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Executive Employment Agreements and Change in Control Arrangements

Structuring Golden Parachutes That Promote M&A Opportunities, Withstand Shareholder Scrutiny, and Avoid Adverse Tax Consequences

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Change in Control Arrangements and IRC § 280G

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Change in Control Agreements

Change in Control Agreements Basics

- Change in Control Agreement is a contract that provides an executive or employee with employment protection (usually severance) and/or enhanced benefits in connection with a CIC

- Common client questions:
  – Why would a Company want to adopt such an agreement?
  – What terms should be included in a CIC Agreement?
  – How will a prospective buyer view CIC Agreements?

Change in Control Agreements
Why Adopt?

- Industry consolidation a major concern
- Focus executives to drive shareholder value despite uncertainty as to future job prospects
- Foster impartial assessment of possible acquisition
- CIC Agreements an important part of the executive compensation package
  - But subject to increased scrutiny from ISS
- Protect against competitors hiring away talent during the acquisition process

Change in Control Agreements Terms

- Who receives a CIC Agreement?
  - Typically includes executive officers
  - Other employees may be included under letter agreements and broad based severance plans ("tin parachutes")
- Level of protection and benefits will vary based on employee's position with the company

Change in Control Agreements Terms

- CIC Definition
- Single Trigger v Double Trigger
- Protection Period
- Time and Form of Payment
- 280G Considerations

Change in Control Agreements
CIC Definition

- Typical events covered under a CIC definition include:
  - Acquiring a specified percentage of the company's voting securities in an open market transaction
  - A change in a majority of the board
  - Merger or consolidation in which the seller's shareholders no longer control the surviving entity
  - Sale of substantially all assets to an unrelated entity
- Need to understand company and shareholder base when preparing CIC definition

Change in Control Agreements
CIC Definition

- Different change in control definitions may apply for tax purposes (§§ 409A and 280G)
  – What is a CIC for purposes of paying nonqualified deferred compensation on an accelerated basis or using a different type or form of payment?
  – What is a CIC for purposes of determining whether golden parachute restrictions may apply?
- A transaction may qualify as a CIC under a CIC agreement but not for tax purposes

Change in Control Agreements
CIC Definitions

- If still working with a "traditional" plan definition, need to be very careful about 280G (which may not be triggered, despite the plan's definition being triggered and entitling participants to benefits) and about 409A (which will not permit a change in payment time or form unless the CIC qualifies as such under 409A)
- Most options and RSUs are exempt from 409A, either as "stock rights" or as short-term deferrals. Restricted stock is not subject to 409A. Most CIC severance is double-trigger, so traditional CIC definition may not preclude 409A exemption.
- But BEWARE of provisions causing loss of short-term deferral status, such as
    - "continued vesting" of RSUs on "retirement"
    - remaining "on the payroll" without duties some period of time or garden leave or terminal leave

CIC Agreements
Definitions

- Better comfort with a single definition that meets 409A and applies in all cases. But be sure to draft parallel exclusions from the "traditional" plan, e.g.,
  - For >50% stock acquisitions, exclude acquisition by subsidiaries or employee benefit plans, or for reincorporation in another state, and other mechanical changes that do not trigger a "real" CIC.
  - For >30% stock acquisition, consider drafting exclusion if incumbent board and/or incumbent CEO remains in place, or set a higher threshold than 30%.
- Can only change the CIC definition with respect to future awards/accruals (or in some cases, with respect to awards/accruals that do not vest until at least the calendar year after the year of the amendment). Otherwise bad 409A acceleration, deferral, or trigger.
- Alternatively, can insert a requirement that, with respect to compensation subject to Section 409A, the CIC provisions requiring accelerated payment will only apply if the CIC is 409A-compliant, but it can be confusing for participants.

Change in Control Agreements
Triggering Event

- "Single Trigger" – benefits become payable or vested upon the CIC; no requirement to end employment

- "Double Trigger" – benefits become payable or vested if there is both a CIC and a qualifying termination of employment within a specified period following a CIC,
  - Involuntary termination without Cause or resignation for Good Reason

- "Modified Single Trigger" – provides a window period following a CIC during which the employee can voluntarily terminate employment for any reason

Change in Control Agreements Triggering Event

- Most CIC agreements that provide severance use a double trigger approach
  - ISS considers automatic single trigger provisions to be a poor pay practice
- Large payouts in connection with a CIC or "walk away" rights may make it hard for Buyer to retain employees
- Double Trigger arrangements give Buyer some degree of flexibility because benefits typically only payable if Buyer terminates employment – Buyer controls
  - Note: beware of double trigger where employee has a walk away right due to transaction alone (e.g., CEO in a take private transaction)

