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Comp Talks Compensation & Benefits Issues in M&A Transactions

Laura McDaniels, Cooley

Craig Menden, Cooley

Pamela Sergeeff, Rovi Corporation

***Moderated by* Amy Wood, Cooley**

“Now…What Shall We Talk About?”

- M&A 101
- Due diligence
- Integration planning
- What to do with Target equity?
- Pre-closing conditions and post-closing covenants
- Dodd-Frank Act say-on-parachute votes
- Issues stemming from the tax code

M&A 101: Types of Transactions

- Stock purchase
- Merger
- Asset purchase
- Sale of a subsidiary/division
- Merger of equals
- Aqui-hire

M&A 101: Transaction Process/Timeline

Non-Disclosure Agreement

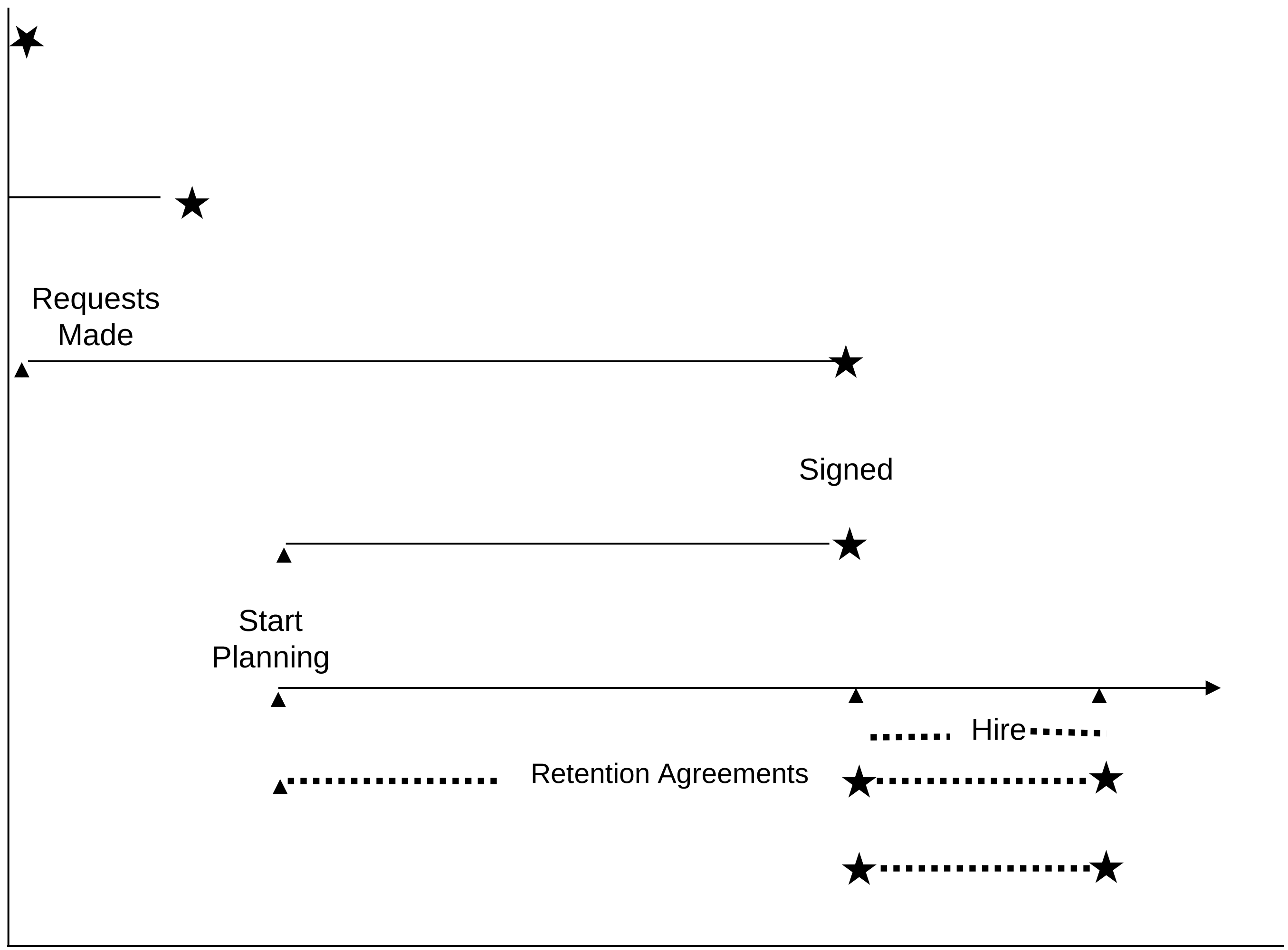
LOI/Term Sheet

"Due Diligence"

Definitive Agreement

Integration Planning

Closing



M&A 101: Deal Timeline and Employee Retention Matters

- Parties often divide employee compensation and retention considerations into at least 2 of the following categories:
  - Group 1: Key employees
    - These are the mission-critical people
    - Buyer should try to identify as early as possible, and negotiate employment/retention/non-competes as conditions to signing
  - Group 2: Other continuing employees
    - This could be everyone else, or a subset of existing employees
  - Group 3: Transition employees (usually < 3-12 month term)
  - Group 4: Terminations pre-closing

Due Diligence

Due Diligence:
What Am I Looking For Again?

