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Structuring Management Carve-Out Plans for Privately Held Corporations: Mechanics, Tax Obstacles and Optimization

Guidance for Employee Benefits Counsel on Private Company Liquidity Bonus Plan Compensation Arrangements

WEDNESDAY, JUNE 3, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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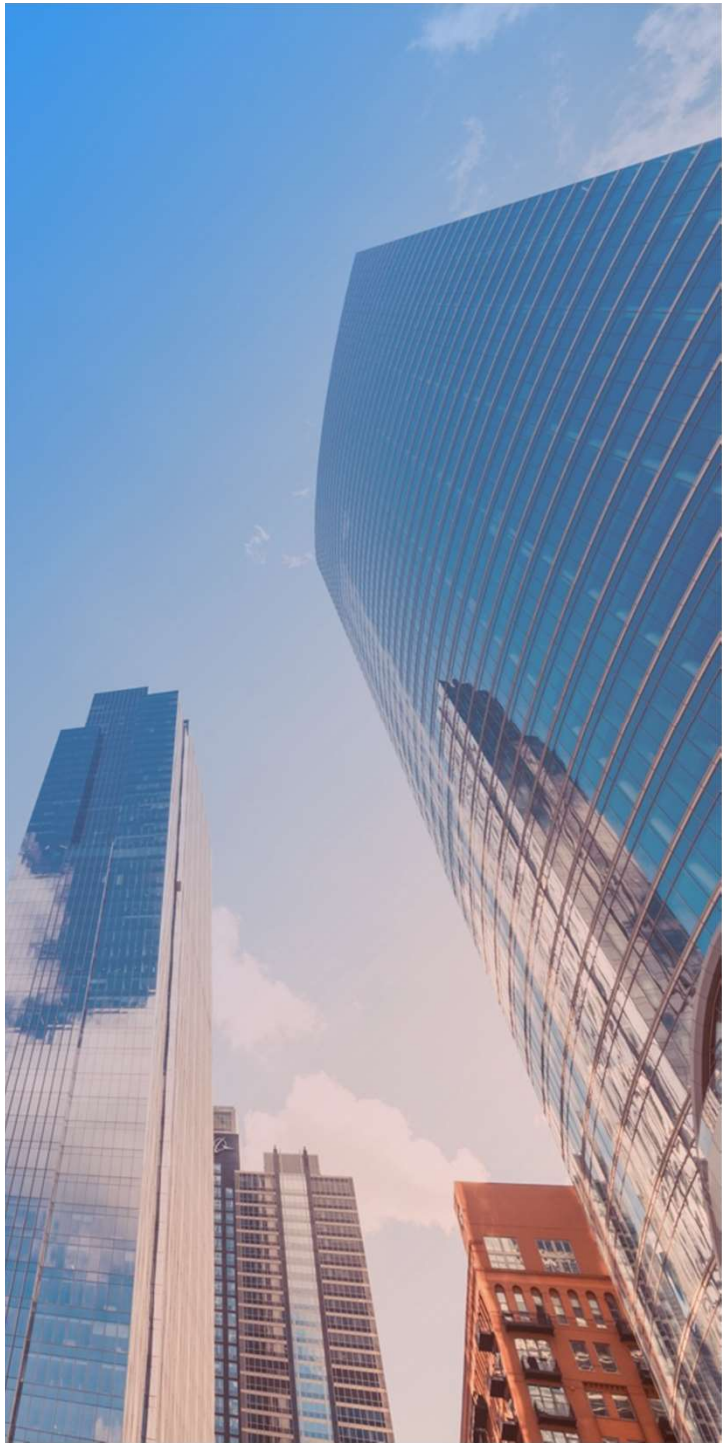


Structuring Management Carve-Out Plans for Privately Held Corporations

Elizabeth Gartland, Marshall Mort

June 3, 2020

Introduction

- Today, we will discuss Carve-Out Plans for privately held corporations. We will discuss:
  - Structure, including mechanics and common characteristics;
  - Key tax and legal considerations;
  - Current trends.

