Designing Change-in-Control Pay

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Housekeeping: About Anthony "Tony" Eppert

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- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
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  - 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

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- Upcoming 2016 webinars:
  - Increasing the Life Expectancy of an Equity Plan's Share Reserve (6/9/16)
  - Compensation Governance: Designing 10b5-1 Trading Plans (7/14/16)
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  - Preparing for the Next Proxy Season: Start Now (9/8/16)
  - Energy Companies: Compensation Governance Survey/Trends (10/13/16)
  - Identifying and Solving Pitfalls in Equity Compensation Administration (11/10/16)
  - The Importance of Miscellaneous Contractual Provisions: A Drafter's Perspective (12/8/16)

- Upcoming 2017 webinars:
  - To be announced in September
  - To suggest a topic for 2017, please e-mail Anthony Eppert

Purpose of this Presentation

- The purpose of this presentation is to discuss various compensation designs that can be used to incentivize and retain key employees through a change in control ("***CIC***") of the employer

- To that end, this presentation covers the following:
  - Certain preliminary questions,
  - Considerations when no CIC is imminent,
  - The attractiveness of certain pay structures from an acquiror's perspective,
  - The perspective of shareholders on any increased stock or value dilution, and
  - Certain 409A and 280G tax issues

Certain Preliminary Questions

- Is the entity in question a C corporation, an S corporation, a partnership, an LLC, etc.

- Is the entity publicly-held or privately-held? The issues are generally the same; however, public companies have additional concerns relating to:
  - CD&A and Form 8-K disclosures,
  - Section 16 issues,
  - SEC tender offer issues (in the context of repricings and/or certain spin-offs),
  - Form S-8 issues, and
  - Shareholder approval requirements under NYSE/NASDAQ listing rules

- What is the nature of the intended transaction? Typical transactions include:
  - Sale or merger of the employer,
  - Sale of a division,
  - Spin-off of assets,
  - Cash distribution to shareholders, and
  - Self-tender of common stock

Certain Preliminary Questions (cont.)

- What is the impact of a prospective transaction on existing key employee compensatory arrangements? Typical items to review include:
  - Severance pay,
  - CIC arrangements and definitions,
  - Golden parachute payments (280G),
  - Tax gross-ups (280G and 409A),
  - Outstanding equity awards, such as:
    - Accelerated vesting provisions,
    - Extension of the post-termination exercise period for stock options, and
    - Adjustments to outstanding equity awards,
  - Certain performance-based awards, and
  - Continuation of medical and life insurance benefits post-termination (related to severance)

- The above items are typically found in:
  - Employment agreements/offer letters,
  - Equity incentive plans,
  - Cash-based incentive plans,
  - Severance plans and arrangements, and
  - CIC agreements

Certain Preliminary Questions (cont.)

- Are there any retention gaps within existing arrangements? If yes, new retention arrangements should be designed to fill or resolve such gaps. For example, consider whether the:
  - Existing arrangements retain the employee through closing
  - Existing arrangements retain the employee for a defined period of time post-closing

No CIC Imminent: Revisions

- Revise potentially objectionable compensation structures
  - Other than compensation structures intended to ensure someone “turns off the lights,” the compensation should be designed to increase shareholder value
  - For example, consider whether to revise “single” triggers and “double” triggers
    - Single trigger = award vests upon a CIC
    - Double trigger = award vests upon a termination of employment within a specified period following a CIC (usually triggered if the employee is terminated by the employer “without cause” or he or she resigns for “good reason”)

- Objectionable compensation structures could include:
  - Golden parachute payments exceeding industry practice, and
  - Cashing out stock options rather than rolling them into options to acquire stock of the new employer

No CIC Imminent: Vesting Considerations

- Consider whether the applicable arrangements should require full or partial accelerated vesting upon a CIC. Alternatives include:
  - No acceleration,
  - Discretionary acceleration,
  - If an equity award, single trigger acceleration unless such equity is assumed or replaced,
  - Double trigger acceleration (*e.g*, termination of employment within 6 to 18 months following the CIC),
  - If an equity award, single trigger acceleration even if equity is assumed or replaced

- Some tax considerations associated with the above include:
  - 280G,
  - Accelerating vesting is permissible under Section 409A, and
  - ISO status of stock options would be lost to the extent the aggregate value of the underlying shares with respect to which the stock option became exercisable for the first time by any individual during a calendar year exceeded $100,000

No CIC Imminent: Vesting Considerations (cont.)