- Identify red flags in legal/regulatory compliance
  - Benefit plan operational issues
  - Section 409A issues
  - Employee classification issues
- Assess potential cost of CIC-related obligations
  - Change in control triggers and transaction-based arrangements
  - Cost of potential layoffs before or after closing
  - International plans and employees

Due Diligence:
What Am I Looking For Again?

- Evaluate proposed treatment of equity awards in light of plan terms and outstanding awards
  - Vested vs unvested held by key employees
  - Possible to subject option cash-outs to escrow/earnout?
  - Widespread accelerated vesting rights?
- Identify potential integration challenges
  - Disconnect between organizations in levels of compensation? Benefits offered?
  - Potential obstacles to Buyer’s retention goals

Integration Planning: View From the Trenches

- Don’t rush it
  - Both parties have imperfect information in diligence process
- Make thoughtful decisions and compromises
  - “This is how everyone does it in an M&A deal…”
  - Every deal is different – depends on facts and circumstances of specific parties

Integration Planning: View From the Trenches

- Consistency is key
  - If favoring retention of some key person/group, have a business rationale that is consistently conveyed
- Communication, communication, communication
  - It is OK to say “I don’t know” while integration planning is ongoing
  - Be transparent about the process and timing for decisionmaking

Treatment of Target's Equity Awards

- Often driven structure of transaction
  - Merger/stock sale: may assume or terminate awards
  - Asset sale: awards generally terminate
  - Acquisition of a subsidiary: analogous to termination of employment
- Deal economics considerations
  - If Buyer assumes awards, "cost" deducted from deal price
  - If unvested Target awards are cancelled for no $$ at closing, Buyer likely will need to be proactive about replacement awards

Equity Awards:
To Assume or Not to Assume?

- **Assume** = remain subject to terms of Target's plan; **Exchange** = cancel and regrant under Buyer's plan
  - Must comply with Section 409A, and also ISO rules if retaining ISO status
- Typically only assume/exchange unvested awards held by continuing employees
- Retain existing vesting schedule or "revest"?
- **409A no-no**: exchanging in-the-money options for RSUs
- Carefully evaluate private company RSUs before agreeing to assume

Equity Awards: To Assume or Not to Assume?

- Cancelling awards at closing
  - Requires individual consent to waive accelerated vesting
  - Depending on equity plan terms, may require individual consent to subject option cash-out to escrow or earn-out provisions
  - Paying cash-out payment along original vesting schedule – uncertain Section 409A treatment

Pre-Closing Conditions

- Hiring by Buyer
  - All, or on case-by case basis?
  - Layoffs pre-closing?
- Retention arrangements
  - Lock up key employees pre-signing if possible!
  - Retention bonus pool vs individual arrangements
  - New hire equity packages
  - Minimum retention requirement to close
- Transition services agreements

Pre-Closing Conditions: Market Trends (Public Target)

- Retention of specified employees
  - Per ABA 2015 strategic buyer/public target M&A deal points study (deals announced in 2014), ***98% of merger agreements did <u>not</u> include a pre-closing condition tied to retention of specified employees***
  - By contrast, this is a very common condition imposed on private Target companies

Post-Closing Covenants for Continuing Employees

- Comparable salary/incentive compensation
  - At Target pre-closing level? Or Buyer's? How long?
  - Guarantee vs. emphasizing fair/equitable treatment
- Offering "comparable" benefits
- Keep Target benefit plans in place or terminate pre-closing?
  - Consider when Target's plans normally terminate, and whether they use a PEO (e.g. TriNet)
  - 401(k) Plan – typically terminated pre-closing
  - Existing severance arrangements usually negotiated on a case by case basis

Post-Closing Covenants: Market Trends (Public Target)

Per January 2016 Law 360 study of Q3 2015 mid-market public company M&A deals:

- Comparable compensation packages
  - 90% provided limited protection – 12 months duration is typical
  - 2/3rds excluded some arrangement; over 50% excluded equity-based compensation
- Termination of 401(k) Plan – 50% addressed treatment of plan, and of those 90% terminated Target's plan
- Waiver of eligibility conditions
  - 80% of Buyers agreed to use commercially reasonable efforts to waive plan conditions, and provide credit for pre-closing payments towards deductibles, coinsurance and copayments

