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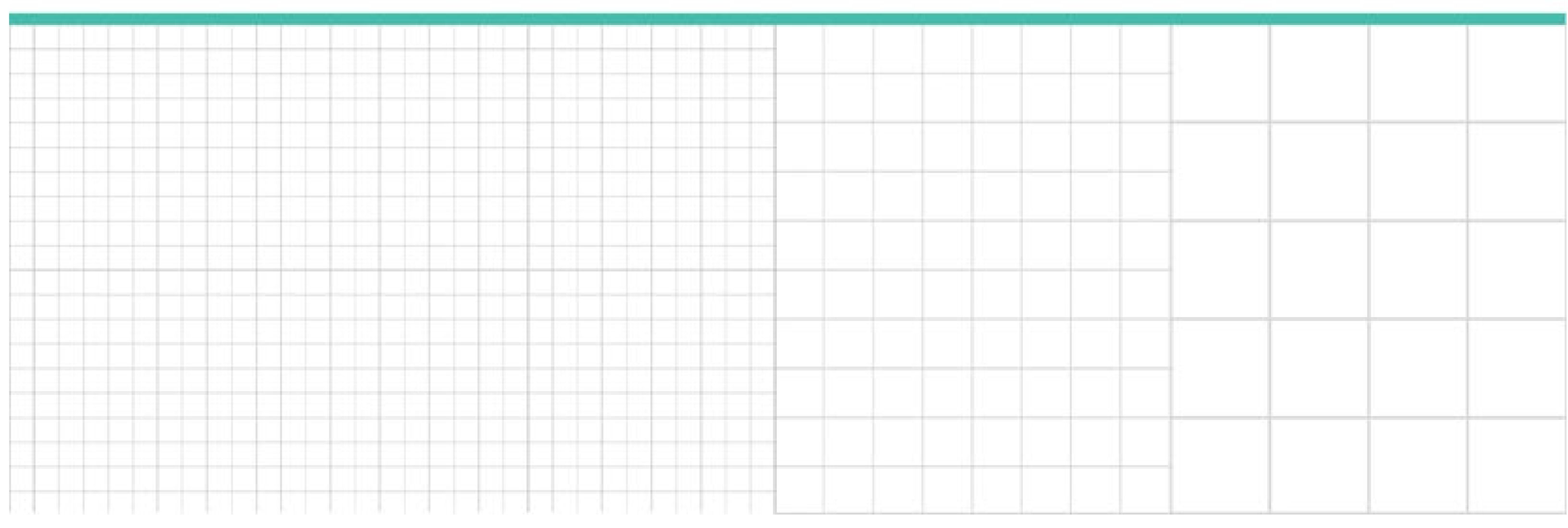
Executive Compensation Guide

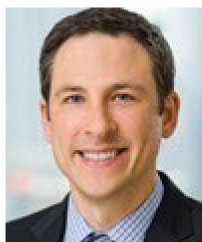
Executive Compensation Considerations in Mergers and Acquisitions



Executive Compensation Guide

1100. Changes in Ownership or Control

Chapter 180. Executive Compensation Considerations in Mergers and Acquisitions



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.10 Introduction —

The treatment of executive compensation arrangements is an important focus of mergers, acquisitions and other similar transactions. Identifying the issues involved and appropriately dealing with them is crucial to the overall success of the transaction. Executive compensation arrangements can be a source of potential liabilities that must be considered in determining the price that an acquirer will pay for the target company (the "target"). In addition, an appropriately designed executive compensation program can also help ensure that key employees of the target are properly incentivized through the closing of the transaction and through any post-closing integration period.

Compensation workstreams for an acquirer will vary from one transaction to another but typically include due diligence of the target's compensation arrangements; drafting and negotiation of the compensation-related provisions in the transaction agreement; review and preparation of public disclosure of the transaction and related compensation arrangements; and the implementation of new compensation arrangements for key employees of the target. A key workstream will be to determine whether the transaction constitutes a "change in control" of the target (or of the acquirer) and if so, to analyze the resulting implications for executive compensation arrangements.

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 optimal outcomes to support the success of the overall transaction and post-closing integration.

.10.10 What Is a Change in Control? —

A change in control, for purposes of analyzing executive compensation issues, is a merger, acquisition or other significant change in the ownership or management structure of a company. The level of change necessary to effect a change in control is determined by contract (and in certain cases applicable tax rules), but typically will include a change in a majority of shareholders (measured by voting power or economic value); a sale of all or substantially all of the target's assets; an unapproved change in the majority of the members of the board of directors; and certain other triggers, as further discussed below.