What is a Carve-Out Plan?

- A Carve-Out Plan “carves out” value that would otherwise be paid to preferred shareholders in a Change in Control transaction (e.g., a merger) (“CIC”) in order to motivate key employees to remain through the CIC.

What is the purpose of a Carve-Out Plan?

- A Carve-Out Plan is a cash bonus plan designed to incentivize key employees in the event of a CIC where the equity held by the key employees is substantially underwater (i.e., of little or no economic value).
  - Carve-Out Plans are more commonly used during economic downturns.
- Generally, a Carve-Out Plan is used to incentivize key employees to remain with the Company through a CIC by paying a cash bonus in connection with a CIC.

How does a Carve-Out Plan Work?

- Typically, a Carve-Out Plan designates either a percentage of the aggregate consideration payable by the acquiror in the CIC (the "Net Proceeds") or a fixed amount, to be paid to key employees in connection with the CIC (the "Pool").
  - Each participant in a Carve-Out Plan receives a portion of the Pool.
- Payment is a "debt" and thus is paid before CIC consideration is paid to the preferred shareholders.
- Payment can be structured to pay on the CIC or at a future date.

Key Structure Considerations

- Pool Size & Calculation;
- Form of Payments;
- Participants;
- Allocation Method & Forfeitures;
- Reduction of Bonus Payments;
- Timing & Conditions on Payments;
- Amendment & Termination.

Structure – Pool Size & Calculation

- Pool size varies greatly from deal to deal.
  - ~10% of the aggregate CIC consideration is common; rarely under 5% or over 15%;
  - The more participants, the larger the Pool.
- Pool may be a straight % of the aggregate CIC consideration.
- Pool may be a sliding formula (e.g., Pool % moves up as the aggregate CIC consideration increases), example:
  - Pool is 10% if aggregate CIC consideration is between $X and $Y, but pool is 12.5% if aggregate CIC consideration is between $Y and $Z.
- Pool may be a fixed dollar amount (more common when implemented in connection with CIC term sheet).

Structure – Pool Size & Calculation

- Definition of aggregate CIC consideration from which the Pool is determined is important.
- Typical definition is the total consideration payable to Company shareholders (i.e., the "Net Proceeds").
- The definition of Net Proceeds can include / exclude specific payments or liabilities, such as:
  - Common to exclude transaction expenses (e.g., banker and legal fees incurred in the CIC);
  - Common to assume that no payment is made under the Carve-Out Plan itself (i.e., the Net Proceeds definition assumes there is no Carve-Out Plan);
  - Unusual to exclude other general liabilities (i.e., vacation accrual or bonus accrual); as a result these liabilities reduce the Net Proceeds.

Structure – Pool Size & Calculation

- Definition of Net Proceeds can also include earn-outs or escrow.
- Most Carve-Out Plans include earn-outs and escrow and provide that the portion of the Pool attributable to the earn-out or escrow is only payable if and when the earn-out and escrow is paid to shareholders.
  - We recommend alignment on these two positions in order to avoid windfalls or overly harsh results.
  - Plans can provide that, if not assumed by the surviving entity, all amounts subject to earn-outs or escrow pay out at the Closing.
  - Recommendation – Since including earn-outs and escrow can add complexity, consider giving the Board discretion to determine whether to include earn-outs or escrow at the time of the CIC.
  - Warning – There are 409A implications if earn-out or escrow payments are included.

Structure – Form of Payments

- Carve-Out Plans can pay in cash or acquiror stock to reflect the structure of the CIC. Most pay in the same form as provided to the stockholders generally, except if disallowed by applicable law.
- Warning: If paid in acquiror stock, consider securities law compliance.
  - Will the acquiror stock need to be registered if the acquiror is public?
  - What exemption will apply if the acquiror is a private company?
- Warning: If the CIC consideration is a mix of stock/cash and paid in an earn-out, 409A implications may arise if payment is not on the same "terms and conditions" as to stockholders generally.
  - Is the "form" of the earn-out Carve-Out Plan consideration part of the "terms and conditions"?
- Payment under a Carve-Out Plan is a taxable event and cash will be needed.