Say-on-Parachute Votes

- Exchange Act Rule 14a-21(c) requires a *non-binding* shareholder vote on Named Executive Officer (NEO) compensation when an acquisition, merger, consolidation or asset sale is being voted on
  - Generally only impacts public company Target NEO golden parachute arrangements
  - In rare instances may require vote on Buyer NEO golden parachute arrangements as well
- Companies must describe golden parachute arrangements and quantify them
- The say-on-parachute vote requirement does not apply if the golden parachute compensation arrangements were subject to a prior say-on-pay vote and have not changed (subject to limited exceptions)

Say-on-Parachute Votes: Market Trends

- Through end of 2015, only ~5% of proposals have received less than majority support
- ISS has historically recommended voting against ~20% of proposals submitted each year
- Single- or modified-single trigger cash payments is most frequently cited issue, followed by single- or modified single-trigger equity vesting acceleration, gross-up payments and excessive payments
- Say-on-parachute proposals have generally not impacted vote results for transactions (median support for transactions has not declined)

Tax-Related Compensation & Benefits Issues

Remind Me What Section 409A Is Again?

- Internal Revenue Code section governing *deferred* compensation
- What is deferred compensation?
  - Legally binding right to compensation in current tax year which is to be paid in a future tax year
  - Paid more than 2 ½ months after tax year in which no longer subject to a "substantial risk of forfeiture" (generally March 15)
- **SEVERE** tax penalties for violation: 20% excise tax + early income recognition
  - California has additional 5% penalty tax as well

What Arrangements Are Subject to Section 409A?

- "Top hat" plans and SERPs
- Possibly, depending on terms:
  - Equity awards
  - Severance arrangements
  - Expense reimbursement + gross-up rights
  - Bonus rights
- Qualified plans (401(k), pension), "cafeteria" plans & COBRA premium reimbursements are *exempt*

Section 409A Traps and Tips: Equity Awards

- Stock Options
  - Exercise price must be at least equal to **100% of FMV on date of grant** to be “exempt” from Section 409A
  - Must be granted on “service recipient stock” – that is, common stock of the company that employs the optionee or a parent
  - Buyer should verify that stock options comply with or are exempt from 409A before agreeing to assume options
- RSUs and phantom awards
  - Must have 409A-compliant payment terms (or are exempt as “short term deferrals”)
  - Pay attention to “liquidity event” RSUs

Section 409A Traps and Tips: Severance

- Reviewing existing terms:
  - Does the “good reason” trigger really = a constructive termination, or is it a “walk right”?
  - Different payment timing (lump sum vs installments) depending on type of termination
  - Payment tied to a release requirement
- 6 month delay for “specified employees” in a public company
- Need to verify any proposed changes to severance arrangements to ensure they will comply with 409A

Section 409A Traps and Tips: Other Deferred Comp Plans

- Special opportunity in CIC for Buyer to terminate Section 409A arrangements
  - Examples: supplemental deferred compensation plan; “liquidity event” RSUs
- Must terminate all plans of the same type for all participants
- Special timing rules apply

Section 280G/4999 aka "Golden Parachute Tax"

- No employer deduction for "excess parachute payments" (§ 280G)
- 20% excise tax on recipient of "excess parachute payments" (§ 4999)
- Only applies to corporations
- Exemptions for:
  - Companies that qualify as S corps
  - Private companies that obtain stockholder approval of payments
  - "Reasonable compensation" for services

Dealing with Section 280G/4999 aka "Golden Parachute Tax"

- "Change in control" means (i) >50% stock, (ii) ≥20% stock if control actually passes or (ii) ≥1/3 of FMV of all assets
- "Safe harbor" amount is generally 3X the base amount minus $1.00
  - If the safe harbor is exceeded, all parachute payments over 1X base amount are "excess" parachute payments and are subject to the 20% tax and loss of deduction (i.e., it's a cliff)
- "Base amount" is average taxable (W-2/1099) compensation for the five taxable years preceding the year of the change in control