.10.20 Why Have Change in Control Protections? —

A change in control transaction will require executives to wear several hats. By law, executives must act in the best interests of the company and, ultimately, the shareholders. Exploring and entering into transactions, whether a merger, acquisition, spin-off, or other event, may be part of that shareholder focus. As leaders of the company, executives must also consider the well-being of employees and consider whether the company is best served by the retention, incentive and severance programs that are in place or whether changes need to be made. Finally, Executives' reward opportunities, especially those delivered through annual and long-term incentive programs, are aligned with the creation of shareholder value. In the context of a transaction, executive compensation should act as both a retentive and incentive tool to encourage executives to work hard to accomplish the best deal for the company while being protected from changes in management that may occur as a result of a change in control transaction.

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A transaction that is in the best interests of shareholders may not be in an executive's personal best interest. The transaction can result in the cessation of an executive's employment or other adverse changes in duties or responsibilities. Even if that is not the case, it can affect an executive's compensation, especially with regard to various forms of long-term incentives. Even if an executive's position and compensation ultimately are unaffected by the transaction, there is a substantial period of uncertainty, which can distract an executive from their duties.

Change in control protections can erase this uncertainty and thus permit executives to focus on business without undue concern for their own personal situations. Sometimes called “golden parachutes,” these protections typically take the form of enhanced severance payments and/or accelerated vesting of equity awards. The protections are put into writing, either in an employment agreement or in a special change in control agreement, or sometimes in a change in control severance plan, and permit executives to evaluate offers to their company involving a transaction in an objective fashion, knowing that they will be adequately protected even if the transaction would otherwise put their own employment or compensation at risk. These protections ideally will act to retain key executives through the closing of the transaction, thereby helping to ensure the greatest possible purchase price for the shareholders.

.20 Circumstances Under Which Executives Receive Change in Control Protection —

The first item to be explored when designing new change in control protections, or in evaluating existing protections in the context of a potential transaction, is the circumstances under which executives are entitled to payments or benefits. The determination of whether the change in control protections are triggered depends on two factors, each of which is discussed in the following section:

• the definition of a “change in control”; and

• the requirements, if any, that the executive is terminated by the employer without cause or resigns for good reason before payments are triggered.

.20.10 Defining a Change in Control —

Equity plans, employment agreements and change in control severance and retention agreements provide varying definitions of “change in control” that depend on the parties’ needs, objectives and relative bargaining power. The definition can be critical to the level of protection provided to executives, since satisfying the requirement of a change in control is the first step in determining whether payments or benefits may be provided under particular circumstances.

From the company perspective, change in control protections are incentives for executives and other key employees to work towards the successful completion of a transaction while mitigating financial concerns that their efforts will result in essentially working themselves out of a job. In this way, change in control protections are a helpful tool to align shareholder and executive interests when shareholders receive consideration for selling significant levels of ownership. Alternatively, companies should be careful about designing change in control definitions that are too easily, and perhaps inadvertently, triggered upon transactions where management (or the power to institute management) of the company is unlikely to change.

There are many variations of change in control definitions that attempt to satisfy these competing aims. Typically, public-company style change in control definitions focus on the acquisition of a specified percentage of the voting power or value of stock (generally a majority but other percentages are also

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used) by an unrelated third party, or a merger or other type of corporate transaction that results in the target's voting shareholders holding less than a majority (or other specified percentage) of the voting power in the surviving company. A change in the majority of directors due to a hostile takeover (i.e., appointments that are not approved by the pre existing board) is also a common trigger, as is the sale of all or substantially all of the assets of the target or shareholder approval of a plan of liquidation or dissolution.

In addition to the provisions above regarding an acquisition of a majority (or other specified percentage) of stock, private-company style change in control definitions also often focus on the exit from investment by a single significant owner or group of owners.[1]

[1] Lower thresholds for a change in control may run afoul of the regulations under I.R.C. § 409A. *See* 26 C.F.R. § 1.409A-3(i)(5)(v) and the discussion of I.R.C. § 409A below. Change in control definitions often include Section 409A "savings language" that address this potential issue by providing that for compensation subject to Section 409A, a change in control does not occur unless it satisfies "a change in the ownership or effective control of the Company or a change in ownership of a substantial portion of the assets of the Company" under Section 409A.

Practice Tip: To ensure that change in control protections are not unintentionally triggered, many agreements stipulate that no change in control occurs where at least 50% of the outstanding shares continue to be owned by existing shareholders after the transaction. Similarly, agreements typically state that no change in control occurs where the literal change in ownership of the target is simply the result of a corporate restructuring, and the pre-transaction shareholders continue, directly or indirectly, to own the majority of shares of the company, measured by voting power or value.

For more on definitions of "change in control", see 396 T.M., *Golden Parachutes,* III.

.20.20 Effect of a Change in Control —

Once a "change in control" has occurred, protected executives may not necessarily receive payments or benefits. For public companies, immediate vesting most often occurs when shareholders are receiving cash for their shares. In private companies, immediate vesting and liquidity for equity awards may occur if majority investors exit from ownership.

