



Professional Perspective

Executive Compensation & Private Company M&A Transactions

Joseph Penko and Michael Wiseman, Skadden, Arps, Slate, Meagher & Flom

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Executive Compensation & Private Company M&A Transactions

Editor's Note: This article is part of an ongoing series exploring executive compensation considerations in different types of M&A transactions. For more articles in this series, see Bloomberg Law's [Professional Perspectives](#) authored by experts from Skadden, Arps, Slate, Meagher & Flom.

Contributed by [Joseph Penko](#) and [Michael Wiseman](#), Skadden, Arps, Slate, Meagher & Flom

This article provides a high-level overview of the key executive compensation matters that arise in acquiring a US private company. The concepts and guidance in this article are intended to be generally applicable to all transactions in which the target company is a US private company, regardless of whether the target company is a startup owned solely by its founders, a company that has been through various rounds of equity financing, an entity that is owned by a private equity fund or related vehicle, or somewhere in between.

Identifying and appropriately dealing with executive compensation matters are critical to the overall success of a private company transaction. Such matters are a source of potential liabilities to consider in determining the price that an acquirer will pay for the target company. Ensuring that key employees of the target are appropriately incentivized through the closing of the transaction and any post-closing integration period is crucial.

Similar to public company transactions, private transactions will require an acquirer to perform due diligence of the target's compensation arrangements, draft and negotiate the compensation-related provisions in the transaction agreement, and implement new compensation arrangements for key employees. Private company transactions also may include provisions requiring target company management to roll over all or a portion of their company equity into equity of the resulting entity; close analysis of this process is necessary to ensure optimal tax treatment.

Executive compensation practitioners should be engaged at the beginning stages of the transaction and remain in close contact with the broader deal team throughout the entirety of the transaction. This is critical to ensure these matters achieve favorable outcomes to support the success of the overall transaction and post-closing integration.

Due Diligence

One of the first steps for an acquirer is to conduct a thorough due diligence review of the terms of the target company's compensation arrangements and any related liabilities. Unlike public company transactions, the purchase price in the acquisition of a private company will typically be subject to an adjustment that factors in executive compensation components, which must be identified and analyzed to be appropriately referenced in the transaction agreement.

Scope of Review

The scope of review commonly includes, as applicable, employment agreements and other individual compensation arrangements; cash incentive and severance arrangements; retention, transaction, and similar types of bonuses; nonqualified deferred compensation arrangements; and perquisite or other enhanced benefit arrangements.

In addition, if compensatory equity awards are outstanding, the review also should include equity incentive plans and award agreements. These include any applicable terms that may be included in stockholder, partnership, LLC, or similar operating agreements, equity valuation reports used to determine the exercise price of stock options and the threshold value for profits interest grants, and capitalization tables and corporate organizational charts to determine the type and number of outstanding equity awards.

Practitioners should seek a comprehensive understanding of the target's compensation program and identify any compliance issues under relevant tax and securities laws. In particular, the acquirer's counsel should review stock option grants for compliance with [Section 409A](#) of the Internal Revenue Code (Code), confirm supportable valuations of profits interests and evidence of effective [Code Section 83\(b\)](#) elections, and obtain evidence of a robust process to determine and comply with applicable private securities exemptions (such as [Rule 701](#) of the Securities Act of 1933). The results of the review often are communicated by the acquirer's counsel to the broader deal team through the form of a due diligence report that summarizes the terms of the compensation arrangements and related potential liabilities.

In addition, the acquirer may want to negotiate compensation arrangements with members of management that will come into effect as of closing. Therefore, it is important to understand the terms of management's current arrangements to help inform the acquirer about how the go-forward terms may need to be designed.

Obtaining Materials

Most information about a private company's compensation programs is not publicly available. Typically, the process starts with the acquirer creating a comprehensive due diligence request list and initial management-led diligence calls, followed by lawyer-led area-specific diligence calls. The process is iterative, with the target providing documents in a virtual data room and responding to supplemental diligence requests by the acquirer.

Transaction Agreement & Disclosure Schedules

The terms and conditions of the transaction are set forth in a transaction agreement, often in the form of a merger or stock purchase agreement, along with accompanying disclosure schedules. The provisions that are most relevant to executive compensation matters generally include:

- Employee benefit representations and warranties
- Interim operating covenants regarding compensation actions that are restricted between signing and closing, as well as exceptions to those restrictions
- Post-closing covenants regarding the treatment of compensation arrangements for the target company's employees
- Treatment of the target's equity awards at closing
- The definitions of transaction expenses and indebtedness
- Any covenants for key employees to enter into new employment or rollover agreements.

Additionally, private company transactions often will include a covenant that the target solicit waivers of golden parachute payments from applicable individuals and conduct a [Code Section 280G](#) shareholder vote, as further discussed below.

