

Finding Value: How to Negotiate Compensatory Drivers in a Change in Control Transaction

Presentation for:
Executive Compensation Webinar Series
April 8, 2021

Presentation by:
Anthony Eppert
AnthonyEppert@HuntonAK.com
512.542.5013

Housekeeping: Questions

- Questions during this presentation
 - We encourage questions (even though your audio lines are muted)
 - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
 - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

- Recording
 - This presentation is being recorded for internal purposes only
- Continuing education credits
 - A purpose of the webinar series is to provide FREE CE credits
 - To that end, each presentation is intended to provide 1 credit hour in the following areas:
 - CLE: 1 credit hour (CA, FL, GA, NC, NY, TX and VA)
 - CPE: 1 credit hour (Texas)
 - HRCI: This activity has been approved for 1 (HR (General)) recertification credit hours toward California, GPHR, PHRI, SPHRI, PHR, and SPHR recertification through the HR Certification Institute
 - SHRM: This program is valid for 1 PDC for the SHRM-CPSM or SHRM-SCPSM
 - If you have any questions relating to CE credits, please direct them to Anthony Eppert at AnthonyEppert@HuntonAK.com or 713.220.4276
- Disclaimer
 - This presentation is intended for informational and educational purposes only, and cannot be relied upon as legal advice
 - Any assumptions used in this presentation are for illustrative purposes only
 - No attorney-client relationship is created due to your attending this presentation or due to your receipt of program materials

About Anthony “Tony” Eppert



Anthony Eppert , Partner
Hunton Andrews Kurth LLP

Tel: +1.713.220.4276

Email: AnthonyEppert@HuntonAK.com

- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
 - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
 - Obtained his LL.M. (Taxation) from New York University
 - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
 - Editor-in-Chief, Journal of Medicine and Law
 - President, Tax and Estate Planning Society

Upcoming 2021 Webinars

- 2021 webinars:
 - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees? (5/13/21)
 - Training Course on Designing an Equity Incentive Plan (6/10/21)
 - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
 - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
 - How to Properly Hire and Fire an Executive Officer (10/14/21)
 - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
 - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

Sign up here: <https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
 - Tax,
 - Securities,
 - Accounting,
 - Governance,
 - Surveys, and
 - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
 - Tax lawyers,
 - Securities/corporate lawyers,
 - Labor & employment lawyers,
 - Accountants, and
 - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Executive Contract Considerations

- Duties section
 - This is a key provision that helps determine whether:
 - The executive can later terminate employment for Good Reason and receive severance pay, or
 - The Company later seeks to terminate the executive's employment for Cause
 - Purpose of this provision is to address the executive's title, reporting responsibilities and job description duties
 - To provide the Company with flexibility, the provision should be structured to have the executive report to a position instead of a person
 - The Company has the greatest level of flexibility if the Duties section is drafted generically as opposed to being highly specific (*i.e.*, such provides the Company with flexibility if later the executive's duties need to be changed)
 - Such is particularly important if the executive contract contains a Good Reason provision

Executive Contract Considerations (cont.)

- A typical definition of Cause includes:
 - A material breach by the executive of his or her obligations under the agreement;
 - A willful or continued failure to follow orders or perform;
 - A conviction or plea of nolo contendere to any felony or a crime involving dishonesty or moral turpitude or which could reflect poorly on the Company;
 - The executive engaging in misconduct, negligence, etc. that is injurious to the Company;
 - A material breach by the executive of a written policy of the Company; and
 - Any other misconduct by the executive that is injurious to the financial condition of the Company and/or its reputation

- Should a notice and cure period be provided?
 - See the explanation under Good Reason

- It is the modifiers that are most negotiated

- Consider the Board’s use of after-acquired evidence to determine whether the executive terminated employment for “Cause.” Otherwise, evidence supporting a termination for Cause that is found after the executive’s termination of employment would not likely be used to retroactively re-characterize the executive’s termination of employment

Executive Contract Considerations (cont.)

- A typical definition of “Good Reason includes:
 - A material diminution in the executive’s base salary or a failure by the Company to material compensation when due;
 - A material diminution in the nature or scope of the executive’s authority, duties, responsibilities or title from those applicable to him or her as of the Effective Date of the executive contract;
 - The Company requiring the executive to be based at any office or location more than x miles from y location; or
 - A material breach by the Company of any term or provision of the executive contract

- It is favorable to the Company to require both a notice and cure period before Good Reason can be triggered by the executive
 - Consider that if a notice and cure period is used in Good Reason, whether it is also fair to apply a mirror notice and cure provision within the defined term Cause

- Should there also be a claims run out period, such that if Good Reason exists, the executive must provide notice with x days of his or her knowledge of such existence (otherwise the claim is considered waived)
 - Such should prevent the executive from saving a Good Reason condition for a later rainy day 6 months of years after the fact
 - Should the defined term Cause contain a similar provision

Executive Contract Considerations (cont.)

