

Designing Transaction-Based Compensation and Resolving Certain 409A, 457(f) and 280G Issues

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Presentation by:

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About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation, ESOPs and employee benefits and leads the Firm’s national Compensation Practice

- 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 2018 and 2019 Webinars

- Upcoming 2018 webinars:
 - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
 - How to Negotiate Executive Employment Contracts (12/13/2018)

- Upcoming 2019 webinars:
 - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/17/2019)
 - Equity Awards: Design Tips for Navigating Blackout Periods (2/14/2019)
 - Golden Parachutes & 280G: Design Pointers on Being a Winner (3/14/2019)
 - Best Practices for Conducting the Compensation Committee Meeting (4/11/2019)
 - Anatomy of ISS (5/9/2019)
 - Tips to Increase the Longevity of the Equity Plan's Share Reserve (6/13/2019)
 - Multi-Disciplinary Facets to Net Withholding: It Ain't Boring (7/11/2019)
 - Everything Perquisites: The 101 Training Course (8/8/2019)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/12/2019)
 - Stock Ownership Policies & Clawback Policies: Design Pointers (10/10/2019)
 - Employee Stock Purchase Plans: The Introductory Course (11/14/2019)
 - How to Design Restrictive Covenants & Economic Forfeitures (12/12/2019)

- Sign up here: <https://www.huntonak.com/en/insights/2018-executive-compensation-webinar-schedule.html>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, 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

Purpose of this Presentation

- The purpose of this presentation is to address various design considerations when structuring management carve-out or change-in-control bonus arrangements for key employees, with a specific emphasis on certain 409A, 457(f) and 280G issues arising in the design or implementation of such arrangements
 - However, the 409A and 457(f) issues will be addressed orally and outside of this Slide Deck

- To that end, this presentation covers:
 - Preliminary considerations,
 - Identifying the key employees,
 - Determine the type of funding trigger,
 - Determine the value of the award,
 - Vesting conditions and forfeitures,
 - Form and timing of payment,
 - Ability to amend or terminate,
 - Ordinary income tax treatment, and
 - 280G “golden parachute” mitigation techniques

Pointer No. 1 – Preliminary Considerations

- Determine the primary goal
 - To motivate the key employee to increase the Company’s value and incentivize the key employee to remain employed through consummation of the change-in-control transaction (the “CIC Transaction”)?
 - Same as above, but also to incentivize the key employee to remain employed after the CIC Transaction?
 - Same as above, but also to motivate the key employee to, on a post-CIC Transaction basis, work hard to maximize the earn-out for the benefit of the selling stockholders?

- Identify which key employees should participate and at what approximate values

- Review applicable corporate documents to determine whether any corporate formalities must be satisfied
 - Review the stockholders’ agreement, if any
 - Review the Corporate Charter or Bylaws
 - Approval by the Board of Directors is likely required. But is it required to have stockholder approval or is such approval warranted under the applicable facts?

Pointer No. 2 – Identify the Key Employees

- Determining which key employees should receive an award depends upon highly specific facts. Typical thoughts to consider include:
 - Do any of the key employees:
 - Have the ability to increase the value of the Company,
 - Need to be incentivized to remain employed with the Company, and/or
 - Need to be motivated to increase stockholder value
 - Will any of the key employees be necessary to transition with the Company to the buyer?
 - Assuming there is contingent consideration in the CIC 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 for the benefit of the selling stockholders?

Pointer No. 3 – Determine the Type of Funding Trigger

- What types of transactions should trigger payout? Typical triggers include:
- Sale of 50% or more of the Company's total voting power? 75%? Something more close to 100% Thoughts to consider include:
 - A determination needs to be made within the applicable granting documents as to what happens to the remaining compensatory interest if less than 100% of the Company is sold
 - Does the remainder terminate? Does the employee get to keep the portion of the award/pool not settled until the remaining ownership is sold upon some later date, and if yes, should a sunset provision be inserted? Would the foregoing answers change if the employee moved with the assets?
- Consummation of a merger or consolidation in which the Company is not the surviving entity
 - However, it is typical to retain a carve-out so that this trigger 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
- Sale of all or substantially all of the Company's assets
- Should the transaction trigger include any monetization of the Company's intellectual property rights that results in payments to the stockholders?
 - This issue is often missed

Pointer No. 4 – Determine the Value of the Award

- How should the value of the award be determined?
 - On an individual basis or pursuant to a pool?
 - 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?
 - Should a sliding formula or scale be included?
 - Will the key employees participate in any earn-out dollars? To state the opposite, is the value reduced by any earn-outs or holdbacks?
 - Should the value of any change-in-control bonus be reduced by payments the key employee receives with respect to his/her common shares?

- If the award is determined based upon a fixed dollar amount?
 - Example: Bobby is awarded \$1.2mm upon a CIC Transaction and Mary is awarded \$1.4mm upon a CIC Transaction

- If a pool is created (fixed or percentage) from which key employees will participate?
 - A pool of dollars is created for the benefit of key employees. The pool is either: a fixed dollar amount (e.g., \$3mm) or a percentage of the sale proceeds or net proceeds (e.g., 8% of the net proceeds)
 - Typically, key employees would participate in the pool based upon a percentage
 - Example: Bobby's percentage of the pool is 35%, Mary's percentage of the pool is 45% and 20% of the pool remains available for the Company to award to key employee who have not yet been identified

Pointer No. 4 – Determine Value of the Award (cont.)