More typically in public company transactions where both the target and the acquirer are publicly-held, shareholders receive equity in the acquirer or a mix of cash and equity. When this occurs, it is increasingly rare for executives to receive single-trigger vesting of their equity awards, or large cash payouts. It is more common for public company equity awards to contractually provide for enhanced protections following closing based on whether the executive is terminated from employment by acquirer without cause, or resigns for good reason. Similarly, executive severance is often enhanced following a change in control, representing an acknowledgment that change in control transactions often include turnovers of the management team.

.20.20.10 Single-Trigger Provisions —

Single-trigger change in control provisions provide the broadest protection to executives. A typical single trigger provision provides that, immediately upon the occurrence of a change in control, either equity awards immediately vest or alternatively, an executive can voluntarily terminate

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employment and receive equity award vesting or severance payments (often referred to as a “walkaway right”). Single trigger arrangements can be windfalls for executives and can cause the acquirer to face significant hurdles in retaining key employees, in addition to making it more difficult to manage any golden parachute tax implications.

Single trigger provisos are becoming more rarely used at public companies given the opposition to those provisions from investors and proxy advisory firms. Despite some of the consequences, there may be arguments for using single-trigger arrangements for public companies under appropriate circumstances, but the target board should carefully consider the implications.

In contrast, private company transactions often include single-trigger protections. Private companies are not subject to review by proxy advisory firms and sponsors of private companies often live by the mantra “management gets its money when we get our money.” This mantra aligns interests in achieving successful private company transactions. Even so, as discussed below, it is not uncommon for private company acquirers to require executives to rollover (or “reinvest”) their vested equity awards (if possible to do so in a tax efficient manner) or reinvest proceeds from the cashout of vested equity awards or other equity holdings in the target.

.20.20.20 Double-Trigger Provisions —

Similar to single-trigger provisions, double-trigger provisions require that there be a change in control. However, rather than providing for immediate vesting or permitting the executive to decide whether payments are going to be made by merely resigning, double trigger provisions typically require that the executive's employment be terminated by the acquiring company without cause, or that the executive terminate employment for “good reason,” in order to receive the payments. A good reason typically results from changes in the employment relationship, such as:

- material diminution in base compensation or target bonus opportunity;
- material diminution in authority, duties or responsibilities;
- material change in the geographic location of employment; or
- any material breach of an employment agreement by the employer.

In each case, customary notice and cure periods of 30-90 days will typically apply for any of these triggers to constitute “good reason,” and the executive will often be required to terminate employment within a specified period of time after expiration of the cure period.

Typically, there is a specified period after the closing of the transaction by which a termination by the company without cause, or a termination by the executive for good reason, must occur for the executive to be entitled to the payments. If the executive is terminated without cause or terminates for good reason by the end of this period the specified change in control payments are made during a defined period, such as one year, after the termination. This period often ranges from one to two years following the closing of the transaction.

Double-trigger arrangements are now the most prevalent form of change in control protection. These arrangements assure executives that if they lose their jobs, or if there is a significant adverse effect on their employment relationship, as a result of the transaction, they will be financially protected.

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From the company's perspective, a double-trigger provision ensures that the executives it wishes to retain will not resign solely to receive the change in control payments. In fact, the double-trigger agreement encourages executives to stay with the surviving company because they are protected by the provision throughout and after the transaction; even if the company were to terminate the executive's employment within a defined period of time after the transaction, the executive would still receive the payments. The double-trigger provision also serves to force the surviving company to carefully assess any restructuring so that it does not unintentionally provide those executives that it wishes to retain with good reason to resign and receive the change in control payments.

That said, acquirers (and targets) need to be wary of good reason definitions that effectively provide the executives with the immediate right to resign employment and receive severance protections. A typical trigger is “a material diminution in authority, duties or responsibilities” that for certain public company executives, such as the chief executive officer and chief financial officer, may be triggered when a public company is acquired and the individuals no longer serve as officers of the surviving company (even if they are able to continue in their current positions, but do not serve as officers of the public company acquirer). The underlying rationale is that because the executive's duties prior to the transaction were intrinsically related to managing a public company and serving the interests of public shareholders, their role and responsibilities are now diminished serving as officers of a private company with a closely held shareholder base.

.30 Amount and Form of Change in Control Compensation —

Once the circumstances under which the executive will receive compensation related to a change in control are determined, the inquiry shifts to the amount and form of any payments or benefits to be provided. For more on amount and form of benefits, see Executive Compensation Guide, Employment Agreements, *Executive Employment Contracts*; Executive Compensation Guide, Equity and Incentive Compensation, *Annual Incentive Plan Design Considerations*.