- [Good Reason continued from prior slide]
- As reflected on the prior slide, consider adding a Good Reason definition that includes:
 - “. . . a material breach of any provision of this Agreement . . . “ and
 - Insert a provision elsewhere in the executive contract that provides something to the effect “. . . Failure of the Company to obtain a written agreement of any successor or assign of the Company to assume the obligations of the Company under this executive contract upon a Change in Control shall constitute, and be deemed to be, a material breach of this executive contract.”
- The foregoing could provide the executive with substantial negotiating power if the acquirer wants to retain the executive after consummation of the transaction (i.e., because any deviation from the agreement could give rise to Good Reason) and the existing executive contract is otherwise something the acquirer would want to renegotiate if it is otherwise deemed to be “rich”

Severance Pay

- Typically provided (if at all) only in the instance of a termination by the Company without Cause or the executive quits for Good Reason
- Consider whether severance pay should be “bridge pay”
 - Severance pay packages should be designed to act as a “bridge” between jobs
 - In the change in control context, severance pay is provided so as to encourage the executive to race towards his or her job elimination (thus alignment with shareholder value)
 - Should the multiple of severance pay be higher in change-in-control situations?
- Consider designing severance pay to take the form of salary continuation (and not a lump sum payout)
 - Such allows the Company to hold the purse strings to enforce various restrictive covenants such as non-competes, non-disparagement, etc.
- Be sure to require within the executive contract that the executive must sign a waiver and release of all known and unknown claims as a condition precedent to receiving any severance pay
 - Such should be attached to the executive contract as an Exhibit

Severance Pay (cont.)

- Should severance pay wear away as wealth accumulation builds?
- Should the severance pay be single trigger or double trigger. With respect to double trigger, how far out should be the post change in control protection (i.e., 12 months, 2 years, etc.)?

Other Terms

- Require an executive's automatic resignation from the Board and all committees upon his or her termination of employment
- Include a survivability provision so that payment terms and restrictive covenants, for example, survive the termination of the executive contract
- Consider whether to contractually toll the non-compete provision for any period of time the executive violates the restrictive covenant
 - Some states do not allow equitable tolling and therefore would not otherwise toll the non-compete beyond the terms of the contract
 - Absent equitable tolling or a contractual tolling provision, it may be difficult for the Company to enforce, for example, a 6-month non-compete provision (*i.e.*, it could take more than 6 months just to get to court)
- Consider whether to implement a robust clawback provision

Considerations Prior to a Change in Control

- Consider whether the equity plan permits net exercises of stock options in addition to cash-out of stock options. If the equity plan does not permit a net exercise, then consider adding a net exercise feature to the change in control section of such equity plan
 - As shown on the next slide, implementing a net exercise feature with respect to ISOs within a change in control transaction (*i.e.*, in lieu of a cash out feature) can save BOTH company dollar and employee dollars
 - And depending upon the structure of the working capital adjustment, such savings could effectively increase the sale proceeds realized by shareholders WITHOUT any corresponding increase to the purchase price paid by the buyer (thus a win-win)

- Consider whether to extend the post-termination exercise period for stock options
 - Such is permissible under Section 409A if the option term is not extended beyond its original term (*i.e.*, typically stock options contain a term of 10 years from the date grant)
 - However, ISO status would be lost if the stock option is not exercised within 3 months from the optionee's termination of employment

Considerations Prior to a Change in Control (cont.)

- Consider whether to add a Skype-type provision that would, immediately prior to consummation of the change in control, allow the Company to repurchase certain stock held by the former optionees at the exercise price
 - Concept would apply only to former employees who previously terminated employment and exercised in conjunction with the change in control transaction
 - Should such former employees be permitted to partake in the financial upside or exit transaction even though they “jumped ship” at some point prior?
 - Shouldn’t the employees be treated comparable to shareholders by requiring them to be “in-it-to-win-it”?

- Consider whether to enter into a springing executive contract that becomes effective only upon consummation of a change in control

- Consider certain post-closing incentives such as the payment of a bonus upon successful completion of performance goals (e.g., successful integration of IT or accounting systems, payout of earnout at higher levels, etc.)