Purchase Price Adjustments

The transaction agreement usually includes purchase price adjustment provisions, which are often reflected by the concepts of indebtedness, transaction expenses, and working capital. For instance, the agreement may specify executive compensation-specific liabilities, such as transaction-based bonuses, enhanced severance, nonqualified deferred compensation liabilities, underfunded pensions, accrued severance and bonuses, and other employee benefits.

The acquirer often will ask the target to cover the cost of any employer-side employment taxes related to transaction-based bonuses and, somewhat less often, long-term incentives that are paid in connection with closing. In response, the target may attempt to restrict these costs to the amount that would be incurred above the employment taxes paid on regular compensation, estimated based on the prior year's compensation.

Representations & Warranties

The transaction agreement will include a set of representations and warranties made by the target on various matters relating to its business, operations, and contractual arrangements, including the target's compensation arrangements and outstanding equity awards.

In a transaction involving a private company, such representations and warranties may survive the closing of the transaction and may be subject to post-closing indemnities. Sometimes an escrow of purchase price proceeds is reserved to cover such indemnities, which places an increased emphasis on the level of materiality of representations made by the target.

Representation and warranty insurance (RWI) is a common feature of modern private company transactions. When the acquirer has purchased RWI, it will seek to have the target provide more extensive disclosure and remove any materiality, knowledge, or similar qualifiers. The acquirer's counsel may provide the insurer diligence reports they have prepared. The process will involve communication to the insurer from the acquirer's counsel that both the target's level of diligence production and the acquirer's review were adequate. If one or both parties' performance is not sufficient, the insurer may seek to limit its liability by excluding certain provisions from the insurance coverage.

Treatment of Target Equity Awards

If executives of the target company have outstanding equity awards in the target or any of its subsidiaries, the transaction agreement will include covenants governing the treatment of those awards in connection with the transaction. Private company equity commonly consists of stock options, restricted stock or restricted stock units if the target is taxed as a corporation, and partnership equity in the form of profits interests and sometimes capital interests if the target is taxed as partnership.

It is essential to analyze the contractual treatment of target equity awards under the applicable equity plan, award agreements, and other applicable arrangements—including any provisions contained in stockholder, partnership, LLC, or similar operating agreements—in order to understand whether certain equity award treatment is required or alternative treatment is permitted without participant consent and to inform negotiation between the parties.

In addition, rollover equity is considered when the acquirer expects to continue to employ management after closing, in which case it will want to make sure that management remains focused on completing the transaction, has “skin in the game,” and is appropriately incentivized to continue working for the acquirer after closing.

The parties must ensure that any contemplated treatment of the target's equity awards does not violate the deferred compensation rules set forth in Section 409A and that any partnership interests are appropriately taxed at closing as either long- or short-term capital gain, or potentially as ordinary income. Partnership interests must be analyzed to confirm whether profits interests will be respected as such—including with respect to grant dates and whether the interests were structured to have zero liquidation value on grant—and to determine whether employees have made Code Section 83(b) elections.

Careful analysis of equity awards is important to ensure the appropriate tax reporting and potential withholding in connection with closing treatment and to avoid any Section 409A violations that can result in severe, and often unexpected, tax penalties for target employees holding equity awards.

Interim Operating Covenants

The transaction agreement and accompanying disclosure schedules contain covenants governing the period between the signing of the transaction agreement and the closing of the transaction—the interim period. These covenants typically cover the ability to make compensation and benefits increases, adopt or amend severance arrangements, create employee retention pools or award change in control bonuses, and hire and terminate executives and other employees. Generally, the agreement lists compensation-related actions that a target can take unilaterally during the interim period and a list of actions that only can be taken by the target with the consent of the acquirer.

These provisions are often negotiated and can vary widely from one private transaction to another. The target's ability to continue to control employee matters during the interim period often will depend on the nature of the acquirer's business and whether it intends to operate the target as a standalone company or integrate the target into an existing business.

When the acquirer is a private equity sponsor and intends for the target to continue to operate post-closing as a business that is distinct from its other portfolio companies, there may be more latitude for the target to continue to operate as usual during the interim period. Often in this scenario, the acquirer may be less concerned about non-ordinary course compensation, such as transaction-based bonuses, if these items are treated as transaction expenses that are borne by the target's owner. However, there may be employee relations implications for these payments and the acquirer may want to have input on the amount and terms of the payments to ensure that employees are not provided a windfall.

While the ultimate outcome of the interim operating covenants will depend on many factors—including the duration of the interim period, the acquirer's plans for post-closing integration, and the overall leverage between the parties—developing a comprehensive set of specific rules for these actions can be mutually beneficial and will allow the parties to avoid disputes. Moreover, it will help the acquirer ensure that the business it ultimately acquires upon closing is not substantially different from the business it agreed to acquire when the transaction agreement was signed.