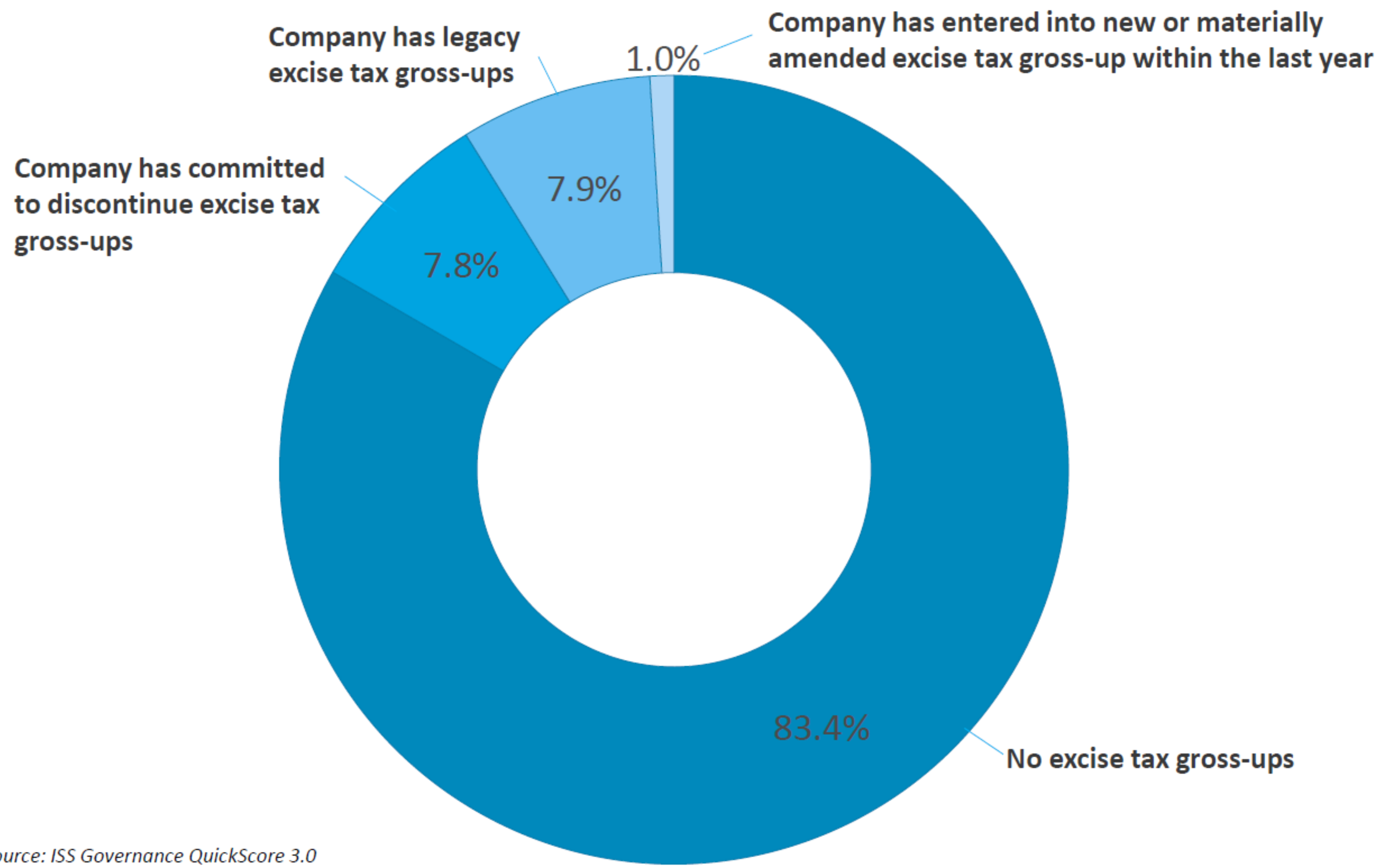
What Are Parachute Payments?

- Use a *"but for"* test – would this benefit be given or payment be made if there were no CIC?
- Specific examples:
  - Accelerated vesting or recently granted equity awards (< 12 mo.)
  - Change of control bonus payments
  - Severance payments – even if not strictly "double trigger"
  - Bonus or other new benefit/payment made at CIC, or within a 12 month lookback (unless rebutted by "clear and convincing" evidence)
  - Payments under new agreements with Buyer, if there is a legally binding right prior to the closing (retention bonus; new hire equity awards)

Stockholder Approval Exemption – aka "280G Cleansing Vote"

- This exemption only applies to ***privately held companies***
- Key requirements:
  - More than 75% of stockholders approve payments
  - Adequate disclosure of all material facts to <u>all</u> <u>voting</u> stockholders
  - Payments must be "at risk"
  - Stockholders must be able to vote separately on M&A transaction and 280G payments

Excise Tax Gross-Ups at Russell 3000 Companies



Source: ISS Governance QuickScore 3.0

Public Companies and 280G Strategies

- Reasonable compensation for post-CIC services are not subject to 280G
  - What is *reasonable* compensation?
    - If duties/responsibilities have not changed, compensation "not significantly greater" than pre-CIC compensation
    - If duties/responsibilities have changed, compensation "not significantly greater" than paid for persons performing comparable services
  - May include valuing a non-compete
  - Usually parties will obtain 3rd party market study
- Agreements entered into *after* a CIC are not subject to 280G
  - BUT watch out for facts that suggest pre-CIC agreement

Questions????

Laura McDaniels, Cooley
lmcdaniels@cooley.com

Craig Menden, Cooley
cmenden@cooley.com

Amy Wood, Cooley
awood@cooley.com