Davis Polk

Executive compensation issues in M&A: A roadmap for staying prepared

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Agenda

- Introduction
- Types of transactions
- Target perspective
- Acquirer perspective
- Considerations related to public company targets
- Tax matters: Section 280G and Section 409A

Types of transactions

Target company considerations may differ:

- If target is public vs. private
- If prospective buyer is strategic vs. financial (i.e., PE fund)
- If prospective buyer is domestic vs. ex-US
- If target is exploring strategic alternatives vs. receives an unsolicited offer or other indication of interest
- If the transaction is a “merger of equals”
- If the transaction is a carve-out of a business or division

Acquirer considerations may differ:

- If acquirer is a serial strategic acquirer vs. an occasional player in the M&A market
- If acquirer is a financial buyer
- If acquisition is a carve-out vs. acquisition of an entire company
- If transaction price includes contingent consideration (e.g., an earnout or milestone payments)
- If transaction involves “acqui-hiring”

Target perspective: Severance and equity as key change in control protections

Purposes of change in control severance protection:

- Keeping management team focused on corporate transaction opportunities, without regard to possible job loss
- Retention of key talent during season of uncertainty
- Part of competitive compensation program, so may be key to recruitment and retention

Key issues:

- Severance multiple (can range from 1-3x base + bonus)
- Treatment of outstanding equity compensation – “single-trigger” vs. “double-trigger”
- Treatment of performance goals – will goals be measurable post-acquisition?
- Potential golden parachute excise tax (*see* slides 9-11)

Traps for the unwary:

- Definition of “change in control” – not all definitions are equal
- Definitions of “cause” and “good reason”

Recommendation: Potential target companies should periodically review severance and equity protections to assess their adequacy under various scenarios

Target perspective: Other change in control protections

Annual incentive plans

– Protection of bonuses earned during an interrupted performance year
– "Double-trigger" protection of employees who lose their jobs due to a change in control

Deal bonuses

– Key employees who will be critical to get the company from signing to closing and who will be "working two jobs" during that time

Deferred compensation and supplemental pension plans

– Some plans pay out automatically on a change in control
– Change in control is a rare case where Section 409A of the Code (see slide 12) allows some flexibility to terminate/pay out even if not required by the plan
– Deferred compensation is subject to creditors' claims, so company's post-closing risk profile should be considered (e.g., PE buyer funds acquisition with significant debt)
– Rabbi trust funding obligations

Qualified plans (e.g., 401(k) match)

Acquirer perspective: Retention concerns and strategies

- Retention concerns and challenges vary by transaction and by employee position
- Different strategies are utilized to:
  - Retain top leadership for a transition period to allow knowledge transfer vs. for an ongoing period
  - Encourage contributions to the future success of the business vs. tie retention solely to continued service
- Rollover of existing equity vs. new equity grants going forward
- Waiver of good reason rights and possible conversion of change in control severance to retention, which may raise potential issues under Section 409A of the Code (*see* slide 12)
- New employment agreements
- Restrictive covenant agreements (e.g., non-competes); currently regulatory climate may make enforceability more challenging
- Target company management may retain separate counsel to negotiate these arrangements

Acquirer perspective: HR due diligence issues

Liability/cost issues

- Change in control-related payments (e.g., executive severance and equity treatment)
- Significant liability items (e.g., pension plan underfunding)
- Golden parachute excise tax (*see* slides 9-11)
- Section 409A violations (*see* slide 12)

Legal issues

- Employee misclassification
- Discrimination and harassment
- Immigration issues
- Benefit plan compliance
- Union/organized labor issues

Reputational issues

- Workplace culture/diversity issues

Public company targets: Merger agreement

Merger agreement sections include:

- Treatment of equity-based award and employee stock purchase plan
- Interim operating covenants (i.e., restrictions and prohibitions between signing and closing) – exceptions are in the schedules
- Post-closing covenants (i.e., covenants that buyer makes to target company regarding post-closing treatment of employees, as well as their compensation and benefits)
  - Basis for effective employee communications
  - Not enforceable by employees (i.e., no third-party beneficiary rights)
- Representations and warranties – exceptions are in the schedules

NOTE: Merger agreement is publicly filed, but schedules to the merger agreement generally are not

