Strafford

Presenting a live 90-minute webinar with interactive Q&A

Executive Employment Agreements and Change in Control Arrangements

Structuring for M&A Transactions, Withstanding Shareholder Scrutiny, Avoiding Adverse Tax Consequences

WEDNESDAY, JANUARY 6, 2021

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

Today's faculty features:

Anthony J. Eppert, Partner, **Hunton Andrews Kurth**, Austin, TX

Marshall Mort, Partner, **Fenwick & West**, Mountain View, CA

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the ‘Full Screen’ symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Executive Employment Agreements and Change in Control Arrangements

January 6, 2021

Part 1

Change in Control Design Considerations

Part 1A: Primary Retention Strategies & Key Employees

1. A primary goal leading into a change-in-control transaction (a "***Transaction***") is to increase the Company's value for the shareholders and to retain and incentivize employees through the Transaction. Other Transaction-related goals include:
   a. Incentivize key employees to remain employed well after the Transaction.
   b. Motivate the key employees to, on a post-Transaction basis, work hard to maximize any earn-out that otherwise could be paid to selling shareholders.
2. When equity awards become insufficient or are not tax efficient, a Company should consider implementing a 'Carve-Out Bonus Plan.'
3. There are several different structures that can be used for a Carve-Out Bonus Plan, such as:
   a. Present to Win
   b. Retain Vested Entitlements
   c. Maximize Earnout

Part 1A: Identify Key Employees

1. In identifying which key employees should participate in a Carve-Out Bonus Plan, thoughts to consider include:

   a. Do any of the key employees (i) have the ability to increase the value of the Company, (ii) need to be incentivized to remain employed, and (iii) need to be motivated to increase shareholder value in the Transaction.

   b. Will any of the key employees be necessary to transition with the Company to a buyer?

   c. Assuming there is contingent consideration in the Transaction (e.g., an earn-out), are any of the key employees likely to have an ability to increase the value of such contingent consideration due to their services provide post-Transaction?

Part 1B: Carve-Out Bonus Plan Triggers

1. Carve-Out Bonus Plans are designed to pay a percentage of the proceeds obtained by the Company in connection with a trigger event.
2. Examples of potential trigger events are as follows:
   a. A merger (though it is typical to contain a carve-out so that this provision would not apply if the majority of the Board of the surviving company are persons who were members of the Company’s board for a certain period of time prior to the merger);
   b. A sale of the Company (50%, 75%, or otherwise) (this could include shares of stock and/or assets); and
   c. Monetization of Intellectual Property that results in a payment to shareholders.

Part 1B: Determine the Value of the Award

1. How should the value of the award be determined?
    a. On an individual basis or pursuant to a pool?
    b. On a fixed dollar basis or as a percentage of the sale proceeds? And if the latter, are the sale proceeds determined on a gross or net basis?
    c. Should a sliding formula or scale be included?
    d. Will the key employees participate in any earn-out dollars? To state the opposite, is the value reduced by any earn-outs or holdbacks?
    e. Should the value of the award be reduced by payments the key employee receives with respect to his or her common shares?

Part 1B: Determine the Value of the Award (cont.)

1. Example of a fixed dollar award
   a. Mary is awarded $1.2mm upon consummation of a Transaction and Bobby is awarded $1.1mm upon consummation of a Transaction.
2. Alternatively, a pool could be created (fixed or a %) for key employees
   a. A pool of dollars is created for the benefit of key employees. The pool is either (i) a fixed dollar amount (e.g., $3mm) or a percentage of the sale proceeds or net proceeds (e.g., 8% of the net proceeds).
   b. Typically, key employees would participate in the pool based upon a percentage awarded to each key employee.
   c. Example: Bobby's percentage of the pool is 35%, Mary's percentage of the pool is 45%, and 20% remains unallocated for future grants to others.

Part 1B: Determine the Value of the Award (cont.)

1. But what if the carve-out bonus plan is being implemented at a time when the shareholders are able to determine the maximum amount of cash dilution they are willing to share with key employees, but neither the Company nor the shareholders are able to identify all of the key employees who should participate in the pool?
    a. In this situation the Company is not likely able to divide the pool into percentages or award fixed dollar amounts.
2. A solution is to convert the pool into an indefinite number of "Units" where the denominator is the number of units outstanding, thus solving for future dilution within a set pool size.
3. An example of a Unit concept is set forth on the next slide.

