consider include:
 - Do any of the key employees have the ability to increase the value of the Company, need to be incentivized to remain employed, and motivated to increase stockholder value?
 - Will any of the key employees be necessary to transition with the Company to a buyer?
 - Assuming there is contingent consideration in the CIC Transaction (e.g., earn-out), are any of the key employees likely to have an ability to increase the value of such contingent consideration?

Pointer No. 3 – Determine Type of Funding Trigger

- What types of transactions should trigger payouts? Typical triggers include:
- Sale of 50% or more of the Company's total voting power? 75%? Something more close to 100%? Thoughts to consider include:
 - A determination needs to be made within the applicable granting documents as to what happens to the outstanding awards/pool when less than 100% of the Company is sold
 - Does the remainder terminate? Does the employee get to keep the portion of the award/pool not settled until the remaining ownership is sold upon some later date, and if yes, should a sunset provision be inserted?
- Consummation of a merger or consolidation in which the Company is not the surviving entity
 - It is typical to retain a carve-out so that this trigger would not apply if the majority of the Board of the surviving company are persons who were members of the Company's Board for a certain period of time prior to the merger
- Sale of all or substantially all of the Company's assets
- Should the transaction trigger include any monetization of the Company's intellectual property rights that results in payments to the stockholders?

Pointer No. 4 – Determine Value of the Award

- How should the value of the award be determined?
 - On an individual basis or pursuant to a pool?
 - On a fixed dollar basis or as a percentage of the sale proceeds? And if the latter, are the sale proceeds determined on a gross or net basis?
 - Should a sliding formula or scale be included?
 - Will the key employees participate in any earn-out dollars? Put another way, is value reduced by any earn-outs or holdbacks?
 - Should the value of any management carve-out bonus be reduced by payments the key employee receives with respect to his/her common shares?
- Determine individual awards based upon a fixed dollar amount?
 - Example: Bobby is awarded \$1.2mm upon a CIC Transaction and Mary is awarded \$1.4mm upon a CIC Transaction
- Create a pool (fixed or percentage) from which key employees will participate?
 - A pool of dollars is created for the benefit of key employees. The pool is either: a fixed dollar amount (e.g., \$3mm) or a percentage of the sale proceeds or net proceeds (e.g., 8% of the net proceeds)
 - Typically, key employees would participate in the pool based upon a percentage
 - Example: Bobby's percentage of the pool is 35%, Mary's percentage of the pool is 45% and 20% of the pool remains available for the Company to award to key employees who have not yet been identified

Pointer No. 4 – Determine Value of the Award (cont.)

- A benefit of the pool concept is that it could be denominated in Units
 - As background, sometimes the change-in-control bonus plan is being implemented at a time when the stockholders are able to determine the maximum amount of CIC Transaction proceeds to which they are willing to share with key employees, BUT neither the Company nor the stockholders are able to identify all of the key employees to participate in the pool
 - As a result, the Company would be unlikely to divide the pool into percentages and award those percentages
 - Converting the pool into a Unit concept where the denominator is the number of units outstanding, is a rather simple way to contain any future dilution (e.g., due to adding new key employees) within the pool

- An example of a Unit concept is contained on the next slide

Pointer No. 4 – Determine Value of the Award (cont.)

- An example of a unit concept is as follows:
 - The amount of the pool is designated as either a percentage of the CIC Transaction proceeds or as a fixed dollar amount
 - The key employee is awarded a certain number of Units. For this purpose, a Unit does not represent any equity ownership and is not a derivative security; instead, the purpose of the Unit concept is to designate the sharing ratio by each key employee within the pool
 - Typically, the formula for determining the value of a key employee's Units is: [Pool Value divided by total # of Units outstanding immediately prior to consummation of the CIC Transaction] x number of Units awarded to the key employee

- An example of a more advanced unit concept is as follows:
 - **Value of the key employee Units =**
$$\frac{[A - (B+C)] \times D}{E} \times F$$
 - **A** = The value (as determined by the Board) of all cash and non-cash proceeds that are paid to the Company or its stockholders in the CIC Transaction
 - **B** = Any and all Company-related debt or liability that continues (or will continue) to be held by one or more stockholders of the Company immediately after the CIC Transaction
 - **C** = All CIC Transaction costs (e.g., accountant fees, attorney fees, investment bankers, etc.) as such costs are reasonably determined by the Board
 - **D** = The intended pool size, set forth as a percentage of the above equation
 - **E** = The total number of Units granted under the Plan that remain outstanding (*i.e.*, were not previously forfeited) as of immediately prior to consummating the CIC Transaction
 - **F** = The number of Units held by the Key Employee

Pointer No. 4 – Determine Value of the Award (cont.)