- For public companies it is important to note that ISS highly disfavors single-trigger vesting provisions

- With that said, the following is a reason why some public companies continue to use single trigger vesting provisions (as reported in some proxy filings):
  - Interest alignment between employees and target shareholders is strengthened;
  - Equitable treatment to target shareholders, especially in instances where unexercised options are in-the-money prior to closing but underwater after closing due to inept management at acquiror level;
  - Possibly more effective to retaining management through closing (though acquiror would prefer double trigger for post-closing retention purposes);
  - Post-closing disputes over constructive termination is higher in the double-trigger context than in the single trigger context; and
  - Awards with significant value at time of closing would otherwise encourage employees to be among those terminated

No CIC Imminent: Exercise Period

- Consider whether to extend the post-termination exercise period for stock options
  - Such is permissible under Section 409A if the option term is not extended beyond its original term (*i.e.,* typically stock options contain a term of 10 years from the date of grant)
  - However, ISO status would be lost if the stock option is not exercised within 3 months from the optionee's termination of employment

No CIC Imminent: Performance Awards

- Performance-based awards have unique circumstances to consider, including:
  - Should the award be paid in full or pro rata upon a CIC,
  - How should the level of performance be measured, and
  - How should the time period for performance be measured

CIC Identified: Retention Objectives

- The retention objectives should be designed to:
  - Ensure the impartiality and objectivity of key members of management in order to protect the interests of shareholders in a potential CIC transaction, and
  - Ensure the retention of key employees to help maintain the continuity of the business through closing of the potential CIC
- An effective retention tool should address one or both of the following:
  - To provide employees with termination protection (*i.e.*, reducing personal risk due to a CIC maximizes value to the employer), and/or
  - Provide employees with prospective financial upside for remaining employed with the employer through consummation of the CIC
- Additionally, the retention strategy should be aligned with the interests of the employer's shareholders
  - Ensure continuity of key employees pending consummation of the transaction (or during a transition period following the close of the transaction)
  - Ensure impartiality and objectivity of key members of management during the transaction process by mitigating the consequences of potential job loss (*i.e.*, reduce personal risk)

CIC Identified: Retention Alternatives

- Stay bonuses typically provide for a cash payment upon completion of a specified period of service or closing of a subsequent transaction
  - Typically provide full or partial payment in event the employee is terminated by the employer without Cause or by the employee for Good Reason within x months of the CIC
  - Stay bonuses could also provide a performance-based element, such as ultimate success of the deal (*e.g.*, the size of the deal) or the satisfaction of other performance criteria such as attaining EBITDA goals
  - Stay bonuses could also be in the form of restricted stock units ("***RSUs***") that similarly could have time or performance-based vesting
  - A benefit of RSUs over cash bonuses is that participants could participate in the growth of the employer, if any

- Severance pay typically provides a payout if the employee is terminated by the employer after the transaction without Cause or by the employee for Good Reason
  - What should be the amount?
  - Consider having the benefit expire after [__] months following the transaction

CIC Identified: Retention Alternatives (cont.)

- Change-in-control agreements
  - Provide various types of payments of cash or equity upon a CIC (*e.g.*, accelerated vesting upon a CIC, enhanced severance benefits upon a termination after a CIC, etc.)

