Executive Compensation Due Diligence in 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.

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This article provides a high-level overview of the executive compensation due diligence workstreams that an acquirer and its legal advisors conduct in a typical M&A transaction involving the acquisition of a US company.

A thorough review of the compensation arrangements of the target company should be conducted early in the transaction process as part of the broader due diligence process. This review allows the acquirer to gain a comprehensive understanding of the target's compensation program and to uncover any compensation-related liabilities or legal/regulatory compliance issues that could impact the purchase price payable in the transaction or the operation of target's business post-closing. The acquirer's compensation diligence may surface information needed to accurately draft the transaction documents and to plan for post-closing integration of the target's compensation programs.

Scope of Review

The scope of the executive compensation due diligence review involves a comprehensive evaluation of all the target's compensation plans, programs, agreements, and arrangements.

While the actual materials included in the review depend on the target's specific compensation program, the materials within the scope of this review include:

- Employment agreements, offer letters and other individual compensation agreements
- Equity incentive plans and award agreements
- Cash bonuses and other incentive arrangements
- Severance plans and arrangements
- Retention, transaction, change in control and similar types of incentive arrangements
- Nonqualified deferred compensation arrangements
- Perquisite or other enhanced benefit arrangements

Obtaining Materials

The ability to obtain executive compensation materials that are within the scope of the due diligence review differs depending on whether the target is a public company or a private company.

In a transaction with a public company target, copies of applicable executive compensation materials, including all material contracts, should be publicly available as attachments to the target's Forms 10-K or 10-Q—and sometimes other filings, including Forms 8-K and S-8. Summaries of the target's executive compensation program also are described in more detail and, for the prior fiscal year, quantified for the top executive officers included in the target's annual proxy statement.

Additional information about the target's stock-based compensation must be included in the notes to the audited financial statements attached to its Form 10-K filing. Form 4 filings and other Section 16 filings can also be useful as the forms disclose certain equity transactions that occur throughout the year—although, notably, performance-based equity awards are not always required to be disclosed in these filings.

For public company targets, however, the publicly available materials likely are limited to arrangements for the most senior executive officers, and the acquirer will need to request materials covering lower-level executives and rank-and-file employees. For private company targets there is unlikely to be any publicly available material—other than certain benefit plan tax filings. Therefore it is necessary to review compensation materials that are provided by the target or its representatives.

The executive compensation materials typically are included in an electronic data room made available by the target, but also may be provided directly by the target, depending on the circumstances of the transaction.

To ensure that the target provides all applicable materials, the acquirer should create a comprehensive due diligence request list that asks the target to provide copies of all relevant materials in the data room or to specifically confirm that the requested materials do not exist. If possible, a follow-up due diligence call—or calls—with the target's management team and other compensation professionals—including the target's counsel—also may be helpful to gain a deeper understanding of the terms of the arrangements, the target's compensation-setting process in general and any changes that are contemplated in connection with the proposed transaction.

Organizing Materials

The acquirer should collect the target's executive compensation materials in a single place for easy reference. This can be handled through the use of an electronic binder or similar format, which may include the use of shared electronic folders or by creating an actual binder with paper copies of the materials. Having all the applicable materials in a single location with a detailed index or table of contents allows for easier access in order to reference materials both for the due diligence review itself and with respect to any questions that may arise in the future with respect to the materials.

Before printing or saving any of these materials, it is necessary to check with the broader deal team to determine whether there are restrictions on printing or saving documents as part of the transaction. Advisors should be mindful that many transactions include nondisclosure agreements that may require the parties to destroy all copies of confidential information shared as part of a transaction that ultimately is not consummated.

Transaction-Specific Considerations

In conducting the due diligence review, the acquirer should determine whether there are any considerations specific to the transaction that could expand or shift the focus of the review. These considerations may involve things such as the type of transaction—e.g., the acquisition of an entire company or a carve-out transaction involving the acquisition of only a single division or business line—the structure of the transaction as a merger, stock or asset purchase or the target's status as a public or private company, in addition to the applicable employee jurisdictions.

For example, if the target is a private company with outstanding compensatory equity awards, the acquirer needs to review 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.