Structure – Participants

- Who?
  - Can be broad-based, but typically limited to management or top employees who are key to retain through a CIC.
- How?
  - Board (or its delegate, often CEO) designates each participant and allocation.
  - Participants should sign a short participation agreement.
  - Less often, plans may reserve the right for a post-closing independent committee to administer the plan to avoid administration by Buyer's board.
- When to designate participants and allocations?
  - May be notified at time the plan is adopted (maximizes retention).
  - May be notified later, and close in time to CIC (less retentive value, but increased flexibility in divvying up Pool).

Alternative Structure – Phantom Stock

- An alternative structure that can be used to provide payouts for a larger group is a Phantom Stock Plan.
  - Under a Phantom Stock Plan each participant has the right to receive payment as if holding actual shares of stock (i.e., a notional shareholder).
    - The right to payment may be structured to mirror payment on account of shares of common stock or preferred stock.
  - A Phantom Stock Plan is structured so that the total amount of the pool is tied to the value to be paid on a certain number of shares in a CIC:
    - This permits grants under a Phantom Stock Plan that can be equivalent in value to fractional shares (e.g., if the Phantom Stock Plan is funded with 10,000 shares and 32 participants, each would receive the value associated with 312.5 shares of Company stock).

Structure – Allocation Method

- Payment Value - Allocation of payment value is highly flexible (e.g., may be linked to duration of service, rank, title, percentage of base pay).
  - Award based on a percentage of the pool:
    - Ex: “A” gets 5% of the pool, “B” gets 3% of the pool.
    - Problem: Run out of percentages, as approaching 100% awarded. No room for new additions.
  - Award based on units:
    - Ex: The pool has 1,000 units, “A” gets 100, “B” gets 50, “C” gets 300, etc.
    - Problem: Easy to increase pool of units and dilute prior holders, without increasing overall carve-out dollar size.
  - Awards may be subject to vesting:
    - Can impose vesting and provide that only vested awards at an exit will get paid.
    - Possible to impose post-CIC vesting, but this is less common.

Structure – Present to Win?

- Most Carve-Out Plans require continued employment through the CIC date.
  - If a Participant leaves the Company prior to the CIC, the Participant typically forfeits his allocation.
  - The plan may protect against forfeiture in cases of qualifying terminations (e.g., without cause, for good reason, for death/disability).
    - Our experience is that almost all plans require continued employment through CIC, but a smaller subset of plans will allow an earlier termination without cause within a short window pre-closing to not cause forfeiture.
    - In setting protected termination window, consider whether the person contributed to the value generation (i.e., a 30-day, 3-month look back).

Structure – Reallocation

- If a unit or a percentage of the Pool is not allocated, or if a participant forfeits his or her right to participate in the plan, there are various structures regarding reallocation:
  - Permissible Reallocation – Provides that the Board may reallocate unallocated percentages/units to participants, in its sole discretion or may choose not to do so.
  - Mandatory Reallocation – Provides that any unallocated percentages/units are automatically reallocated to other plan participants on a pro-rata basis.
    - Warning: In theory, all participants could leave and the sole remaining participant would automatically be allocated the full Pool. While unlikely, some acquirers may require the maximum potential reallocation to be included in the Company's 280G disclosures.
  - No Reallocation – Provides that any unallocated awards are not reallocated and that the proceeds that would otherwise have been associated with such awards shall instead be distributed to the shareholders.