- Consider whether to implement a springing employment agreement that becomes effective upon the closing of the CIC

- Consider certain post-closing incentives such as payment of a bonus upon successful completion of performance goals (*e.g.*, successful integration of IT or accounting systems)

Equity Awards in Specific CIC Transactions

- Review all applicable stock plans and award agreements to determine treatment in the context of the CIC
  - Determine effect of plan provisions on retention of key employees
  - Determine potential cost, dilution and overhang issues
  - Determine Board's authority to amend terms of outstanding stock options under the plans, or to cancel the stock options in exchange for cash

- Provisions to review include:
  - CIC definitions
  - Adjustment clauses (ensure sufficient flexibility to treat awards in the manner desired)
  - Vesting provisions (*e.g.,* single or double trigger, vested only if not assumed, etc.)
  - Post-termination exercise provisions
  - Determine "value" of any cashouts (spread v. economic value)

Equity Awards in Specific CIC Transactions (cont.)

- Divestiture – sale by an employer of a subsidiary or division
  - Not likely a CIC unless it constitutes a sale of substantially all the employer's assets
  - May constitute a termination of employment triggering the post-termination exercise period of vested options and the cancellation of unvested stock options

Equity Awards in Specific CIC Transactions (cont.)

- Stock for stock deals
  - It is most common to rollover the awards based on an exchange ratio used in the CIC that converts shares of target employer into shares of acquiror (designed to preserve the economic benefit of the award). Thoughts to consider:
    - Acquiring employer typically will not want to have target options outstanding
    - Target employees likely prefer acquiror stock because it is more liquid
    - A rollover should enhance shareholder alignment
    - A rollover should be non-taxable to the holder under Sections 409A (applicable to all options) and 424 (applicable only to ISOs) of the Code
  - For stock options, the exercise price would be set such that on a share-by-share basis the ratio of the value of an acquiror share post-rollover over the option exercise price equals the ratio of the value of a target share pre-rollover over the exercise price of such target share

Equity Awards in Specific CIC Transactions (cont.)

- All cash deals (*i.e.,* stock of the target is cancelled in exchange for a cash payment)
  - Equity awards are often cashed out (*e.g.,* cancelled in exchange for a cash payment equal to the excess of cash paid to target shareholders over exercise price)
    - Provides similar treatment to shareholders and aligns their interests
  - However, it is not uncommon to rollover the equity in order to
    - Allow holders to benefit from the time-value optionality inherent in the award
    - Avoids cashout frustrations associated with underwater stock options or those options that are marginally in the money
- Part cash and part stock transactions
  - Alternatives include:
    - Equity is rolled over,
    - Equity is cashed out, or
    - Some of the equity is rolled over and some is cashed out in the same proportion as the target employer stock is converted into stock and cash (*e.g.*, 40% of awards are cashed out and 60% are rolled over)
  - Be sure to structure in compliance with Sections 409A and 424 of the Code

Equity Awards in Specific CIC Transactions (cont.)

- Advantages of rollover include:
  - Awards that do not vest upon closing offer continued retention
  - Awards that may be exercised post-closing offer continued retention
  - Rollovers of vested options have little compensation expense
  - Help acquiror avoid mandatory accelerated vesting
  - No immediate cash outlay

- Advantages of cashout include:
  - Avoids additional post-closing dilution
  - Avoids post-closing increase in overhang from target options
  - Allows acquiror to terminate awards that could be inconsistent with its compensation culture
  - Allows cancellation of underwater, and sometimes the cancellation of unvested options, without payment of consideration
  - Could allow target employees to receive accelerated vesting not available in rollover
  - Avoids post-closing administration of performance targets that may be impossible to measure
  - Generally results in smaller value than a rollover for determining liability under Section 280G of the Code

Equity Awards in Specific CIC Transactions (cont.)