.30.10 Amount of Compensation —

The amount of payments or benefits provided to an executive varies by the executive's level in a company, by the size of the company and by the compensation levels relative to the company's peer group. Executive compensation programs for public companies are subject to proxy advisor and shareholder scrutiny, whereas executive compensation programs for private companies often must be negotiated with major investors. In addition, change in control severance programs should also be designed with an awareness of potential impacts under I.R.C. § 280G, as further discussed below. Because compensation programs are often influenced by market practice, in addition to the concerns noted above, companies should work closely with their compensation consultants and other advisor in designing appropriately sized change in control programs.

.30.20 Change in Control Severance —

Change in control severance benefits can take the form of any or all of the following:

• cash severance payments;

• accelerated vesting and settlement of equity awards (restricted stock units, stock options, restricted stock, and other equity-based awards); and

• subsidized health care continuation and other post-employment benefits.

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When preparing a change in control cash severance payment program, a company must determine what is taken into account in calculating those payments. Some arrangements are based on only the executive's base salary, on the theory that only the base salary is guaranteed. Most arrangements, however, also take into account the target annual cash incentive awards in determining the cash severance amount to pay. Some arrangements also include the cash value of certain equity-based or long-term cash awards. As discussed below, vesting and payout of all or a portion of annual cash incentives may also be included.

Public company executive severance programs often include severance formulas that are a multiple of the executive officer's base salary plus target bonus opportunity. Change in control severance multiples are usually an enhancement over non-change in control severance, i.e., 3x the sum of base salary plus target for a CEO if the qualifying termination of employment occurs during the period beginning on a change in control and ending one or two years later, versus 2x for non-change in control severance if the qualifying termination occurs outside of that period.

Below the executive level, severance plans vary considerably if any are maintained. Sometimes, non-executive employees receive enhancements to severance formulas but more often there are protections included in transaction documents which require the acquirer to maintain existing severance plans for a post-closing period, or give target employees the benefit of acquirer severance plans for similarly situated employees.

.30.30 Treatment of Annual Cash Incentives —

Cash incentive plans provide for a cash payout to the executive on the attainment of financial objectives by the company or other performance goals by the company or individual. In the ordinary course outside of a transaction, most plans require an executive to remain with the company at least through the entire performance cycle[2] to be eligible for an award. If an executive's employment ceases midcycle, the executive often loses the opportunity to earn a payout under the plan. Similarly, a midcycle change in control often will make the performance objectives meaningless.

[2] Some plans require the executive to still be with the company on the date of payout.

During a transaction, one primary objective is to motivate executives to continue creating shareholder value. Allowing executives to earn incentive payouts linked to performance assists in meeting that objective. Change in control agreements use various methods for determining how to handle annual incentive plans that are affected due to a midcycle transaction. Companies must balance plan integrity, shareholder value creation, and executives' financial interests when determining how to make payments and the amount of annual incentive to include in an executive's severance package under this circumstance.

In determining the amounts to include in executive severance arrangements, companies typically look to put the executive in as good a position as if the transaction had not occurred. The incentive plan amounts to include in a severance arrangement can be determined in various ways under change in control agreements, including:

- calculating the incentive amount based on the year-to-date goal achievement;
- using the last full-cycle incentive payout received by the executive;

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- using the executive's target or maximum payout under the incentive plan; or
- using the greater, or lesser, of target or actual payouts.

Once the incentive amount has been calculated, the payout to be included in severance—whether a full-cycle or pro rata payout—must be determined. Examples of different payout options are as follows:

Pay full incentive amounts but measure on year-to-date goal achievement. The company calculates the rate of goal achievement as of the date of the transaction and presumes that this same relative level of achievement will continue through the remainder of the cycle. Full-cycle payouts are made on the basis of this presumption.

Provide a pro rata payout based on year-to-date goal achievement. Under this method, executives receive a payout based on actual performance against the plan goals, as of the date of the transaction, and only for the period already in the cycle. Thus, if a transaction occurs midcycle, the payout would be only half of the full-cycle payout for a similar level of achievement.

Provide a full or pro rata payout, based on target performance levels. Often, performance levels may be affected by the announcement of a public transaction or otherwise existing performance criteria fails to reflect the impacts of a transaction. For these reasons, companies sometimes choose to forego the complexity of determining performance mid-stream based on projected results and opt to instead pay out annual incentives at the target level of performance.

Adjust performance goals to reflect the new realities of the transaction. Where the transaction, or the announcement of the transaction, significantly impacts the ability to achieve goals, setting new goals ensures that executives remain focused on those activities that the company considers critical. It is less common for annual incentives to rollover in full company mergers and acquisitions, but when that is the case, adjustments to performance criteria are often necessary to preserve the original intent of the program.