In addition, if the transaction is a carve-out from a larger business rather than the acquisition of an entire company, some or all of the compensation arrangements that apply to employees within the scope of the M&A transaction may be sponsored by the parent seller, rather than the target subsidiary or other entities transferring to the acquirer in connection with the transaction. In this case, compensation arrangements may not automatically transfer to the acquirer in connection with the transaction. They may remain with the parent, need to be assumed by the acquirer or target or replicated at the target level. As a result, the executive compensation due diligence review in a carve-out transaction often focuses on determining which arrangements transfer and which are to be retained, compliance issues related to arrangements that will transfer and, to a lesser extent, compliance issues relating to seller arrangements that cover in-scope employees (because arrangements that are maintained by the seller may have little to no impact on the acquirer).

Many target companies have employees located in various countries outside the US. If this is the case, local counsel in the applicable jurisdictions typically are consulted in order to determine any potential issues that may arise with respect to those arrangements under local law.

Focus of Review

The focus of the executive compensation due diligence process is to gain a comprehensive understanding of the target's executive compensation program and individual arrangements. This understanding allows the acquirer to determine whether any potential payments or liabilities may be triggered in connection with the transaction and to identify any tax, securities or other legal compliance issues that could impact the transaction purchase price or the transaction documents. A comprehensive understanding also allows the acquirer to assess potential retention issues and determine appropriate incentives, in addition to aiding in the integration of the target's compensation programs with those of the acquirer.

The acquirer may also engage an accounting firm or compensation consultant to assist with the review of compensation programs on a more granular, operational level. If this is the case, the acquirer's legal advisors should closely coordinate with the acquirer's other advisors to maintain an efficient process that avoids duplication and ensures that applicable findings are shared in real time. That way, the acquirer can receive the benefit of the collective input and analysis of material issues from all advisors as they may arise.

While the focus of review is generally similar whether the target is a public company or a private company, it is important to note that the purchase price payable for the acquisition of a public company generally is fixed at a set price per share at the time the transaction agreement is signed, with no subsequent adjustments, while the purchase price payable for the acquisition of a private company often is set at an aggregate dollar amount, subject to adjustments for transaction expenses, indebtedness and related items.

While it is important to determine all potential compensation-related liabilities as far in advance of signing the transaction agreement as possible, the lack of post-signing purchase price adjustments in the acquisition of a public company makes it crucial to determine all potential items that may impact the purchase price as far in advance of signing as possible so that all potential liabilities can be factored into the purchase price.

Identifying Potential Compensation Payments & Benefits

A key component of any executive compensation review is determining whether any compensatory payments or benefits will be triggered in connection with the transaction. These payments and benefits typically arise in several forms: transaction, sale or retention bonuses; enhanced severance obligations payable in connection with a qualifying termination of employment within a specified period of time before or after the transaction; or through the accelerated vesting or settlement of outstanding equity awards, which may occur either immediately as a result of the transaction or in connection with a qualifying termination of employment within a specified period of time before or after the transaction.

Various documents, including employment agreements, severance plans, retention arrangements or equity plans and related award agreements contain contractual obligations to make these payments. It is important to carefully review all applicable documents to determine whether the transaction qualifies as a "change in control," "corporate transaction," or similar concepts under applicable definitions and whether any applicable payments or benefits may be triggered by the transaction or a related termination of employment. It is also critical to confirm whether the contemplated transaction triggers any applicable payments or the acceleration of vesting or funding of compensation.

This review is also important for purposes of determining whether any payments or benefits payable in connection with the transaction would be subject to the 20 percent excise tax and corresponding loss of corporate tax deduction imposed on so-called "golden parachute payments" under sections 280G and **4999 of the Internal Revenue Code**. While the actual calculations relating any exposure for these payments will be conducted by third-party accountants or other advisors, the due diligence review is a critical factor in identifying the potential payments that could be subject to the excise tax and loss of deduction and determining whether there are facts and circumstances relevant to any tax mitigation analysis.

Identifying Other Liabilities & Compliance Issues

The executive compensation due diligence review is also important for uncovering any other potential liabilities or legal compliance issues that may exist with respect to the target's executive compensation program. These liabilities and issues can arise in various ways, including the target's failure to follow the specific terms of the arrangement or the documentation or operation of arrangements in a way that fails to comply with applicable laws, including tax or securities laws.

Determining whether the target has appropriately followed the contractual terms of an arrangement is an important part of the diligence process because any failure to do so could expose the target to liability both from the employee counterparty and potentially from governmental authorities. Once the acquirer's advisors identify a failure of the target to comply with a compensation arrangement, there often needs to be a direct discussion with the target and target's legal counsel to understand the circumstances of the failure and any corrective actions that may have been taken. It is important for the acquirer request in diligence that the target disclose any compliance failures and, furthermore, for the transaction agreement to include representations that all such failures have been disclosed.