Change in Control Agreements Protection Period

- Most typical CIC Agreement is a double trigger arrangement providing for 12-24 month Protection Period following CIC
- Agreements may (but do not always do) provide for **pre-CIC protection**
  - "period pending" a CIC
  - "in anticipation of" a CIC
  - the 6/12 month period prior to a CIC
  - Avoids loophole where a Buyer demands that certain executives are terminated before Closing
- Note: most CIC Agreements have a stated term and will expire if no CIC occurs during the Term; there may be an evergreen provision

Change in Control Agreements Amount

- CIC Agreements generally provide for a payment based on a multiple of base salary and/or bonus (or multiple of generic severance)
- Can be paid in a lump sum or installments (usually lump sum in CIC context)
  - Note: may be structured to be paid out over applicable non-compete period to facilitate compliance with restrictive covenants and 280G "reasonable compensation " position
- Equity awards may be single trigger or double trigger
  - ISS views automatic single trigger vesting to be a poor pay practice
- Unvested NQDC often becomes fully vested upon a CIC

Change in Control Agreements Buyer's Perspective

- Sophisticated Buyer will evaluate impact of CIC Agreement in connection with acquisition
  - May result in buyer seeking to restructure agreements before the CIC
  - May result in pre-transaction terminations
  - May require payment of retention bonuses to keep executives
  - Uncertainty regarding post-Closing retention
  - May result in purchase price adjustments and/or indemnities
- Buyer will typically seek to eliminate single trigger CIC provisions

Change in Control Agreements Related Arrangements

- Sale Bonus – cash payment upon successful completion of a sale:
  - % of Net Proceeds
  - Fix dollar amount
  - Phantom Equity settlement
- This is effectively a single trigger CIC Agreement
  - Sale Bonus typically implemented as an incentive/reward to employees and often goes deeper
  - Sale Bonus often implemented in contemplation of sale
  - CIC Agreement typically part of employment negotiations and more limited in depth

Change in Control Agreements
Related Agreements

- Retention Arrangement – cash payment based upon continued employment through a specified date:
  - Consummation of sale
  - Specified period of time following transaction
  - Some arrangements also layer in performance conditions (often synergy metrics in strategic transactions)
- Retention Arrangements can also take other forms:
  - Equity rollover
  - Earn-outs
  - Post-Closing Buyer arrangements

IRC § 280G

IRC § 280G Background

- Section 280G of the Code denies corporations tax deductions for "excess" parachute payments to "disqualified individuals" contingent on CIC. Partnerships (and LLCs treated as partnerships) are exempt.
- Section 4999 of the Code imposes a 20% additional penalty tax on disqualified individuals receiving "excess" parachute payments contingent on CIC.
- "Safe harbor" payments up to just less than 3x the "base amount" (average W-2 comp for the 5 years preceding the year of the CIC) may be made without incurring the 20% tax or loss of deduction.
- If the safe harbor is exceeded, all parachute payments over the base amount are "excess" parachute payments and are subject to the 20% tax and loss of deduction (i.e., it's a cliff).
- Alternative rule for S corporations or privately held companies where shareholders approve payments. (See infra.)

IRC § 280G
Background

- Justifications
  - Encourage objective transaction review by target's management.
  - Discourage management from leaving prior to pending transaction.
- Criticisms
  - Directors and management owe a fiduciary duty to shareholders anyway.
  - If too small, no impact on objectivity - if too large, objectivity impaired.
- Corporate law governs parachute payments.
  - Business judgment analysis applies to parachute payments.
  - Courts have enjoined parachute packages (Tate & Lyle PLC, Black & Decker).
- Shareholder proposals to ban parachutes are on the rise.