Part 1B: Determine the Value of the Award (cont.)

1. An example of a Unit concept is as follows:

   a. The amount of the pool is designated as either a percentage of the Transaction proceeds or as a fixed dollar amount.

   b. The key employee is awarded a certain number of Units. For this purpose, a Unit does not represent any equity ownership and does not track stock price; instead, the purpose of the Unit concept is to designate for each key employee his or her sharing ratio of the pool.

   c. A typical formula for the value to each key employee is: [Pool Value divided by total number of Units outstanding immediately prior to consummation of the Transaction] x number of Units awarded to the key employee.

   d. A more advanced Unit formula is on the next page.

Part 1B: Determine the Value of the Award (cont.)

1. A more advanced Unit concept formula is: $\dfrac{[A-(B+C)] \times D}{E} \times F$

   a. A = The value (as determined by the board) of all cash and non-cash proceeds that are paid to the Company or its shareholders in the Transaction.

   b. B = Any and all Company-related debt or liability that continues (or will continue) to be held by one or more shareholders of the Company immediately after the Transaction.

   c. C = All Transaction costs (e.g., accountant fees, attorney fees, investment bankers, etc.) as such costs are reasonably determined by the board.

   d. D = The intended pool size, set forth as a percentage of the above equation.

   e. E = The total number of Units granted under the Plan that remain outstanding as of immediately prior to consummating the Transaction.

   f. F = The number of Units held by the key employee..

Part 1C: Vesting Conditions & Forfeitures

1. Most common vesting condition is "present to win," though a common exception is to allow payment to the key employee if his or her employment was terminated after the Transaction by the employer without Cause or by the key employee for Good Reason.
    a. Consider whether forfeitures should be reallocated to remaining key employee.
2. Failure to timely execute a Waiver and Release is also a common forfeiture trigger.
    a. A Waiver and Release protects against future claims from key employees.
    b. Consider eliminating the age discrimination provisions from the Waiver and Release so that the form can be signed and effective at consummation of the Transaction.

Part 1D: Carve-Out Bonus Plan Payment Timing

1. The form of payment can be cash or property, and often will follow what the shareholders are receiving in the Transaction.
   a. If instead the contractual agreements require only cash to be paid to the key employees, then the Company's shareholders risk that the key employees could draw a disproportionate amount of the cash-based sale proceeds.

Part 1D: Carve-Out Bonus Plan Payment Timing (cont.)

1. Unless the consideration is intended to retain the key employee with the buyer after closing of the Transaction, the consideration is often paid at closing or at the same time the shareholders are paid (as to latter part, timing needs to comply with Section 409A)
2. If instead the consideration is intended to retain the key employee with buyer after closing, then payment is often accelerated upon earlier of:
   a. Termination with buyer by employee for Good Reason or by the buyer without Cause, and
   b. A set number of days after the Transaction (e.g., 6 months after closing).

Part 1E: Amending/Terminating a Carve-Out Bonus Plan

1. Question. After the bonus plan is distributed to a key employee, should the Company have the ability to amend or terminate such plan without consent from the key employee?

2. Prior to the Transaction, one thought is that the Company should retain the discretion and flexibility to terminate the arrangement without consent of the key employee if, for example, the Transaction is not consummated.

    a. However, such ability could create impression that the arrangement is illusory.

    b. And if such discretion is not maintained, then minimally the arrangement should contain an auto sunset, such that if the Transaction is not consummated within a set period of time, the arrangement automatically terminates.

Part 1E: Amending/Terminating a Carve-Out Bonus Plan (cont.)

1. And if any payouts are to occur after the Transaction, then consider having a provision in the document that requires the key employee's consent before any amendment can be effectuated.

2. And too, consider inserting a provision that requires any non-payouts to be remitted to the selling shareholders.

Part 2

Employment Agreement Considerations

Part 2A: Equity Acceleration

1. Equity acceleration means that an award that is subject to a vesting condition is deemed to have met part or all of such vesting condition automatically upon certain trigger events.
2. Single-trigger equity acceleration means there is only one trigger event – typically a change of control or a termination.
3. Double-trigger equity acceleration means that there are two trigger events – both of which must be met for the equity acceleration to occur. Typically, this is a termination in connection with a change of control.
    1. The timing for the termination is one factor to be considered (can the termination be before the change of control?).
    2. Typically, a termination only triggers acceleration if it is not for “Cause” or if it is a resignation for “Good Reason.” We will discuss these terms shortly.