A significant area in which compensation-related issues may be identified as part of due diligence involves the target's compliance with applicable tax laws. While there are numerous tax laws that may need to be examined as part of an executive compensation review, the under **section 409A of the Internal Revenue Code**, relating to including deferred compensation under nonqualified deferred compensation plans in gross income, are usually a key focus. This is because of their complexity and the potential for significant penalties that may apply as a result of failures to comply—i.e., a 20% penalty tax plus penalties and interest imposed upon the employee. While a full examination of the section 409A rules is beyond the scope of this article, it is important to note that the section 409A rules are wide-ranging and cover a variety of arrangements, including equity awards, employment agreements, severance arrangements, cash incentive plans and other similar arrangements. It therefore is necessary to review each compensation arrangement to ensure that it is either exempt from or complies with the applicable section 409A rules.

Another key area in which compensation-related liabilities may arise involves the target's compliance with applicable securities laws. These laws generally relate to the grant of equity awards and apply at both the federal and state levels—the latter commonly referred to as "blue sky" laws. The applicable rules vary based on numerous factors, including whether the target is a public company or a private company and the location of the award recipients, in addition to the number and type of recipients. It is often necessary to understand the status of the target and the facts surrounding equity award grants to determine whether awards had been appropriately registered or fall under an applicable exemption from registration—or are illegal.

Post-Closing Integration Concerns

After closing, the focus of the acquirer turns to the operation of the combined business and integration of the target's employees. Successful integration often requires advanced planning. A careful review of the target's compensation arrangements allows the acquirer to determine how the existing program might fit within the acquirer's broader programs and to determine whether any changes are needed as part of the post-closing integration process. The acquirer also needs to determine whether any potential changes to the target's compensation programs require the consent of employees or would trigger any "good reason" or similar contractual provisions in employment or related agreements that could permit the employee to voluntarily resign from employment and receive severance or other benefits. If that is the case, the acquirer may want to obtain consents and /or good reason waivers before the transaction closes.

Many transaction agreements include provisions requiring that the acquirer maintain the existing compensation levels for continuing employees for a specified period of time following the closing of the transaction. In order to assess whether this continuation is possible or advisable, the acquirer needs to know the specific details of the target's compensation programs, which is only possible if there is a robust pre-signing diligence process.

Due Diligence Report

The results of the acquirer's executive compensation due diligence review often are communicated through a dedicated attorney-client workstream and usually are relayed to the broader deal team through a due diligence report summarizing the terms of the compensation arrangements and related potential liabilities.

This due diligence report is generally part of a broader due diligence report that is provided to the acquirer and covers a wide range of issues outside of executive compensation.

The due diligence report can take many different formats, ranging from a simple “red flags” report that summarizes only the most material issues to a report that summarizes the terms and conditions of all arrangements and spans many pages. The format and scope of the report is generally dictated by the acquirer, so it is important to discuss client expectations to ensure that the appropriate level of report is produced. The acquirer's compensation or human resources professionals may request different or additional summary materials, so it is important to remain in contact with them specifically throughout the transaction to ensure that they are also receiving all the necessary information.

Regardless of the scope or format of the due diligence report, it is critically important to provide the acquirer with a summary containing a clear, user-friendly description of the key issues and related potential liabilities that can be easily digested since the issues can often be very technical. Depending on the client's requested format, it is often helpful to provide materials using bullet points or simple tables and to add extra emphasis—bolding, highlighting, etc.—to the most critical issues.

Conclusion

Executive compensation due diligence is a key component of a successful M&A transaction and is most effective when conducted early in the transaction process. Doing so may provide the acquirer with key information and the opportunity to use that information in the negotiation process.

There may be strategic or cost considerations when acquirers forego all or part of a comprehensive diligence process, but acquirers that do so may need to rely more heavily on representations and warranties and plan for contingencies. By contrast, acquirers that conduct fulsome executive compensation due diligence can gain a comprehensive understanding of the target's compensation program and uncover liabilities and legal compliance issues that could impact the purchase price and other terms of the transaction. Adequate diligence also allows the parties to draft a more accurate transaction agreement and schedules and is necessary to integrate the target's compensation programs in the post-closing organization.