Change in Control Agreement Example

- Employee has a base amount of $300,000
- Payments contingent on CIC are $1,000,000.
- 20% golden parachute excise tax applies
  - CIC contingent payments ($1,000,000) exceeds three times Employee's base amount ($300,000).
- All CIC contingent payments above the base amount- so-called "excess parachute payments" - are subject to 20% excise tax
  - CIC contingent payments ($1,000,000) less base amount ($300,000), or $700,000
  - Excise tax is $700,000 * 20% or $140,000

Change in Control Agreements IRC § 280G

- CIC Agreements for public company executives will typically address the 20% excise tax
  - Cutback—payments reduced to avoid 20% excise tax
  - Modified cutback—payments reduced to avoid 20% excise tax if the executive would be in a better after-tax position
  - Full gross-up—payment to pay for the 20% excise tax and related income tax
  - Modified gross-up or cutback—grossed-up or cutback only if payments exceed a specified threshold
  - Should ordering be included for any cutback to comply with §409A
- Tax gross-up payments, which were prevalent in the 1990s and 2000s, are now quite uncommon

Change in Control Agreements
Evaluating Impact of 20% Excise Tax

<u>Base Example</u>: Employee has a base amount of $300,000 and will receive parachute payments of $1,000,000. Employee's effective tax rate is 40%. Employee has $700,000 of excess parachute payments and owes $140,000 in excise tax.

- Although Employee received $1M in CIC Payments, Employee is left with only $460,000 after paying his regular and excise taxes.

Change in Control Agreements Evaluating Impact of 20% Excise Tax

<u>Cut-Back</u>: reduce benefits to avoid 280G limit

<u>Cut-Back Example</u>: If Employee's parachute payments were reduced by $100,001, Employee would be "better off" (i.e., Employee would be better off by receiving $100,001 less in parachute payments because if the total parachute payments were reduced by $100,001, Employee would avoid a tax of $140,000)

- $1,000,000 reduced to $899,999 is below the 3X threshold
- If cutback, Employee would receive <u>$540,000</u> on an after tax basis
- If Employee did not reduce his payments, Employee would receive <u>$460,000</u> on an after-tax basis

Change in Control Agreements
Evaluating Impact of 20% Excise Tax

<u>Modified Cutback</u>: reduce benefits below 280G limit <u>only if</u> employee is in a better after-tax position

<u>Modified Cutback Example</u>: if Employee were to receive $1,300,000 in parachute payments, Employee would be better off paying the 20% excise tax (which would be $200,000) rather than having the parachute payments reduced by $400,001 (i.e., the amount necessary to avoid the tax)

- $1,300,000 reduced to $899,999 is below the 3X threshold
- If cutback, Employee would receive <u>$540,000</u>
- If Employee did not reduce his payments, Employee would receive <u>$580,000</u> on an after-tax basis

Change in Control Agreements
IRC § 280G

Gross-Up: employee receives additional payments so that employee is in the same after-tax position, taking into account the excise tax

Gross-Up Example: under the Base Example, if Employee's CIC Agreement had a "gross-up" provision and the Company did not obtain shareholder approval, the Company would be required to pay Employee a total amount of $1,350,000 (equal to $600,000 on a net Section 280G tax basis)

- Note the gross-up payment is also a parachute payment
- As highlighted by the disparity between the CIC benefits and the aggregate amount payable to the executive on a grossed-up basis, a gross-up provision can become quite costly to the Company

IRC § 280G
Selected Issues

IRC § 280G
Parachute Payment Definition

- Payment in the "Nature of Compensation"
- "Contingent" on a "Change in Control" (CIC) of a "Corporation"
- To a "Disqualified Individual"
- Total PV of Contingent Payments => 3 Times the "Base Amount"
- Many of these terms ambiguous and vague in the statute.

IRC § 280G
In the Nature of Compensation

- Any employment based payment is likely in the nature of compensation.
- Examples include:
  - Cash severance payments
  - Fringe benefits continuation
  - Additional service in retirement plans or SERPs
  - Accelerated bonus payments
  - Accelerated vesting of unvested options and restricted stock
- All options are valued for 280G purposes – even underwater stock options!
- Final regulations require fair value approach, not just the option spread.
- <u>Practice Point</u>: identify all compensatory payments related to the deal.

IRC § 280G
Compensatory Equity

- The Section 280G regulations provide a favorable means of calculating the "parachute value" of time-vested options whose vesting is accelerated on CIC (single or double trigger).
- <u>Example</u>: Assume award of 50,000 options, cliff vesting 3 years after grant, accelerated on CIC. Grant price $12/share. CIC occurs 16 months after grant @ $20/share. Assume the value of the option on acceleration is $400,000. ("Value" is not the same as "spread.")
- Under 1.280G-1 Q&A 24, the parachute payment is only $90,000: the difference between $400,000 in 20 months (i.e. at vesting) and the present value of $400,000 (say the difference is $10,000) plus 1% x $400,000 per 20 months of acceleration, or $10,000 + (20 x .01 x $400,000) = $90,000.