Public company targets: Disclosure issues

Disclosure of compensation for executive officers and directors

- Detailed, quantitative disclosure regarding interests of certain persons in the merger, including change in control-related payments
  - Will be closely scrutinized and may be part of the basis for a plaintiff's lawsuit
- Non-binding advisory vote on "golden parachutes"
- Due to disclosure and governance concerns, acquirers often wait until after the shareholder vote on the merger has occurred before entering into new employment arrangements with target management
  - In any event, for fiduciary reasons, it is very important for there not to be any discussions regarding employment and compensation arrangements with target management before the price is agreed to

Tax matters: Section 280G

Golden parachutes

- Sections 280G and 4999 of the Internal Revenue Code impose tax penalties on “excess parachute payments” made to “disqualified individuals” – colloquially called “280G”
  - Section 280G disallows employer tax deductions for excess parachute payments
  - Section 4999 imposes a 20% excise tax on the recipient of an excess parachute payment equal to 20% of the amount of such payment
- The amount of the “excess parachute payment” received by a “disqualified individual” equals the amount of the “parachute payments” received by the individual minus the individual’s “base amount”

Tax matters: Section 280G

Public company targets

Tax penalties on “excess parachute payments” made to “disqualified individuals”

- Excess parachute payment – Amount of parachute payments that exceed the disqualified individual’s base amount if the total parachute payments exceed the individual’s safe harbor
  - Parachute payments – Payments in the nature of compensation (broadly defined) and contingent on the change in control
  - Base amount – Average of the disqualified individual’s W-2 income for each of the five years prior to the change in control (e.g., if a transaction closes in 2023, then W-2 income from 2018-2022)
  - Safe harbor is equal to 3x base amount
- Disqualified individual – An individual who performs personal services for the corporation and, at any point during the 12 months preceding the change in control, is:
  - an officer (facts and circumstances test and generally limited to no more than 50 employees or, if less, the greater of three employees or 10% of the employees of the corporation);
  - a significant shareholder (FMV of individual’s stock exceeds 1% of total FMV of all classes of company stock); or
  - a highly compensated individual (generally, highest 1% of employees of the company up to 250 employees)
- Opportunities for planning/mitigation may exist, but may be complicated and will require advance planning

Tax matters: Section 280G

Private company targets

Adverse tax consequences can be avoided entirely through a shareholder cleansing vote

- Any payment to a disqualified individual with respect to a corporation that does not have (and no member of its affiliated group has) any stock which is readily tradable on an established securities market or otherwise is not a parachute payment if:
  - such payment is approved by shareholders owning more than 75% of the voting power of all outstanding stock of the corporation; and
  - there is "adequate disclosure" to all persons entitled to vote of all material facts concerning the potential parachute payments
- Payments must be contingent on the vote; mere stockholder ratification is not sufficient
- Vote must be separate from any vote to approve the transaction
- Shareholders who are disqualified individuals who would otherwise be entitled to receive parachute payments are not entitled to vote and are excluded from the calculation
- It may be preferable for employees to receive a non-voting class of stock or provide a proxy to the company to avoid the need for all employee-shareholders to receive disclosure on change in control payments
- The acquirer may want to wait until after closing to agree to new employment, retention and equity arrangements to avoid the need to subject them to the shareholder vote

Tax matters: Section 409A

Deferred compensation issues

- Section 409A outlines the specific requirements for the timing of deferral elections and the designation of the time and form of payment of deferred amounts under nonqualified deferred compensation plans
  - Adverse consequences (20% additional federal tax + premium interest) if the requirements are not met
- Deferred compensation is very broadly defined as any form of compensation which is or may be paid in a year following the year in which the legal right to the payment arises
  - Can pick up unexpected items such as severance or equity awards
- Effect of deferred compensation being subject to Section 409A:
  - Strict limitations on the timing of initial deferrals
  - Limited permissible payment events (e.g., specified date, change in control, termination, death)
  - **Limited ability to modify time and form of payment, including strict rules for the subsequent deferral of previously deferred compensation**
    - **Some exceptions apply in a change in control**
  - Must be pursuant to a written plan that complies in documentary respects as well as in operation
  - Some ability to correct Section 409A violations with reduced or no penalties, but corrections typically have to be made well before compensation becomes payable

Thank you for joining us!

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