Structure – Reduction of Bonus

- The Carve-Out Plan may provide for reducing the bonus amount for payments the holder receives in respect of equity.
  - Reduce carve-out bonus for payments at closing in respect of common shares;
  - Reduce carve-out bonus for payments at closing in respect of options / RSUs;
  - Reduce carve-out bonus for payments post-closing in respect of unvested equity at close (this is uncommon).
    - Warning: This may result in a low payout in the case of revesting of consideration (i.e., a holdback) or where the participants may never fulfill the post-closing vesting conditions on unvested merger consideration.
- The Carve-Out Plan may reduce the bonus amount for payments otherwise received in the transaction by any holder (e.g., severance or other CIC bonuses). This is uncommon.

Structure – Payment Timing & Conditions

- Typically, Carve-Out Plans pay upon or within a set number of days following the closing of the CIC (e.g., 60 days). Most always, payments run through a payroll provider.
- Less commonly (<25% of the time), the payments may be subject to post-closing vesting requirements based on continued employment with the acquirer.
  - Pro - Provides retentive value to acquiror; assists in smooth transition.
  - Con – Carve-Out Plan is a means to provide CIC-related payments to certain employees. Incentivizing employees post-closing should be the acquiror's responsibility and cost.
  - If a post-CIC service requirement is included, almost always add termination protection for terminations without cause and good reason resignations.

Structure – Payment Timing & Conditions

- A Company can impose conditions on payment:
  - CIC closing (required);
  - Participant remains employed on the CIC;
  - Participant satisfies post-CIC vesting or service requirement;
  - Participant must sign a release of claims against the Company (typical and recommended);
  - Participant must be in compliance with employment agreement or other Company agreements (i.e., non-compete);
  - Participant executes all documents necessary to be bound to any indemnification obligations in the CIC Agreement;
  - Participant votes his or her shares in favor of the CIC;
  - Participant agrees to be subject to "drag along."

Structure – Amendment & Termination

- Two typical alternatives to amend or terminate:
  - Board may amend or terminate Plan, but only with approval from the holders of a majority of the allocated Pool or, as to adverse changes to any award, with the participant's consent.
    - Limits flexibility to make changes.
  - Board may amend or terminate Plan at any time in its discretion (less common).
    - Awards are essentially illusory; limits retentive value.
- Plan Sunset:
  - Because of the typical approval requirement for amendments and terminations, include an automatic sunset/termination to allow the Company to amend or terminate.
  - Typically range 2 – 5 years.
- Other Terminations:
  - IPO; next financing; CIC in excess of $X.

Key Legal & Tax Considerations

- In Re Trados;
- Corporate Approvals;
- Ordinary Income Tax;
- 280G;
- 409A.

Legal & Tax – In Re Trados: Background

- Trados, Inc. Board approved a Management Incentive Plan ("MIP") which incentivized senior management to sell the Company (at the expense of common consideration).
- Plaintiff (common shareholder) sued for an appraisal of shares and alleged breach of fiduciary duties. Plaintiff argued that the Board had a duty to continue operating Trados in order to maximize value for common stock.
- 6 of the 7 directors who voted in favor of the MIP were conflicted (i.e., "gained a personal benefit that is not equally shared by other stockholders"):
  - 2 due to MIP participation;
  - 1 due to "web of interrelationships that characterizes the Silicon Valley startup community;"
  - 3 due to loyalty to the respective investors' LPs rather than Trados' common shareholders (Various VC business models preferred a quick exit from Trados).
- Thus, Plaintiff successfully rebutted the business judgement rule (and court applied entire fairness review).
- Note: conflicts are especially common in distressed companies due to diverging interests.
  - Court considered Trados to be in distress after reviewing business documents and based on the one-year stock price drop from $2.31 to $.99

Legal & Tax – In Re Trados: Entire Fairness Test

- The entire fairness test is the most stringent standard of review for evaluating whether directors breached fiduciary duties to common shareholders.
  - The entire fairness test lacks the substantial deference given to a Company's directors under the business judgement rule.
- Under the entire fairness rule the Company must prove that the contested transaction had a:
  - 1) fair process; and
  - 2) fair price (i.e. the deal price was fair).