.30.40 Treatment of Equity Awards —

If the target company has outstanding equity awards – which almost always will be the case for a publicly held company and is often the case for executives of a privately held company – the transaction agreement will include covenants governing the treatment of target equity awards as a result of the transaction. The types of equity awards that may be issued by a target include stock options, restricted shares, restricted stock units, and performance shares or performance 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 a 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. Typical treatment can include full or partial accelerated vesting and either cancellation of outstanding awards for cash payments at the closing based on the per-share transaction consideration or the assumption of outstanding awards by the acquirer, as equitably adjusted to preserve the value of the awards.

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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. This is particularly applicable to private company transactions as public company transactions generally treat all equity award holders the same (as may be required by the terms of the equity plans and award agreements).

The treatment of target equity awards that are subject to performance conditions can be particularly tricky. These awards frequently are the subject of negotiation between the parties on how to determine the level of achievement of any performance metrics, particularly for awards that will vest upon closing with a partially completed performance period closing or when performance will be measured at closing but the award will be converted into service-vesting acquirer awards. In each case, the acquirer should request detailed information about the specific performance conditions and where the performance awards are tracking relative to the applicable metrics to help make an informed decision about the appropriate treatment of the target's performance awards. Where performance will be determined based on actual results measured as of the closing date, the acquirer may seek review and approval rights.

The parties must also ensure that any contemplated treatment of the target corporation's equity awards does not violate the deferred compensation rules set forth in Section 409A of the Internal Revenue Code (Section 409A). Section 409A issues can be implicated in various situations, most notably involving either the acceleration of vesting and payment of an equity award or the extension of the vesting terms of an equity award.

Partnership interests will need to be reviewed to determine whether the interests are appropriately taxed at closing as either long- or short-term capital gain, or potentially as ordinary income. Partnership interests must also be analyzed to confirm whether any interests that are intended to be treated as 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 the contemplated treatment 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.

.30.50 Nonqualified Deferred Compensation Plans —

There are various forms of nonqualified deferred compensation plans (“nonqualified plans”) for executives, but each has in common that it permits for deferred compensation governed by I.R.C. § 409A, in contrast to tax-qualified plans such as those governed by I.R.C. § 401(k) and qualified defined benefit pension plans.[3]

[3] These types of plans are discussed more in detail in *Nonqualified Deferred Compensation Plans* ; Executive Compensation Guide, Funding and Accounting Considerations, *Financing Voluntary Nonqualified Deferred Compensation Plans* ; and 385 T.M., *Deferred Compensation Arrangements*.

Deferral plans. Deferral plans permit executives to defer some or all of their cash compensation (for example, base salary or incentive payouts) for a period of time. These plans permit executives to earn a

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rate of return, often tied to the company's cost of capital, stock price, or other measure, on a tax-deferred basis.

Supplemental executive retirement plans (SERPs). SERPs provide retirement benefits in excess of the tax-qualified benefits available. These plans are often put into place because of the limits on qualified plan contributions under the tax code. For more on SERPs, see Executive Compensation Guide, Deferred Compensation, *Excess Benefit Plans and SERPs.*

When the target maintains nonqualified plans, the essential transaction questions are (1) will the proposed transaction trigger any funding or vesting requirements under the plans and (2) will the plan automatically payout at the closing of the transaction, or if not, can the parties terminate the plan at closing in order to payout the accounts in compliance with I.R.C. § 409A. Each issue is discussed below.

.30.50.10 Funding Requirements —

Nonqualified plans may have related trusts or other funding vehicles, commonly referred to as “rabbi trusts,” which essentially set aside money or property to fund the plans, but those funds or property are simply segregated accounts of the company that remain subject to claims of company creditors. A key diligence workstream will be to confirm whether funding of any nonqualified plan accounts or related trusts will be triggered by the proposed transaction. SERPS are often unfunded and deferral plans where the company has not set aside cash in real time when deferral elections are made can cause surprises for acquirers as balances can stretch into hundreds of millions of dollars for large plans. Even if the accruals for these plans are properly recorded in the financial statements of the target, there may not be enough cash on hand to fund these plans and acquirer may need to consider liquidity needs when modelling the purchase price for the transaction. Practitioners should include a review of the target's financial statements and request information related to plan financials, including actuarial reports, as part of their executive compensation due diligence review.

.30.50.20 Vesting Requirements —

Most deferred compensation plans are designed so that executives can opt to defer compensation that they otherwise would have received currently to instead be paid at some specified date or event in the future. As a result, the compensation is often already vested, and only receipt of the compensation is being deferred. To the extent that the plan includes vesting schedules for credited investment returns or for bonus amounts provided by the employer in addition to executives’ deferrals, vesting is often accelerated on a change in control.

SERPs are more likely to have vesting requirements because they often are part of the company's retention program. Again, during a change in control, it is common to see accelerated vesting, so that executives are assured that they will receive the benefits that they were promised.