Part 2A: Performance-Based Awards

1. When considering equity acceleration, one issue is how performance-based awards are treated in a Change of Control. Ultimately, the question is whether the metrics are adjusted, which may occur in any of the following manners:

    1. Is the performance-condition treated as achieved? At target? At the maximum rate (excluding any possible over-achievement)?

    2. Does it convert into a time-based award? (This may be because the metrics become inapplicable, such as metrics relating to stock prices.)

2. This interplays with Section 280G in that the acceleration of performance-based awards is included for purposes of Section 280G at full value (as will be discussed later).

3. Another complex interplay is how performance awards interact with earnouts in a transaction, particularly where achievement is obtained based on an exit price that is only determined after the earnout is released.

4. Another consideration is how the performance-based awards should be adjusted for certain extraordinary event (such as an acquisitions, an accounting change, etc.).

Part 2B: Severance Provisions

1. Severance entitlements come in various differing flavors, including:
    a. Salary payments: either in a lump-sum or paid over time.
    b. Bonus payments: either in full or pro-rated.
    c. Health insurance: either subsidized COBRA or payments to cover the premiums.
2. It is not uncommon to see two levels of severance – one on a termination and one on a termination in connection with a change of control (with the latter providing for a greater level of benefits).
3. Receipt of severance is often conditioned on a release of claims.
4. When considering severance provisions, certain positions (such as the CFO and VPs) are more likely to be terminated on a CIC (the CEO & COO are much less likely to be terminated).
5. The stakes for the definitions of "Cause" and "Good Reason" as they relate to severance provisions depend on the amounts of severance provided.

Part 2B: Death and Disability Payments

1. A consideration when structuring severance is whether to include payments on death/disability.

2. It is important that disability be carefully defined. The following are certain statutory definitions:

   a. Section 409A - (A) The employee is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months. (B) The employee is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the employee's employer.

   b. Section 22(e)(3) - An employee is permanently and totally disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. An individual shall not be considered to be permanently and totally disabled unless he furnishes proof of the existence thereof in such form and manner, and at such times, as the Secretary may require.

3. Companies are often hesitant to include these as payment triggers because they are typically covered by insurance.

4. In addition, providing death or disability as payment triggers can jeopardize the 2x2 exemption under Section 409A (which will be discussed later in this presentation).

Part 2C: Cause and Good Reason Provisions

1. The definitions of “Cause” and “Good Reason” are among the most heavily negotiated portions of an employment agreement.
2. Generally, it is more common for an employment agreement to have a “Cause” definition, and depending on the seniority of the executive, it may be less common for it to have a “Cause” definition and a “Good Reason” definition.
3. The definitions should be negotiated based upon the context of the Company and industry (based on norms and the packages received by other Company executives) as well as the nature of the payments (richer payments should generally be subject to more company-favorable definitions).
4. The definitions may also vary based on the executive’s position (CEOs typically have more favorable definitions than VPs).

Part 2C: Sample Definition –”Cause”

“Cause” means your termination because of:

(i) Any negligent, willful, deliberate and/or material violation of any law or regulation applicable to the business acquirer or its subsidiaries;

(ii) conviction for, a guilty plea to, or a plea of *nolo contendere* to a felony or a crime involving moral turpitude, or any perpetration of a material common law fraud;

(iii) commission of an act of personal dishonesty, fraud/deceit, or embezzlement;

(iv) a material breach or willful failure to substantially perform any provision of any material written agreement by and between you and the company;

(v) your continued failure to perform your duties after receiving 30-days’ written notice thereof;

(vi) your violation of any of the Company’s written policies.