IRC § 280G
Compensatory Equity

- Time-vested restricted stock and RSUs are treated similarly.
- Example: Assume grant of 50,000 restricted shares, cliff vesting 3 years after grant, accelerated on CIC. CIC occurs 16 months after grant @$20/share. The value of the shares on CIC is thus $1 million ($20x 50,000).
- Since the shares would have vested 20 months later, the parachute value is the difference between $1M in 20 months and the present value of $1M at the CIC, say ($1M - $980,000 = $20,000, plus 1% per month (20 x $1M x 1%) of accelerated vesting.
- Thus, the parachute value is $220,000: $20,000 plus (1% x 20 x $1M = $220,000), and not the entire $1 M.

IRC § 280G
Compensatory Equity

- In recent years, shareholder advisory firms have urged public companies to put a higher performance component on equity compensation.
  - Make option and RSU vesting subject to meeting earnings hurdles.
  - Many companies have installed such awards, and may have given the entire term of the award (e.g.,10 years for options) to meet the hurdle. This leaves a lot of unvested awards outstanding for a long time, potentially.
- Under 280G, such awards are NOT entitled to the favorable parachute valuation rules under Q&A 22-24. Instead, the entire spread on the option (or the entire value of the restricted stock or RSU) is a CIC contingent payment if the vesting in connection with a CIC
- In the foregoing example, the entire $400,000 value of the option would be a parachute payment (vs $90,000 if time-vested), and the entire $1M of restricted stock would be a parachute payment (vs $220,000 if time-vested). Performance-vested awards will much more quickly use up the 3x "safe harbor" and trigger parachute taxes than time-vested awards.

IRC § 280G
Contingent on Change in Control (CIC)

- Include payments “closely associated” with a CIC
- Contracts or amendments within one year of CIC
  - Special exemption is available for “new hires” within 12 months of CIC

IRC § 280G
Disqualified Individual

- A Disqualified Individual (DI) is generally any person who is:
  - an employee or independent contractor (including directors); and
  - a shareholder, officer or highly-compensated individual.
- "Shareholder"
  - A person who owns 1% or more of the company
  - Vested options (whether or not in the money) are counted for the 1% test

IRC § 280G
Disqualified Individual

- "Highly-compensated individual" (HCI)
  - A person who has annualized compensation more than the 414(q) HCE limit; and
  - is one of the top 1% highest paid employees,
  - There is a maximum limit of 250 HCIs
- "Officer"
  - Determined on the facts and circumstances – title not determinative
  - Not the same as "executive officer" definition under Exchange Act rules
  - There is a maximum limit of 50 officers
- Special measuring period rules apply

IRC § 280G
Base Amount

- The Base Amount measures:
  - the DI's historical taxable earnings (Form W-2, Box 1)
  - over the five taxable years prior to the year of the CIC
- The Base Amount is often low for companies that rely heavily on options
- Large deferred compensation amounts increase parachute exposure

IRC § 280G
Entities Subject to Section 280G

- 280G covers all corporations subject to limited exemptions
  - Small business corporation exemption.
  - Shareholder approval exemption for non-public companies.
  - Tax-exempt organization exemption.
    - only if the buyer and seller are tax-exempt under the final regulations.
- 280G does not apply to partnerships or LLCs treated as partnerships.
- 280G may apply to REITs, cooperatives and foreign corporations.

IRC § 280G
Shareholder Approval Exemption

- This exemption applies only to companies without publicly traded stock
- There are two general requirements:
  - More than 75% of stockholders approve payments immediately before CIC
  - There is adequate disclosure of all material facts to stockholders
- Compliance with Delaware corporate law is not enough
- Final regulations create practical difficulties to secure this exemption

IRC § 280G Shareholder Approval Exemption

- Separate shareholder vote must be taken on parachute package
- Disclosure materials must be provided to all employee-stockholders
- Disclosure materials must be specific to the transaction with
- numbers
- DIs often required to relinquish right to payments subject to re-approval
- Deal cannot be conditioned on stockholders approving payments
- Some relief provided under the final regulations
  - All DI payments may be subject to a single vote
  - Stock ownership can be determined during a look back period
  - Only actual stockholders are required to receive material
  - Only payments that equal or exceed the parachute limit must be waived

IRC § 280G
Reasonable Compensation

- Certain parachute payments may qualify as "reasonable
- compensation"
- Reasonable compensation reduces 280G exposure.
  - For services on or after CIC: reduction of parachute payment
  - For services before CIC: reduction of excess parachute payment
- Standard of proof is "clear and convincing" evidence
- Covenants not to compete may shield some payments from 280G
- Post CIC contracts that replace parachutes strictly scrutinized (Square D)
- <u>Practice Point</u>: be careful when structuring non-competes and post CIC contracts

§409A
Selected Issues

IRC § 280G
409A Interplay

The issue:

If deferred compensation is reduced in a 280G cutback in order for the employee to receive current payments, it would be treated as an acceleration of the deferred compensation payment under the anti-substitution rules.