Legal & Tax – In Re Trados: DE 2013 Chancery Court

- Trados, a private VC-backed DE corporation, was sold for $60M.
  - Senior management received payments via an MIP pool of 7.8M.
    - Cambell (CEO + Director) – Received 30% of the MIP pool.
      - Testified that 60M was the valuation they were attempting to achieve "and not a penny higher."
    - Hummel (Founder + Director) – Received 12% of the MIP pool.
  - Common shareholders received no consideration.
    - However, absent the MIP they would have received 2.1M.
  - Preferred shareholders received more than their initial investment (i.e. recognized some gain), but less than their entire liquidation preference.

Legal & Tax – In Re Trados: DE 2013 Chancery Court

- The Board of Trados survived the entire fairness review. The court found:
  - (1) an unfair process:
    - Directors failed to implement a fair process and deliberate thoroughly.
  - But, (2) a fair price:
    - The Court claimed common shares had no economic value (even though absent the MIP common would have received 2.1M) and thus, when shareholders received nothing they received the substantial equivalent in value of what they had before the merger.
- Outcome:
  - The fair price determination in *Trados* was enough to cleanse the unfair process and Court found in favor of the Company/Board.
    - Compare: *In re Nine Systems 2014 DE Ch.* (in which defendant failed entire fairness review because recapitalization with fair price did not "ameliorate a process that was beyond unfair").
  - Thus, no economic liability for the Company/Board in *Trados*.
  - Still, *Trados* provides landmark insight into the court's analysis of fair process and the duties owed to preferred and common shareholders.

Legal & Tax – In Re Trados: Takeaways

- A Carve Out Plan may create a risk of shareholder litigation for breach of fiduciary duty due to divergent interests.
- The Board owes:
  - Fiduciary duties to common shareholders; and
  - Contractual duties to preferred shareholders.
    - The Board does not owe fiduciary duties to preferred shareholders unless (and only to the extent that) preferred interests overlap with common interests.
- Reduce risk (i.e. demonstrate a "fair process") by:
  - Merger approval and Plan approval by a disinterested special committee of the Board;
  - Sound Board processes (document Board deliberations and decisions);
  - Independent advisor to confirm fair price.
- If the proceeds will be carved-out from the consideration otherwise payable to preferred holders of Company stock, preferred stockholder approval is generally required.

Legal & Tax – Corporate Approvals

- Plan Adoption:
  - Board must approve Plan.
    - If any Board members are participating, should be approved by independent members.
  - Recommend stockholder approval to reduce litigation risk (see discussion of Trados above), particular attention should be paid to any protective veto powers provided in the Company's charter.
  - Following Plan approval, full Board may approve the participants and allocations.
- Amendment to Charter:
  - An amendment to the Charter may be necessary to clarify the preference of the Plan payments over the Company's capital stock.
  - If so, both Board and shareholder approval is required.