Part 2C: Cause Considerations

1. When defining "Cause," employers should consider:

   a. Whether to include a prong for poor performance (employees are often concerned about these types of provisions);

   b. Whether to include qualifiers ("a <u>material</u> breach of your employment agreement," a "<u>continuous</u> failure to perform assigned duties," etc.) (employees often push for these qualifiers "to avoid foot-faults");

   c. Whether to provide any protections regarding the determination of Cause (e.g., determination by the Company in good faith, by the Board, by a supermajority of the board, etc.);

   d. Whether to permit findings of Cause post-termination (with a clawback);

Part 2C: Cause Considerations

e. Whether to include a notice and cure period.

f. Whether to include potential events indicating moral issues (drugs/alcohol) and whether to carve-out traffic incidents from any related definitions;

g. Relatedly, to what extent actions taken outside of work should be including within the definition of Cause.

h. Whether to include failure to cooperate with an internal investigation (excepting pursuant to any 5th Amendment privilege) as Cause.

Part 2C: Case Study: McDonald's Former CEO

1. In October 2019, McDonald's conducted an internal investigation and fired their CEO for engaging in prohibited relationships with employees.
2. McDonald's wished to avoid legal battles, so it terminated the CEO without Cause, which provided the CEO with severance benefits worth $42 million;
3. McDonald's later discovered that the CEO had lied to cover up the sexual nature of several of such relationships and had approved hundreds of thousands of dollars in stock grants for one such individual.
4. McDonald's is engaged in a lengthy legal battle to clawback this severance due to a post-termination finding of cause.
5. Following the emergence of the "me too" movement, "Cause" prongs relating to harassment have become increasingly common.

Part 2C: Case Study: Hewlett Packard Former CEO

1. In August 2010, Hewlett Packard then-CEO was terminated, following an internal investigation, based on the following:

"numerous instances where [Hurd's love interest, Jodie Fisher] received compensation and/or expense reimbursement where there was not a legitimate business purpose, as well as numerous instances where inaccurate expense reports were submitted by Mark or on his behalf that intended to or had the effect of concealing Mark's personal relationship with the contractor."

2. In spite of the above, the termination was “without Cause.” While there are questions that remain regarding the actual reason for this termination (some allege it was due to harassment), this goes to the situation that employers may find themselves when an executive engages in misconduct.
3. As discussed in the McDonald’s case study, terminating an executive for Cause may lead to significant undesirable publicity for a company.

Part 2C: Sample Definition – “Good Reason”

A resignation for any of the following shall be considered to be for “Good Reason:”

(1) a material reduction in your base compensation or target cash bonus, other than in connection with a general reduction in salary applicable to similarly situated employees;

(2) a material adverse change in your responsibilities, authority or duties as described in your offer letter;

(3) your relocation to a facility or location more than 30 miles from your principal office location;

provided, however, that you timely deliver written notice explaining the circumstances constituting Good Reason within 30 days from the date of the initial act constituting Good Reason and the Company fails to cure such circumstances within 30 days following receipt of such notice; and you resign immediately following such failure to cure.

Part 2C: Additional Possible Good Reason Prongs

1. A change in supervisor or position (including, possibly, a carve-out for title changes or changes in connection with an acquisition).
2. A change in budget or scope of the business (this is an unlikely prong, but may be pushed for by the COO).
3. In the case of a CEO, failure to be elected to the Board (or to be re-elected to the Board).
4. In the case of a CEO, failure to report to the ultimate Board (of the Company or the Parent Company).
    a. This is somewhat of a hair-trigger prong, but may be pushed for by CEOs.

Part 2C: Good Reason Considerations

1. When defining "Good Reason," in addition to several of the considerations applicable to the definition of "Cause," employers should consider:

   a. Whether the definition increases the likelihood of advance claims of Good Reason;

   b. The timing of any applicable cure period (e.g., 30 days to provide notice to the Company following a trigger event; 30 days to resign following a failure to care; requirement to resign early if the Company states that it will not cure, etc.);

   c. Whether to require the individual to sign a release of claims in order to receive any benefits in connection with such resignation.

   d. A timely consideration is how a 'relocation' prong may interact with shifts towards work-from-home.

Part 3

Taxation Considerations

Part 3A: Code Section 280G

1. When structuring an employment agreement (particularly with respect of severance/acceleration provisions) one consideration is how it interfaces with Code Section 280G.
2. Section 280G provides that 'parachute payments' received by 'disqualified individuals' in connection with a 'change of control' are subject to a 20% penalty tax to the extent that such payments exceed statutory thresholds.
   a. For private companies, there is an exception whereby no excise tax will be due if such payments are approved by a 75% supermajority vote of the Company's stockholders.
   b. An overview of Section 280G follows.