.30.50.30 Deferral Period —

The decision as to whether to continue the deferral period often arises in a change in control situation. If nothing changes and the deferral period continues, then executives whose employment continues with the surviving company remain in the same position as they were before the transaction. If the deferred compensation plan is similar to the one in existence at the surviving company, then the decision to continue the plan is easy. The surviving company may also

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continue the plan until its conclusion and then not permit a renewal. For more, see 385 T.M., *Deferred Compensation Arrangements,* XIII.

If the acquired company's deferred compensation plan is more lucrative than the surviving company's plan or the surviving company does not have a deferred compensation plan, then the surviving company may decide to terminate the plan and pay out the benefit. Providing a greater benefit to acquired executives than to existing executives at the acquirer may be viewed as disruptive; therefore, terminating the plan may be the best alternative for employee relations reasons. A drawback to terminating the plan is that paying out the deferral accounts will generally result in early taxation and loss of future tax deferral opportunities for participating executives and may result in additional taxes under I.R.C. § 409A.

.30.50.40 I.R.C. § 409A —

I.R.C. § 409A is a very technical and wide-ranging section of the tax code that governs compensation and benefits arrangements that provide for nonqualified deferred compensation—generally understood to be compensation that is earned in one year but payable in another year and is not part of a tax-qualified plan. I.R.C. § 409A regulates nonqualified deferred compensation plans through election timing and distribution rules, and generally prohibits acceleration of the time or form of payments, with limited exceptions. Certain deferred amounts are exempt from § 409A, for example, certain short-term deferrals, stock options, and stock appreciation rights not issued at a discount, restricted stock regulated under I.R.C. § 83, and separation pay that is payable due to an involuntary separation from service or participation in a window program.[4] Also, termination for good reason can qualify as an involuntary separation from service and thus be exempt from § 409A if the good reason meets certain conditions or fits within the regulatory safe harbor.[5]

[4] 26 C.F.R. § 1.409A-1(b).

[5] 26 C.F.R. § 1.409A-1(n)(2).

Payments made upon a change in ownership or control of the employer are also regulated under I.R.C. § 409A.[6] It cannot be assumed that a change in control that meets the definition in the I.R.C. § 280G regulations will meet the thresholds under § 409A for a change in control distribution event.

[6] 26 C.F.R. § 1.409A-3(i)(5).

Under the § 409A regulations, a change in control is considered to occur if there is:

- a change in ownership;[7]
- a change in effective control;[8] or
- a change in ownership of a substantial portion of a corporation's assets.[9]

[7] This is generally the acquisition by a person, or more than one person acting as a group, of more than 50% of the total fair market value or total voting power of the stock of a corporation.

[8] This is generally the acquisition by a person, or more than one person acting as a group, of 30% or more of the total voting power of the stock of

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a corporation or the replacement of a majority of the members of the board of directors by directors whose appointment is not endorsed by a majority of the members of the prior board.

[9] This is generally the acquisition by a person, or more than one person acting as a group, of 40% or more of the gross fair market value of the corporation's assets. *See* 26 C.F.R. § 1.409A-3(i)(5).

Tax gross-up payments generally are not exempt and would be considered deferred compensation under I.R.C. § 409A. In order to comply with the regulations, a tax gross-up payment subject to § 409A must be paid within the time frame specified in the regulations.[10]

[10] 26 C.F.R. § 1.409A-3(i)(1)(v). The rules also require a six-month delay in payment for specified employees upon separation from service. 26 C.F.R. § 1.409A-3(i)(2).

While this chapter includes a very brief overview of applicable rules under I.R.C. § 409A, the rules are comprehensive and well beyond the scope of this chapter. See Executive Compensation Guide, Impact of the Internal Revenue Code, *Section 409A: Overview* ; and Section 409A Handbook, Chapter 17, Mergers and Other Corporate Transactions for more information regarding these rules.

.40 Golden Parachute Payments —

Sections 280G and 4999 of the Internal Revenue Codeprovide that target officers and other highly compensated individuals – and sometimes shareholders – can be subject to a 20% excise tax on certain compensatory payments made in connection with a change in control transaction, and the acquirer can lose any corresponding tax deduction with respect to those payments. These so-called “golden parachute payment” provisions are punitive and designed to dissuade payments and benefits that generally exceed three times the disqualified individual's average five-year annual compensation. (See Checklist – Identifying Golden Parachute Payments to Disqualified Individuals: A Seven-Step Analysis).

Early in the process of any change in control transaction, a key workstream is to engage the services of third-party accountants to work with legal counsel in preparing an analysis of all golden parachute provisions, determining whether excise taxes and loss of deductibility may be triggered under those provisions, and structuring the appropriate use of any available mitigation strategies.

These mitigation strategies can include the implementation or valuation of restrictive covenant agreements; gross-up payments, which are disfavored among proxy advisor but are used in certain industries; implementation of post-closing retention payments as reasonable compensation for services in lieu of transaction bonuses or enhanced severance payments; and the accelerated payment of compensation into the calendar year before the closing of the transaction where possible.