Legal & Tax – Taxable Income

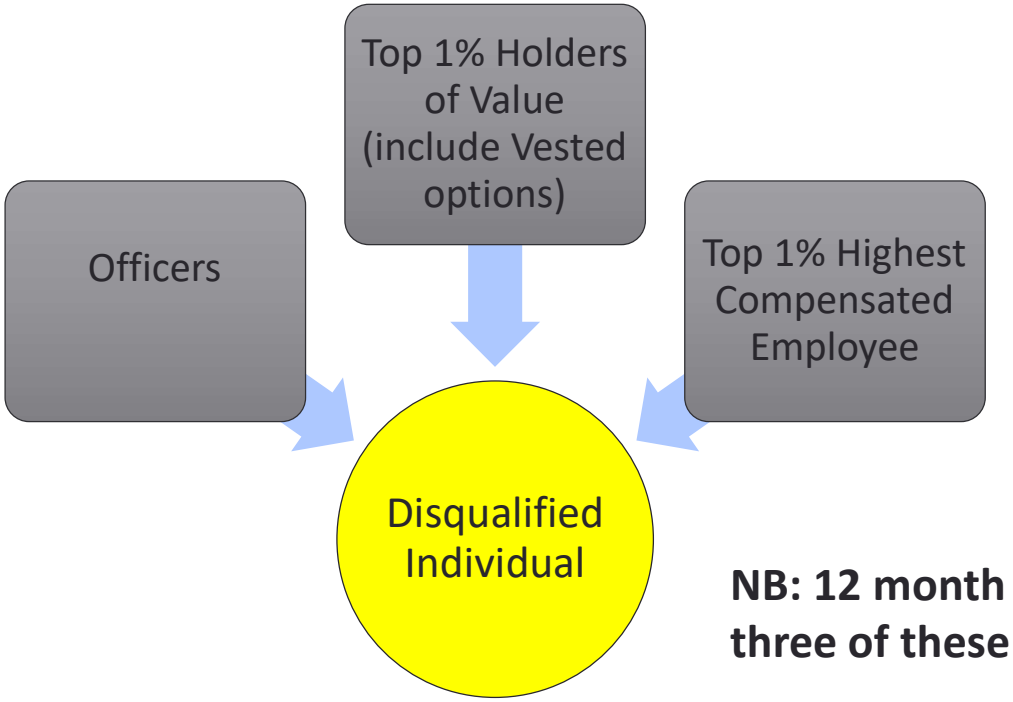
- Cash payments and stock payments will be taxable as ordinary income upon receipt, subject to treatment as wages (withholding and payroll taxes apply).
  - This is true even for participants who are former employees.
- If the CIC consideration includes stock of a private company, then the taxable amounts are illiquid, but the value is still taxable at the CIC (unless subject to additional vesting).

Legal & Tax – 280G & Carve-Out Plans

- Bonus Payments under a Carve-Out Plan will factor into a Company's 280G "golden parachute" tax calculations upon a CIC.
  - Carve-Out Plan participants include top level employees and some of them will likely be subject to 280G.
  - Carve-Out Plans are CIC payments and will be subject to 280G.
- The following slides provide more detail.

Legal & Tax – 280G: Who is Subject?

- Section 280G levies an extra golden parachute tax on CIC benefits to certain "disqualified individuals."
- Who is a disqualified individual? Must be a service provider in the past 12 months.

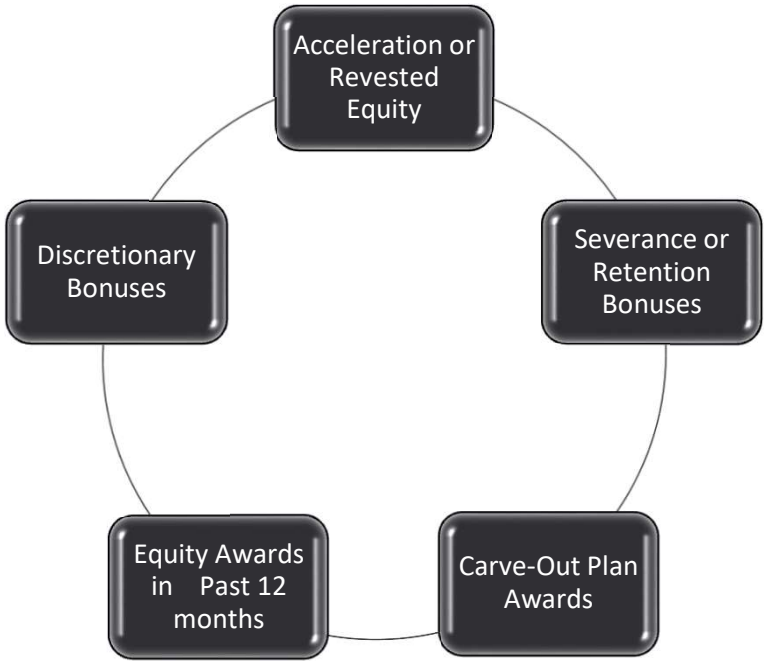


NB: 12 month look-back for all three of these categories.