Golden Parachutes - Background

- Golden parachute payments are governed by Section 280G and 4999 of the Code. If applicable, these Code sections generally:
 - Impose a 20% excise tax on disqualified individuals for their receipt of an excess parachute payment, and
 - Deny a corporate deduction for the same
- Only “excess” (amounts exceeding 2.99x the “base amount”) “parachute payments” that are “contingent” on a change in control and that are paid to a “disqualified individual” are subject to adverse tax consequences under Section 280G
 - Negate any of these four elements and 280G would not apply to that particular payment
- Once the above adverse tax consequences are triggered, a 20% excise tax (and corresponding loss of a deduction) applies to the amount of parachute payments that exceed 1x the base amount

Golden Parachutes – Mitigation Techniques

- Alternative No. 1 – Do nothing
 - Deduction would be disallowed and the disqualified individual would be subject to an excise tax
- Alternative No. 2 – Allow for the payment but provide the disqualified individual with protection through a full or partial tax gross-up
 - This is not a favorable design with ISS and certain other institutional shareholder advisory services
- Alternative 3 – Implement a cutback so that the parachute payment would not exceed 2.99x the base amount
 - Such may not be ideal for a disqualified individual who could be financially better off paying the excise tax (e.g., where payment would otherwise equal 7x the base amount)
 - Conversely, a cutback could be financially advantageous to a disqualified individual if the payment exceeding 2.99x the base amount would otherwise be less than the amount of the excise tax (e.g., where payment would otherwise equal 3x base amount)
 - To this point it is important to remember that the 20% excise tax applies to amounts exceeding 1x base amount, thus exceeding the threshold by \$1.00 can result in substantial taxes absent a cutback

Golden Parachutes – Mitigation Techniques (cont.)

- Alternative No. 4 – Implement a hybrid cutback whereby a disqualified individual would be entitled to receive the greater of a 2.99x cutback or payment of the excess parachute payment with the 20% excise tax
 - This is also known as a “net better” provision
- Alternative No. 5 – Same as Alternative No. 4, but apply a cap so that if the payment triggers a 20% excise tax, that such payment will not exceed a certain dollar amount
- Alternative No. 6 – Implement a stockholder vote exception (applicable only to privately-held corporations), which generally means:
 - The disqualified individual irrevocably waives his or her right to the parachute payment that exceeds 2.99x his or her base amount;
 - Irrespective of the waiver, the payment is approved in a separate vote of the stockholders that is approved by more than 75% of the outstanding voting power;
 - Adequate disclosure to the stockholders must be made of all material facts; and
 - The vote must establish the right of the disqualified individual to receive the payment
- Alternative No. 7 – Same as Alternative No. 6, but provide a gross-up if the corporation fails to seek stockholder approval (but note, this alternative could not apply to the condition of receiving stockholder approval due to the disclaimer requirement)

Golden Parachutes – Mitigation Techniques (cont.)

- Alternative No. 8 – In the year preceding the year in which the change in control occurs, increase the disqualified individual's base amount in order to increase his or her 5-year average (which correspondingly increases the 2.99x amount). Such examples include:
 - Accelerate vesting of outstanding equity awards,
 - Exercise non-statutory stock options,
 - Payout deferred compensation,
 - Increase the timing or amount of the payment of any bonus, and
 - Payout LTIP awards

- Alternative No. 9 – Structure the payment to be reasonable compensation paid for services to be rendered after the change in control
 - The burden of proof is on the taxpayer at a clear and convincing standard
 - If the burden is satisfied, the amount of the reasonable compensation reduces the excess parachute payment
 - In determining reasonable compensation, relevant factors include:
 - Nature of the services to be rendered,
 - The individual's historic compensation for such services, and
 - Compensation for those performing similar services where payment is not contingent on a change in control

Golden Parachutes – Mitigation Techniques (cont.)

- Alternative No. 10 – Structure the payment to represent reasonable compensation for services to be rendered in the future (thereby negating the “contingent” element)
 - Burden of proof is clear and convincing evidence, and if the burden is satisfied, then the amount of the reasonable compensation for future services reduces the excess parachute payment
 - Payments for covenants not to compete can represent payment for future services if there is a reasonable likelihood that the agreement would be enforced against the individual
 - It is an open issue on whether the payment needs to be directly tied to the restrictive covenants
 - Such payment represents compensation for services to be rendered after the change in control if it is “reasonable” in amount. Such amount is reasonable if it does not exceed the lesser of:
 - ❖ Reasonable compensation (determined using a benchmarking analysis against the peer group and after increasing the dollar amount up to the 90th percentile), and
 - ❖ The value of the non-compete, determined pursuant to an independent third-party appraiser, which is the difference between the enterprise value of the employer with and without the non-compete
 - Such payment reduces the excess parachute payment on a dollar-for-dollar basis
 - Thus, the value of the 280G reduction could be more than the severance pay directly associated with the non-compete

Don't Forget Next Month's Webinar

- Title:
 - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees?

- When:
 - 10:00 am to 11:00 am Central
 - May 13, 2021