It is critical to carefully examine all of the target's compensation arrangements as early as possible in the transaction process to determine whether any payments or benefits that may be provided to a disqualified individual could implicate the golden parachute provisions and whether any mitigation tactics can be used to eliminate or otherwise limit their impact.

.40.10 Disqualified Individuals —

For purposes of the golden parachute provisions, disqualified individuals are company officers, highly compensated individuals (the highest paid 1% of the workforce or the 250 highest paid employees,

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whichever is less), shareholders and certain providers of personal services.[11] Payments are considered contingent on a change in control if the change in control determines the timing of the payments or the payments would not have been made except for the change in control.[12] Payments that are made under an agreement (or an amendment to an agreement) entered into within one year before a change in control are deemed to be covered by the I.R.C. § 280G requirements unless the taxpayer shows by clear and convincing evidence that the payments were made in the normal course of business, unrelated to a change in control.[13]

[11] 26 C.F.R. § 1.280G-1, Q&A 15, 19.

[12] 26 C.F.R. § 1.280G-1, Q&A 22.

[13] 26 C.F.R. § 1.280G-1, Q&A 25.

.40.20 Calculating Excess Payments — —

Determining whether there are excess payments involves more than just adding up the cash payouts. In addition to amounts intended to replace lost base salary, other items that must be taken into account, include:

- amounts intended to replace lost annual and long-term incentives;
- accelerated vesting of stock options and restricted stock grants;
- fringe benefits;
- group health and welfare benefits;
- calculating the incentive amount based on the year-to-date goal achievement;
- SERP benefits; and
- retirement plan credits or enhanced payouts.[14]

[14] 26 C.F.R. § 1.280G-1, Q&A 11.

If the executive will render services to the surviving company subsequent to the change in control, an amount that the corporation or executive establishes by clear and convincing evidence represents the reasonable value of those services can be excluded.[15]

[15] 26 C.F.R. § 1.280G-1, Q&A 24(a)(2).

In determining the value of items to be included, lump sum cash payments that are made immediately are simply given their full value. Calculating the value of other items, however, is not as simple. For example, payments made over time, or otherwise in the future, are discounted to their present value. I.R.C. §280G mandates that the discount rate must be equal to 120% of the applicable federal rate (AFR) compounded semi-annually.[16] Similarly, the value delivered by accelerating the vesting of stock options and restricted stock is determined based on the following:

[16] *See* I.R.C. § 280G(d)(4).

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• the amount by which the spread on the date of the change in control exceeds the present value of that same spread if it existed at the date the options were originally to vest – the discount rate used in calculating the present value remains at 120% of the AFR; and

• the value of the lapse of any obligation to perform future services as a condition of exercising the option.[17]

[17] 26 C.F.R. § 1.280G-1, Q&A 24(b), (c).

Once the present value of each includible item has been determined, the total present value must be compared with three times the executive's five-year average taxable compensation, measured based on the five year period prior to the year in which the change in control transaction occurs. If that level is equaled or exceeded, a number of offsets can still be used to reduce the value of the excess payments that will be nondeductible and subject to the 20% excise tax. To the extent that the executive or corporation can show by clear and convincing evidence that change in control payments actually are being made for services rendered *before* the change in control, an amount representing the reasonable value of those services can be deducted.[18] Payments that typically are seen as related to prior service include:

[18] 26 C.F.R. § 1.280G-1, Q&A 3.

• accelerated payout of voluntarily deferred compensation without an increase in present value;

• gains from the exercise of previously vested stock options and other equity instruments; and

• payouts based on the previous cancellation of vested stock options or stock appreciation rights.[19]

[19] *See* Conference Committee Report on the Tax Reform Act of 1984, at 852, 53.

.40.30 Consequences of Excess Payments —

Once the change in control payments are calculated, and reduced by any offsets, they are then compared with the “base amount.” The base amount is the average of the prior five years of includible compensation (generally, the compensation reported on IRS Form W-2), measured based on the five year period prior to the year in which the change in control transaction occurs. If the change in control payments after offsets and reduced to present value equal or exceed three times the base, the amount by which they exceed the base is nondeductible to the company and subject to an excise tax of 20% to the executive in addition to ordinary income taxes. In addition, the surviving company cannot include the excess payments in the purchase price for accounting purposes. It is important to note that the three-times-the-base-amount construct is only used for determining whether there will be any excess parachute payments that are subject to these tax and accounting consequences. If there will be excess parachute payments, their amount is determined as everything that exceeds one time the base amount.

Once it is determined that change in control payments result in excess parachute payments that are subject to these tax and accounting consequences, the company has a number of alternatives:

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Make the payments. If the payments are made, then the company and the executive must handle the adverse tax consequences.