Legal & Tax – 280G: What are potential parachutes?

- A "parachute payment" is an amount by which the total CIC benefits to a disqualified individual exceed 3x his or her average compensation for the past five full years or shorter term of service (use W-2 or 1099 amounts).
- If the disqualified individual exceeds this threshold, then he or she is subject to additional 20% excise tax on all amounts that exceed one times (1x) his or her average historical compensation described above. The payor loses a corresponding compensation tax deduction.

What types of CIC benefits could give rise to parachute payments?



But see: Exception for "Reasonable Compensation."

Legal & Tax – 280G: Shareholder Cleansing

The shareholders of a private Company undergoing a CIC can approve the parachute payments such that the excise tax will not apply and the compensation deduction will be preserved:

- 75% approval by disinterested shareholders.
  - DI's who are subject to the vote may not vote and are excluded from the numerator and denominator for purposes of the 75% threshold.
  - DI's who do not exceed the 3x threshold may vote.
  - All disinterested shareholders need to be given an opportunity to vote.
  - Separate vote – may not be combined with vote to approve the Merger.
- Full disclosure of all payments to DI's needs to be given to all shareholders – usually an information statement.
  - May need to disclose the last man standing concept in the plan and any contingent payments to Carve-Out holders post closing.
- DI's must waive their right to receive payments before solicitation of the vote (parachute payment waiver).

Legal & Tax – 409A

- Warning – Carve-Out Plans may implicate Section 409A. Section 409A assesses additional taxes above ordinary income (20% federally, 5% CA) on nonqualified deferred compensation. If an arrangement is 409A non-compliant, income is recognized once the right is vested, even if the amounts aren't yet paid.
- "Nonqualified deferred compensation" is a *plan* that is *nonqualified* and represents a *legally binding right* during a taxable year to *compensation* that is or may be *payable in a later taxable year* to a *service provider*.
  - *But see: Short-Term Deferral Exception* (payment is within 2.5 months of the calendar year immediately following a vesting event)
  - Vesting Event = a Substantial Risk of Forfeiture (generally, an event relating to compensatory purpose that is substantially uncertain, such as a CIC, or continued employment).
  - If not exempt, then payment must be triggered by one of six permitted events (e.g., a fixed date, separation from service, change in control, disability, death, or unforeseeable emergency). This would make the nonqualified deferred compensation compliant with 409A.

Legal & Tax – 409A : Structuring

- A Carve-Out plan can be drafted to be exempt from 409A, or compliant with 409A.

Exempt	Compliant
Require employment through payment date	No employment requirement, but payout on a 409A-compliant CIC definition
Perhaps maintain that the change in control is itself substantially uncertain and thus a substantial risk of forfeiture.	→ Sale majority of voting / FMV of equity
	→ Change in effective control
	→ Sale of substantially all of the assets

- Exempt arrangements can be more flexibly changed.
- With few exceptions, it is generally not permitted to change the timing of compliant arrangements.

Legal & Tax – 409A: Further Deferral?

- Escrow / Earn-Out ("Transaction Based Compensation"):
  - Must pay on the same schedule and under the same conditions generally applicable to shareholders, but the earn-out period is capped at 5 years post-closing.
  - Only for 409A compliant change in ownership or sale of substantially all assets.
  - Exception is for sale of "stock of the service recipient," so often in reference to enterprise value (such as a Carve-Out plan referring to "Net Proceeds").
- New Vesting Conditions:
  - Permitted to add substantial risk of forfeiture to an amount otherwise vesting on a change in control (due to a 409A-compliant change in ownership or sale of substantially all assets).

Questions

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