Post-Closing Covenants

The transaction agreement typically includes covenants requiring an acquirer to maintain compensation and benefits levels for continuing employees of the target corporation from the date of closing through a specified period of time after the transaction closes—the protection period. For example, the acquirer might agree to provide these employees for one year with at least the same base salary, a substantially similar target cash bonus opportunity, and other employee benefits that are substantially similar in the aggregate to the employee benefits provided by the target immediately prior to closing the transaction.

Additional provisions may be included, such as requiring the acquirer to provide or honor specified severance benefits upon a qualifying termination of employment. In general, employee protections can be more limited than in public company transactions, depending on the number of employees or limited disclosure of the transaction document, which is often not provided to target employees in private transactions.

Enhanced change-in-control severance arrangements are somewhat less common for private companies and there is often no post-closing covenant to maintain long-term incentive compensation levels due to the customized nature of private company equity arrangements. Employees of small private targets being acquired by large companies usually will be asked to transfer into acquirer benefit programs.

Employees of the target company generally do not have any direct right to enforce the provisions of these covenants as parties to the transaction agreement or third-party beneficiaries. In addition, the seller(s) may be agnostic to post-closing employee relations, and the target may no longer exist in a form that will allow it to enforce the covenants. However, post-closing covenants are considered important sources of employee protection because they set forth the intentions of the acquirer with respect to employee treatment following the closing of the transaction.

The length of the protection period and the types of protected items usually are subject to negotiation between the parties. As with interim operating covenants, key considerations include the acquirer's cost of providing the compensation and benefits, the acquirer's plans for post-closing integration of the target's employees in its broader compensation program, and the need to ensure a sufficient workforce remains through the closing and any post-closing integration period.

Golden Parachute Payments

It will be important to identify any so-called “golden parachute payments” under [Code Section 280G](#), which generally include payments and benefits that exceed three times the disqualified individual's average five-year annual compensation. Golden parachute payments can result in imposition of an excise tax under [Code Section 4999](#) on the executive and a loss of deduction for the company under Code Section 280G.

Section 280G is Applicable to C-corporations

Code Section 280G does not apply to a target entity that is not taxed as a C-corporation, as is the case for many private companies that are taxed as partnerships or S-corporations. However, it is necessary to examine more than just the target entity itself, as the existence of a C-corporation anywhere in the target's chain of entities could cause Code Section 280G to apply. For more information, see “Golden Parachute Payments” in [Executive Compensation & Public Company M&A Transactions](#).

Private Companies May Avoid Impact of Golden Parachute Payments

Unlike a public company transaction, a private company shareholder vote to avoid the impact of the golden parachute provisions may be available. The company must be truly private and its securities must not be “readily tradeable on an established securities market,” which, in addition to sales of stock on the national exchanges, can include certain sales on the pink sheets and OTC offerings, as well as tradeable debt.

Private Company Shareholder Voting Process

The first step in the voting process is to secure a written waiver from each individual who is potentially subject to the Code Section 4999 excise tax, agreeing to waive any payments subject to the excise tax if the vote is not secured. Once that occurs, the target will provide a written disclosure statement to all shareholders with voting rights that details the payments to be made to the individuals who have signed the waivers.

If more than 75% of the voting shares vote in favor of the payments that were waived, then all payments will be made without being subject to the excise tax. If the vote is not successful, then the payments subject to the excise tax will be fully waived and not paid. It is very important to secure the waivers before the vote is conducted to ensure that the waivers are respected under the Code Section 280G rules.

Determining Which Shareholders May Vote

In addition to the preparation of initial Code Section 280G calculations, it is prudent to conduct a shareholder analysis to determine who is permitted to vote to approve any golden parachute payments. It also is prudent to identify situations where there is a broad shareholder base, either due to direct holdings or due to application of the entity look-through rules, and to confirm whether employee equity provides voting rights. This analysis can help prevent employee relations issues resulting from required disclosure of golden parachute payments to all voting equity holders.

Post-Closing Compensation Arrangements

In connection with the transaction, an acquirer may desire to enter into new employment agreements with key employees of the target company. These arrangements often are negotiated and executed before the signing of the transaction and generally become effective at the closing of the transaction.

Depending on the nature of the business, employment agreements can be key terms of the general transaction. They are either reflected in the recitals to the transaction agreement as being entered into concurrently as an inducement to an acquirer, or, more dramatically, as a closing condition to consummation of the transaction, although this is rare.

Restrictive covenants are often included as part of the executive employment agreements or sometimes as standalone documents. Where the rollover of management equity is significant, or where management is particularly important to the continuity and success of the business, non-competition and non-solicitation provisions can become key elements in negotiations and will require local law analysis.

Conclusion

Executive compensation matters are intrinsic to any acquisition of a private company with employees and raise unique issues when the acquirer expects to maintain the management team post-closing. Sophisticated acquirers who can present knowledgeable and considered approaches to the treatment of management equity and post-closing compensation arrangements for senior target employees will be at an advantage in attracting potential targets, including in any auction process, and, ultimately, in completing the transaction successfully.