If one amount of deferred compensation is foregone (or reduced) in a 280G cutback in order to receive another amount of deferred compensation at an earlier or later time, is there a deferral election or an acceleration or a substitution that violates 409A?

IRC § 280G
409A Interplay Example

A's employment is terminated in connection with a CIC.

A is entitled to the following payments (assume):

- Cash out of unvested LTI performance-based cash award otherwise payable in 3 years
- Lump sum severance
- Accelerated vesting of unvested in-the-money options (no cash out)
- Accelerated vesting of restricted stock units

IRC § 280G
409A Interplay Example

- Assume the applicable plan/agreement requires a 280G cutback, but does not specify how it is implemented
  - Is there a risk that deciding at the time of a CIC not to receive amounts that would be paid in the future is an impermissible acceleration?
  - If a cutback is determined at the time of the CIC Agreement, how should it be structured and can it be changed?
- If the CIC Agreement specifies the order of cutback in advance, then the 409A risk appears to be minimized, especially if amounts not subject to 409A are cut back first
- What if the applicable document did not have a "best after tax" provision and did not have a 280G gross up or cap, but it gave A the right, but not the obligation, to reduce parachute payments at his/her discretion?

How does 409A Impact Severance Pay?

- Severance pay **may** be subject to 409A
- Critical to evaluate actual terms of agreement to determine if an exemption is available
- Maximizing potential exemptions often requires that specific language be added to the agreement with the employee
- Most important exemptions are:
  - Short term deferral rule
  - 2x severance pay exception

Short-Term Deferral Exception

- Severance payments due to an involuntary termination of employment by an employer are exempt if paid by March 15th of the year following severance
- Payment on account of a voluntary termination of employment for a "good reason" may qualify as an involuntary termination for purposes of this exception
- IRS safe harbor lists acceptable reasons and appropriate process for employment termination to qualify as being for good reason
- Change in control "walk away" right does not qualify as a good reason
- Payment will not be a short-term deferral if it could have been received after the March 15th date described above

2x Pay Severance Exception

- Key requirements:
  - Plan must only allow payments to be made on account of an involuntary termination of employment as described above
  - Separation pay (excluding certain reimbursements) must not exceed two times the lesser of:
    - the employee's annual compensation for the immediately preceding year
    - the maximum limit on compensation under US tax qualified plans (currently $260,000)
  - Payment must be made by the end of the second taxable year following the year of employment termination
    - Example: if an employee involuntarily terminates employment in 2015, severance pay must be completed by 2017

2x Pay Severance Exception

- Severance pay defined to include any amount where one of the conditions to payment is separation from service
  - includes reimbursement payment and other taxable benefits
- A payment may be exempt under this exception even if the total of all severance pay does not meet the 2x severance pay requirements

The Stacking Rule
Putting it All Together

- More than one exemption can apply to a severance pay arrangement with proper drafting
- Stacking rule allows for 409A coverage to be determined on a payment by payment basis
- Severance pay arrangement should designate in writing that the stacking rule is to apply
- "Each payment or benefit provided or referenced under this agreement shall be treated as a separate "payment" for purposes of 409A"
- Stacking rule can result in severance payments being made that might otherwise be delayed for six months

The Stacking Rule
An Example

- "Employee A" involuntarily terminates employment on 4/1/2014
- Severance is equal to $1.5 million payable in 3 installments
  - $500K within 60 days after termination
  - Remaining $500K installments on 1st and 2nd anniversary of termination
- "Employee A" is a specified employee with $500K annual compensation
- Severance agreement provides payments are to be treated separately for 409A purposes
- Issue: what payments are subject to 409A?

The Stacking Rule
An Example

- Initial severance payment is a short term deferral
  - Paid before March 15th of the year immediately following termination
- Second installment payment qualifies for the 2x severance pay exception
  - It is within the 2x limit and paid within maximum permitted period
- Third installment payment is subject in part to 409A
  - $20K is exempt under the 2X severance pay exception
    - ($260,000 * 2) - $500,000
  - Remainder is subject to and complies with 409A
    - Paid on a fixed schedule and later than required six month delay