- Private equity transactions
  - Typically small number of management are not cashed out and are required/permitted to rollover
  - Mechanics of rollover are typically designed to preserve only the aggregate spread (as opposed to spread and exercise price)
    - Preferred by private equity firms because less dilutive to private equity owners than adjustments to both number of shares and exercise price per share

- Addressing awards between signing a CIC transaction document and closing, the document typically restricts grants of new equity during such time period (though generally permitted to provide grants in the ordinary course of business consistent with past practices)
  - The transaction document should place individual and aggregate limits on the number that may be granted
  - Such limit should address whether options should be treated differently from full value awards
    - For example, a restricted share counts as 3 shares and a stock option counts as 1 share

Spin-Offs: Three General Approaches

- If no action is taken, then:
  - Employees moving to SpinCo would likely be deemed terminated from RemainCo and would likely have three months to exercise vested RemainCo options
  - Would need to determine if the spin-off constitutes a CIC, and if yes, whether accelerated vesting is required
  - Would need to determine if an adjustment to RemainCo options are required to reflect the decreased value of RemainCo stock as a result of the spin-off

Spin-Offs: Three General Approaches (cont.)

- Alternatives:
  - Split-off approach
    - SpinCo employees exchange RemainCo equity for SpinCo equity
    - RemainCo employees retain RemainCo equity, but adjusted to take into account the decreased value of RemainCo stock due to the spin-off
  - Spin-off approach
    - Employees of both RemainCo and SpinCo receive equity of both companies
  - Adjustment approach
    - Employees of both companies retain RemainCo equity, but such equity is adjusted to take into account the decreased value of RemainCo stock due to the spin-off
- Under all three approaches, future equity grants would be made by the employing employer

Split-Off Approach

- Advantages
  - Aligns interests of the employees with the interests of the employer's shareholders

- Disadvantages
  - If RemainCo and SpinCo have different growth or volatility assumptions, those employed by the employer with the lower growth would likely object to losing value in equity of the other employer
  - Requires an SEC tender offer under Rule 13e-4 to have SpinCo employees exchange RemainCo equity for SpinCo equity, which generally requires:
    - An announcement of the offer pursuant to the issuance of a press release describing the terms of the transaction;
    - The filing of a Schedule TO by RemainCo with the SEC and mailing an offer to purchase to SpinCo employees;
    - That the offer remain open for at least 20 business days;
    - That a press release be issued announcing the preliminary results upon the offer's expiration; and
    - That SpinCo employees be provided withdrawal rights that will not expire until expiration of the offer and at any time 40 business days from the commencement date

Spin-Off Approach

- Advantages
  - Shareholders and employees are treated consistently
  - Allows RemainCo and SpinCo employees to participate in both companies

- Disadvantages
  - Complexity of arrangement
  - Employees own equity in a non-employer
  - Vesting is tied to employment with another employer
  - Participate in both companies

- To effectuate, RemainCo board would likely have to amend RemainCo equity plans to provide that (and vice versa for SpinCo):
  - SpinCo employees are not deemed “terminated” under the plans; and
  - To allow SpinCo employees to continue to vest in RemainCo equity awards based on employment with SpinCo

- SpinCo would need to register its equity awards issued to RemainCo employees pursuant to a Form S-1 because a Form S-8 is only available to current and former employees

Adjustment Approach

- Advantages
  - Simplicity
- Disadvantages
  - RemainCo employees do not participate in any growth of SpinCo
  - If RemainCo has more growth potential, this approach may be too beneficial to SpinCo employees

Minimize 280G Payments: Overview

- Consider using non-compete provisions to avoid the use of a 280G gross-up provision
  - As background, tax gross-ups are generally preferred by executives and disfavored by shareholders
  - Implementing a non-compete can act to reduce an otherwise golden parachute payment subject to the 280G excise tax
  - Such reduction is applied on a dollar-for-dollar basis equal to the lesser of:
    - Reasonable compensation (determined using a benchmark analysis against the peer group and after applying the 90th percentile)
    - The value of the non-compete, determined pursuant to an independent third-party appraiser, which is the difference between the enterprise value of the employer with and without the non-compete
  - Thus, the value of the 280G reduction could be more than the severance pay directly associated with the non-compete

Minimize 280G Payments: Overview (cont.)