Part 3A: Section 280G Framework

“Change in Control”?
- → Change in >50% vote or value
- → Change in ‘effective control’
- → Sale of substantially all assets (1/3)

Yes

“Disqualified Individual”?
- → ‘Officer’
- → Highly Paid (top 1%)
- → 1% Stockholder

***Must be a service provider sometime in last 12 months**

Yes

“Parachute Payments”?
- → Severance
- → Bonuses
- → Acceleration
- → Recent Equity Grants
- → New Go-Forward Compensation
- → Potentially, Re-Vesting
- → Repurchases at Compensatory Premiums

Yes

Safe harbor exceeded?

Do the totals of all parachute payments of a disqualified individual exceed **3X** that person’s average historical W-2 compensation at the company for the last 5 years (or shorter period of service)?

***Consider mitigation strategies**

Cleanse the Tax
- → Disqualified Individual waives parachute payments > 3X if stockholders vote against him
- → Need 75% of the disinterested stockholders to approve

Only for private companies

Pay the Tax
- → 20% excise tax on all parachute payments over 1X average historical W-2 compensation
- → Payor loses deduction for same amount
- → Company withholding obligation

Part 3A: Code Section 280G

1. As discussed above, Code Section 280G may be implicated in connection with a Change of Control. In order to determine the appropriate tax treatment under Section 280G, several inquiries are necessary.

2. Firstly, the Company must determine whether it is subject to Section 280G – s-corporations (or corporations that are s-corporation eligible) and partnerships (or LLCs that have elected to be taxed as partnerships) are not subject to Section 280G.

3. Then, the Company must determine which of its service providers constitute ‘disqualified individuals’ – these are the ‘officers,’ ‘1% shareholders,’ and ‘1% most highly compensated employees’ of the Company (each is defined in Section 280G and these terms are not entirely intuitive).

Part 3A: Code Section 280G

4. Then, the Company must determine what ‘parachute payments’ each disqualified individual has received – these could be carve-out bonuses, severance payments, equity acceleration, or various other payments (including some that would otherwise appear to be in the ordinary course).

5. To the extent that such payments exceed 3 x a disqualified individual’s average compensation (from box 1 of such person’s W-2) for the last five years with the Company (or less, if applicable), then such payments will be subject to Section 280G.

    a. As previously noted, there is an exception for private companies where 75% of the stockholders approve such payments.

Part 3A: Code Section 280G

6. Another strategy for addressing Section 280G is to attempt to mitigate any potential 'parachute payments:'

   a. One method of mitigation is to categorize certain payments (such as go-forward salary increases with an acquiring company) as 'reasonable compensation' which falls outside of Section 280G. This approach is more common with public companies that cannot use the stockholder approval method, as private companies typically prefer to not take the risk of later challenge when stockholder approval can remove the risk.

   b. Another alternative is to ascribe a value of any non-competes with the disqualified individuals, which can then be used to offset the value of any potential parachute payments. This valuation should be performed by a qualified accounting firm and will typically only be applicable to the top employees at a company.

   c. A final method is to attempt to increase an individual's 280G 'base amount' by paying bonuses or exercising equity awards in a prior calendar year, where the timing of the deal otherwise allows.

Part 3A: Best 280G Result Provisions

1. One method of addressing Section 280G in an employment agreement is to include a "best after-tax result" provision.

2. This type of provision states that the Company will engage a 280G accountant to determine whether cutting back the employee's payments to below the applicable threshold would provide a better outcome than requiring the employee to pay the tax.

3. The employee agrees that, if cutting back would be more advantageous, the 'parachute payments' will be cut back to the extent necessary to avoid the penalty tax (often in an order specified by the document).

4. This provision may also provide that the Company agrees to seek a vote, if possible, in order to avoid any taxes under Section 280G.

Part 3A: Unique 280G Issues

1. Payments made within the 12-months prior to a change of control are presumed to be parachute payments.

2. Go-forward payments are includable in Section 280G even when based on a non-written ‘handshake’ deal. ***Square D Co. v. Commissioner, 121 T.C. 168 (2003)***

3. Severance payments are always considered a parachute (and is typically included even if the severance isn’t being paid on a transaction).