Make the payments and gross up the executive's payments to account for the executive's tax consequences. The company can provide the executive with additional payments to make up for any adverse tax consequences including any resulting from the additional payments. Although the executive is made whole, the payment of additional monies by a company are not deductible and cannot be included in the accounting of the purchase price of the company. Additionally, the gross-up amounts are considered excess parachute payments; therefore, this alternative can be fairly costly to the company.

Cap the payouts at the statutory level. The company and the executive can agree to cap the change in control payouts at less than three times the base amount. The executive thus gives up the additional compensation and the company does not make nondeductible payments.

Provide the executive with either the full payments or the capped amount, whichever puts the executive in the best financial position after taxes. Because excise taxes are due on all amounts over the base amount, a change in control arrangement that provides benefits that are slightly more than three times the base may be less attractive to the executive than one that is capped at less than three times the base.

> ***Practice Tip:*** Treatment of potential golden parachute taxes are often set forth in the transaction agreement, most typically in the disclosure schedules setting forth exceptions to the interim operating restrictions. These covenants will generally permit the target company to take certain actions during the period between signing and closing to mitigate the effect of any loss of deduction under Section 280G and any potential excise taxes under Section 4999. Permitted actions may include the engagement of an accounting firm to perform a golden parachute tax analysis, acceleration of certain types of awards into the year before closing in order to raise the base amount, and sometimes, the provision of gross-up payments to executives although that has typically been limited to certain industries.

.40.40 Cleansing Shareholder Vote —

Unlike a public company transaction, a private company shareholder vote to avoid the impact of the golden parachute provisions may be available – provided that the company is truly private and its securities are not “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. The first step in the voting process is to secure a written waiver from each individual 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.

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, and identify situations where there is a broad shareholder base, either due to direct holdings or due to

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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.

For more on golden parachutes, see 396 T.M., *Golden Parachutes*.

.50 Retention Strategies —

In most transactions, the surviving company faces retention issues arising not only from change in control payments but also from the natural problems that arise in integrating two businesses and their executive teams. How the company approaches compensation issues will help determine whether those executives it wants to retain actually stay with and contribute to the company going forward. A discussion of the issues that must be dealt with follows below.

.50.10 Cash Retention Programs —

Executives from the acquired company may need special retention programs to convince them to learn a new culture and stay with the surviving company.

Special retention arrangements may include cash based awards that vest some percentage at closing (e.g., 50%) and some percentage at six months or one year after closing. Retention can also take the form of new equity award grants, which may be time- or performance-based and may vest over a period of years that is longer than the typical annual award cycle.

Change in control provisions specify the form of cash payments, which may be paid over time (such as salary continuation) or paid in a lump sum, typically promptly after the closing of the transaction. Payments over time permit the company to tie continued severance to the executive's compliance with restrictive covenants and other post-employment requirements. A lump-sum payment, on the other hand, provides the executive with immediate cash; therefore, the executive is not dependent on the continuing financial viability of a company of which they are no longer a part.

.50.20 Post-Closing Compensation Philosophy —

The first step is to determine the compensation philosophy of the surviving company going forward. One company may believe it offers a greater risk/reward profile and thus is able to pay lower base salaries than other companies but offer greater incentive opportunities. Similarly, the role of equity in wealth creation and linkage to shareholder value creation may differ in the acquired and surviving companies, which affects the cash compensation strategy. These issues must be decided early on and communicated to all executives, so they know where the company is going and can make reasoned decisions about their future with the company.

.50.20.10 Cash Compensation —

Base salary and annual incentive programs may have to be realigned on the basis of the surviving company's compensation philosophy. If base salaries are markedly different, increases may have to be moderated or frozen for executives or increased at a greater than normal rate.

Annual cash incentive programs may need to be restructured, depending on their reward opportunities related to the compensation philosophy. In addition, the mix of overall company

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goals, business unit goals, geographic goals, and individual goals may differ in the acquired and acquiring companies.

Extensive and accurate communication about the compensation philosophy, and the actions taken, will be critical to ensuring that executives understand what the company is doing and how its actions will affect them going forward.

.50.20.20 Long-Term Incentive Compensation —

Long-term incentive programs must also align with the compensation philosophy, and the practices at both companies may need to be reviewed. The relative use of stock versus cash and/or deferred awards may differ significantly and may have to be realigned.

.60 Conclusion —

Executive compensation matters represent a critical workstream for an acquirer in its acquisition of a public or private company and are often a key factor in a successful transaction. These matters commence at the very beginning stages of the transaction with uncovering potential liabilities and compliance issues in the due diligence process. They continue through the negotiation of applicable terms in the transaction agreement and new compensation arrangements for target employees and, for public companies, through the public disclosure of those arrangements in the merger proxy.

Thus, it is important for executive compensation practitioners to be engaged as early as possible in a transaction and to remain in close contact with the client and the broader deal team to ensure that these matters are handled optimally in the context of the overall transaction.

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