- Should the value of the award, or the value of the pool, fluctuate based upon a sliding scale? For example:
 - If the CIC Transaction proceeds = or is less than \$15mm, then the pool = \$1mm
 - But if the CIC Transaction proceeds is less than \$40mm but greater than \$15mm, then the pool = \$3mm
 - And if the CIC Transaction proceeds = or exceeds \$40mm, then the pool = \$5mm

- Should the value of the award be tied only to the CIC Transaction proceeds that stockholders receive upon consummation of the CIC Transaction, or should the value of the award also include contingent consideration such as realized earn-outs?

- Should key employees participating in management carve-outs or change-in-control bonus plans share equally (vis-à-vis the stockholders) in the costs of the CIC Transaction?
 - Example: Should the award/pool be proportionately reduced by the costs associated with investment bankers, attorneys, accountants, etc. incurred in the CIC Transaction?
 - Example 2: Should the award/pool be proportionately reduced by debt incurred or assumed by one or more stockholders

Pointer No. 5 – Vesting Conditions & Forfeitures

- The most common vesting condition is to require the key employee to be “present to win”
 - Time-based vesting schedules are generally not used because the goal of a management carve-out or change-in-control bonus plan is for the key employee to be present upon a CIC Transaction
 - However, a common exception to the “present to win” concept is to allow payment if the key employee’s employment with the Company/Buyer at any time after the CIC Transaction and prior to payment is terminated by the Company without Cause or by the key employee for Good Reason (*i.e.*, contingent consideration scenario)
 - Consider whether any forfeitures should be reallocated to remaining key employees

- Failure to timely execute a Waiver and Release is also a common trigger to cause a forfeiture of the key employee’s award
 - Requiring a Waiver and Release helps to protect the selling Company and its stockholders against any future claims brought by a key employee
 - Generally, the key employee is entitled to consider the Waiver and Release for 45 days (though he/she could voluntarily waive this time period). And once the key employee signs the Waiver and Release, he/she may revoke his/her signature within the 7-day period immediately following the signature date
 - Since the foregoing time commitments are required due to age discrimination laws, it is frequently common that the Waiver and Release will not include age discrimination. Thus, providing flexibility for the Waiver and Release to be signed at closing of the CIC Transaction without the 45-day/7-day requirements

Pointer No. 6 – Form and Timing of Payment

- The form of payment can be cash or property, and often will follow what the stockholders are receiving in the CIC Transaction
 - If instead the contractual agreements required only cash to be paid to the key employees, then the Company's stockholders risk that the key employees could receive a large portion of the cash proceeds in the deal if, for example, the sale proceeds to the Company's stockholders were otherwise 70% buyer stock and 30% cash

- Unless the consideration is intended to retain the key employee with the buyer after closing of the CIC Transaction, the consideration is often paid at closing or at the same time the stockholders are paid (as to this latter part, be sure to verify compliance with Section 409A)
 - If the consideration is intended to retain the key employee with the buyer after the closing, then payment is often accelerated upon the earlier of:
 - The key employee terminating employment with the buyer for Good Reason,
 - The buyer terminating the employment of the key employee for other than Cause, and
 - A set number of days after the CIC Transaction (e.g., on the 180th day that immediately follows consummation of the CIC Transaction)

Pointer No. 7 – Taxation

- All ordinary taxable income to the key employee
- Who is the “service recipient”?
 - This question is particularly important in the factual scenario where a key employee is sharing in an earnout on a post-CIC Transaction basis (*i.e.*, the buyer is likely the service recipient)
 - The service recipient is the one who receives the services related to the award
 - The service recipient is the one entitled to the compensatory deduction
 - The service recipient is the one required to satisfy any income tax withholding, and pay the employer portion of any FICA or FUTA
- If the Company is a C corporation, the amounts paid to the key employee could be subject to the golden parachute payment rules of Section 280G (assuming the key employee is a disqualified individual)
 - Mitigation techniques could apply to the extent an “excess parachute payment” exists
- The award should be structured to either avoid the application of (*e.g.*, short-term deferral rule), or comply with, Section 409A

Pointer No. 8 – Ability to Amend or Terminate

- After the management carve-out or change-in-control bonus is distributed to a key employee, should the Company have the ability to amend or terminate such plan without the consent of the key employee?
- One thought is that because the goal of the program is to consummate a CIC Transaction, any inability to accomplish that goal should provide the Company with the flexibility to terminate the arrangement without the key employee's consent
 - However, the presence of such ability could result in the key employees viewing the program as illusory
 - And if this ability is not retained, then minimally the plan should contain an automatic sunset, such that if a CIC Transaction is not consummated within a set period of time, that the management carve-out or change-in-control bonus plan automatically terminates
 - Should the award terminate upon the earlier of an IPO or a financing?

Don't Forget Next Month's Webinar

- Title:
 - Effective Compensation Governance – The A-Z Course

- When:
 - 10:00 am to 11:00 am Central
 - April 12, 2018

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