Part 3A: Unique 280G Issues

4. Equity Awards are subject to differing 280G valuations, based on a few factors:
    a. Awards that are time-based and accelerate in connection with a change of control are ascribed a value pursuant to complex calculations (ex. Adjusted black-scholes values).
    b. Awards that are performance-based, or are granted/modified within the 12-month lookback period are included at full value.
5. Additional complications can arise where a transaction constitutes a series of changes in control.
6. Any provisions providing for tax-gross-ups (relating to 280G or otherwise) are disfavored by ISS and are disclosable on SEC filings.

Part 3B: Code Section 409A

1. Another section of the tax code that should be considered in assembling employment agreements is Code Section 409A.
2. Section 409A governs ‘non-qualified deferred compensation plans’ and provides a heavily regulated framework in which such plans must operate.
   a. Violations of Code Section 409A can result in significant tax penalties, including a 20% penalty tax.
3. Equity awards and arrangements that provide for benefits/payments in a later taxable year (or upon an event that may occur in a later taxable year) must be structured to either comply with or be exempt from Code Section 409A.

Part 3B: 409A Exemptions

1. The most common way to exempt a payment from Section 409A is to require continued employment on the date of such payment or of the triggering event (provided that the payment is then paid by no later than March 15 of the calendar year following the trigger event (known as the "short-term deferral period")).

2. Certain equity awards with respect of "service recipient stock" are also exempt from Section 409A (such as options granted at FMV or restricted stock awards).

3. Another method of exempting a payment (even following a termination) is to make the occurrence of the payment subject to a 'substantially risk of forfeiture' – for example, this is used to exempt Two-Tier RSUs from Section 409A.

Part 3B: 409A Considerations – Severance Issues

1. One consideration relating to Section 409A is the timing of severance payments; naturally, these payments cannot be made subject to continued service, so other methods of exemption are required.

2. To the extent that severance is payable only upon an involuntary termination, such will be considered to be a short-term deferral if paid by March 15 of the year following the year of the separation.

3. However, one complication is the common requirement of a release of claims as a condition to payment of severance, as this requirement could cause the payment to fall outside of the short-term deferral period. This can be resolved by requiring the release to be executed (and to become irrevocable) within a 60-day period post-termination and having the payment occur on the 61st day post-termination.

Part 3B: 409A Considerations – Severance Issues

4. The provision stating that the payment will be on the 61st date is important, as it can be a violation of Section 409A to permit an individual to choose the calendar year in which a payment occurs.

5. If the severance is on a walkaway right (e.g., on a voluntary resignation or if the Cause definition is extremely employee-favorable) then it can be deemed vested up-front for purposes of the short-term deferral rule (resulting in immediate tax and starting the clock for the deferral period).

Part 3B: 409A Exemptions – Two by Two

1. An additional exemption that is relevant to severance arrangements is the two-by-two exemption.

2. It provides that a payment (or sequence of payments) upon an involuntary termination (e.g., a termination without Cause or a resignation due to "good" good reason) is exempt from Section 409A to the extent that all such payments are made by the second year following the year of termination; **and**

3. All such payments, in the aggregate, do not exceed two times the lesser of (i) the employee's base salary or (ii) a statutory maximum (currently $285,000).

4. ******Note that payments that are made upon a separation (or within the short-term deferral period) do not require this exemption.***

5. Note also that this exemption can be combined with the short-term deferral exemption and compliant payment events to achieve the desired result.

6. No disability can be included within this exemption – there must be a true separation from service.

Part 3B: 409A Compliance

1. If a payment cannot be exempted from Section 409A, then it must be made in compliance with Section 409A. Compliant payment events are less preferable, as they are highly regulated and cannot be easily changed or accelerated.

2. The basic premise is that payments can only be made on one of the following triggers:

   a. Death;

   b. Disability;

   c. Separation from Service;

   d. Specified Time/Event;

   e. Change of Control; or

   f. Unforeseeable Emergency.

Part 3B: 409A Compliance

3. The payment triggers relating to death, disability, or a separation from service are particularly relevant to severance arrangements; however, it is important the employment agreement define these terms pursuant to the regulations underlying Section 409A.

4. In addition, a severance payment can be paid pursuant to a fixed schedule following a separation from service; however, it is important to note that deviations from this schedule are generally impermissible under Section 409A.