- Golden parachute payments are governed by Sections 280G and 4999 of the Internal Revenue Code of 1986, as amended (the "***Code***"). If applicable, these Code sections generally:
  - Impose a 20% excise tax on disqualified individuals for their receipt of an excess parachute payment, and
  - Deny a corporate deduction for the same

- Only "excess" (amounts exceeding 2.99x the base amount) "parachute payments" that are "contingent" on a CIC that are paid to "disqualified individuals" are subject to adverse tax consequences under 280G
  - Negate any of these 5 elements and 280G would not apply to that particular payment

- Once the above adverse tax consequences are triggered, the tax applies to parachute payments that exceed 1x the base amount

Minimize 280G Payments: Planning Alternatives

- Alternative 1 – Do nothing
  - Deduction would be disallowed and the disqualified individual would be subject to an excise tax
- Alternative 2 – Allow the payment but provide the disqualified individual with protection through a full or partial gross-up
  - This would raise concerns with shareholders and ISS types
- Alternative 3 – Implement a cutback so that the parachute payment would not exceed 2.99x base amount (*i.e,* the threshold test is NEVER satisfied)
  - May not be ideal for a disqualified individual who could be financially better off paying the excise tax (instance where payment would otherwise equal, for example, 7x base amount)
  - Conversely, a cutback could be financially advantageous to a disqualified individual if the payment exceeding 2.99x base amount would otherwise be less than the amount of the excise tax (instance where payment would otherwise equal, for example, 3x base amount)
    - Remember, excise tax applies to amounts exceeding 1x base amount

Minimize 280G Payments: Planning Alternatives (cont.)

- Alternative 4 – Implement a hybrid cutback whereby a disqualified individual would be entitled to receive the greater of a 2.99x cutback or payment of the excess parachute payment (with the 20% excise tax)

- Alternative 5 – Implement a hybrid cutback whereby an excess parachute payment would not exceed a certain dollar amount

- Alternative 6 – Implement a shareholder vote exception (only applicable to private corporations), which generally means:
  - Payment must be approved in a separate vote
  - Payment must be approved by more than 75% of the outstanding voting power
  - Adequate disclosure must be made of all material facts
  - Vote must establish right of disqualified individual to receive payment (means such individual must first disclaim all rights to such payments)

- Alternative 7 – Same as Alternative 6, but provide a gross up if the corporation fails to SEEK shareholder approval (however, this alternative could not apply to the condition of GAINING shareholder approval due to the disclaimer requirement)

Minimize 280G Payments: Planning Alternatives (cont.)

- Alternative 8 – Allow employee the opportunity to rebut the presumption with a tax opinion

- Alternative 9 – Structure the payment to be reasonable compensation paid for services rendered before the CIC
  - Burden of proof is clear and convincing evidence
  - If the burden is satisfied, the amount of the reasonable compensation reduces the excess parachute payment
  - In determining reasonable compensation, relevant factors include:
    - Nature of the services to be rendered,
    - Individual's historic compensation for such services, and
    - Compensation for those performing similar services where payment is not contingent on a CIC

Minimize 280G Payments: Planning Alternatives (cont.)

- Alternative 10 – Structure payment to represent payment for future services (thereby negating the "contingent" element
  - Burden of proof is clear and convincing evidence
  - If burden is satisfied, the amount of the reasonable compensation reduces the excess parachute payment
  - Payments for covenants not to compete can represent payment for future services if there is a reasonable likelihood that the agreement would be enforced against the individual

- Alternative 11 – In the year preceding a year of CIC, increase the disqualified individual's base amount in order to increase the 5-year average
  - Exercise stock options
  - Payout deferred compensation
  - Increase bonus
  - Payout LTIP

Don’t Forget Next Month’s Webinar

- Title:
  - Increasing the Life Expectancy of an Equity Plan’s Share Reserve
- When:
  - 10:00 am to 11:00 am Central
  - June 9, 2016

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