Part 3B: 409A Considerations – Specified Employees

1. Another issue relates to severance payments made on compliant payment schedules for "specified employees." Specified employees are employees of public companies who:

    a. Own over 5% of the Company's stock;

    b. Own over 1% of the Company's stock and receive compensation over $150,000; or

    c. Are among the 10% of the most highly compensated officers of the company (capped at 50 officers) and receive compensation over $185,000.

2. Payments to specified employees may not be made during the first six months following such individual's terminations. Therefore, employment agreements should contain language providing that an employee's payments may be made following such period if such individual is determined to be a specified employee.

Part 3B: 409A Considerations – Anti-Toggling Rules

1. Compliant payment events are also subject to the anti-toggling rules.
2. These rules provide that a company cannot provide for one payment date or schedule for one event and another payment date or schedule for another event within the same permissible payment trigger
3. Ex. Severance is paid in installments upon a resignation for Good Reason and in a lump sum on a termination without Cause.
4. Note that there are exceptions for payments on a separation for service before/after a 409A compliant change of control event.

Part 3B: 409A Considerations – Subsequent Deferrals

1. As noted above, it is difficult (and often impossible) to accelerate a compliant payment event.
   a. There are some exceptions for payments on a change of control or a complete liquidation of all related plans.
2. It is also difficult to defer a compliant payment event - to defer a compliant payment, an employee must make a "deferral election" which
   a. May not take effect for 12 months from the date of such election;
   b. Must be only applicable to payments first scheduled more than 12 months away; and
   c. Sometimes must defer the payment for no less than five years beyond the originally scheduled payment date.

Part 3B: 409A Considerations – Commissions

1. The 409A rules also have specific provisions (including regulations regarding initial elections) for commissions, which vary based on the nature of such commissions (e.g., sales commissions v. investment commissions).

2. Generally, commissions may be considered to be exempt to the extent that they are paid pursuant to a mandatory schedule (and/or within the short-term deferral period) and continued employment is required to receive such commissions.

3. Otherwise, for compliant payment structures, the 409A rules provide that commissions may be paid in tandem with receipt by the Company of funds from customers for bona fide and regular business sales.

Part 3B: 409A Considerations – Practical Concerns

1. Employees often want to re-negotiate arrangements after some time or in connection with certain events, but there is a broad anti-circumvention/substitution principle.

2. Compliant arrangements must be made in operation AND documentary compliance with 409A. There are authorized correction mechanisms, but they sometimes involve the payment of certain penalties.

3. Effort should be made to keep any arrangements exempt as short-term deferrals when possible to promote flexibility.

4. Section 409A also interplays with Section 280G, as there are debates regarding whether cutbacks should occur to 409A compliant payments preferentially before impacting exempt payments.

Part 4

Other Considerations

Part 4A: Treatment of a Change of Control Arrangement during a Merger/Sale

1. One consideration in selecting a change of control arrangement is the flexibility provided to alter such arrangement on a merger/sale.
2. Equity grants often provide for extensive flexibility; however, they are governed by the company's equity incentive plan (which can be structured to be highly-flexible or very restrictive).
3. Carve-Out Bonus Plans, on the other hand, may be highly-restrictive, to the extent that they are structured to be compliant with Code Section 409A, as the rules underlying that section do not permit many changes.
   a. The limitations associated with structuring a plan or payment arrangement to be compliant with (rather than exempt from) Code Section 409A are significant and should be discussed with counsel.

Part 4B: Compensatory Issues that Buyers should consider when conducting M&A Due Diligence

1. As noted, one major consideration is what is permitted by a target company's existing compensatory arrangements (equity plans, Carve-Out Bonus Plans, employment agreements, etc.).
    a. Certain company's equity incentive plans may contain mandatory acceleration on a change of control or provide that the equity awards cannot be cancelled for no consideration.
    b. In these cases, creative structuring of the transaction terms may be required in order to account for these limitations.
2. In addition, to the extent that a plan that was intended to be compliant with (or exempt from) Section 409A has been structured incorrectly, counsel should be consulted to determine what fixes may be appropriate in order to avoid adverse tax consequences.

Questions

Any time left?

Contact Information

Anthony J. Eppert
anthonyeppert@huntonak.com

Marshall Mort
mmort@fenwick.com