- A benefit of the pool concept is that it could be denominated in Units
 - As background, sometimes the change-in-control bonus is being implemented at a time when the stockholders are able to determine the maximum amount of CIC Transaction proceeds to which they are willing to share with key employees, BUT neither the Company nor the stockholders are able to identify all of the key employees who should participate in the pool
 - As a result, the Company would be unlikely to divide the pool into percentages and award those percentages
 - Instead, converting the pool into a Unit concept where the denominator is the number of units outstanding is a rather simple way to self-contain any future dilution (e.g., due to adding new key employees) within the pool

- An example of a Unit concept is contained on the next slide

Pointer No. 4 – Determine Value of the Award (cont.)

- An example of a Unit concept is as follows:
 - The amount of the pool is designated as either a percentage of the CIC Transaction proceeds or as a fixed dollar amount
 - The key employee is awarded a certain number of Units. For this purpose, a Unit does not represent any equity ownership and is not a derivative security; instead, the purpose of the Unit concept is to designate the sharing ratio by each key employee within the pool
 - Typically, the formula for determining the value of a key employee's Units is: [Pool Value divided by total # of Units outstanding immediately prior to consummation of the CIC Transaction] x number of Units awarded to the key employee

- An example of a more advanced unit concept is as follows:
 - **Value of the key employee Units** =
$$\frac{[A - (B + C)] \times D}{E} \times F$$
 - **A** = The value (as determined by the Board) of all cash and non-cash proceeds that are paid to the Company or its stockholders in the CIC Transaction
 - **B** = Any and all Company-related debt or liability that continues (or will continue) to be held by one or more stockholders of the Company immediately after the CIC Transaction
 - **C** = All CIC Transaction costs (e.g., accountant fees, attorney fees, investment bankers, etc.) as such costs are reasonably determined by the Board
 - **D** = The intended pool size, set forth as a percentage of the above equation
 - **E** = The total number of Units granted under the Plan that remain outstanding (*i.e.*, were not previously forfeited) as of immediately prior to consummation of the CIC transaction
 - **F** = The number of Units held by the key employee

Pointer No. 4 – Determine Value of the Award (cont.)

- Should the value of the award, or the value of the pool, fluctuate based upon a sliding scale? For example:
 - If the CIC Transaction proceeds equals or is less than \$15mm, then the pool is \$1mm
 - But if the CIC Transaction proceeds is less than \$40mm but greater than \$15mm, then the pool is \$3mm
 - And if the CIC Transaction proceeds equal or exceeds \$40mm, then the pool is \$5mm

- Should the value of the award be tied only to the CIC Transaction proceeds that stockholders receive upon consummation of the CIC Transaction, or should the value of the award also include contingent consideration such as realized earn-outs?

- Should key employees participating in change-in-control bonuses share equally (vis-à-vis the stockholders) in the costs of the CIC Transaction?
 - Example 1: Should the award/pool be proportionately reduced by the costs associated with investment bankers, attorneys, accountants, etc., incurred in the CIC Transaction?
 - Example 2: Should the award/pool be proportionately reduced by debt incurred or assumed by one or more stockholders, or debt that one or more stockholders will continue to hold after the CIC Transaction?

Pointer No. 5 – Vesting Conditions & Forfeitures

- The most common vesting condition is to require the key employee to be “present to win”
 - Time-based vesting schedules are generally not used because the goal of a change-in-control bonus is for the key employee to be present when the CIC Transaction is consummated
 - However, a common exception to the “present to win” concept is to allow payment if the key employee’s employment with the Company/buyer at any time after the CIC Transaction and prior to payment is terminated by the Company without Cause or by the key employee for Good Reason
 - Consider whether any forfeitures should be reallocated to remaining key employees

- Failure to timely execute a Waiver and Release is also a common trigger to cause a forfeiture of the key employee’s award
 - Requiring a Waiver and Release helps to protect the selling Company and its stockholders against any future claims brought by a key employees
 - Generally, the key employee is entitled to consider the Waiver and Release for 45 days (though he/she could voluntarily waive this time period). And once the key employees signs the Waiver and Release, he/she may revoke his/her signature within the 7-day period immediately following the signature date
 - Since the foregoing time commitments are required due to age discrimination laws, it is frequently common that the Waiver and Release will not include age discrimination. If the age discrimination is eliminated from the release, then logistically the Waiver and Release could be signed at closing of the CIC Transaction without regard to the 45-day or 7-day consideration period/revocation time periods

Pointer No. 6 – Form and Timing of Payment

- The form of payment can be cash or property, and often will follow what the stockholders are receiving in the CIC Transaction
 - If instead the contractual agreements required only cash to be paid to the key employees, then the Company's stockholders risk that the key employees could receive a disproportionately large percentage of the cash proceeds in the deal if, for example, the sale proceeds to the Company's stockholders were otherwise 70% stock in the buyer and 30% cash

- Unless the bonus payment is intended to retain the key employee with the buyer after closing of the CIC Transaction, the consideration is often paid at closing or at the same time the stockholders are paid (as to this latter part, be sure to verify compliance with Section 409A)
 - If the consideration is intended to retain the key employee with the buyer after the closing, then payment is often accelerated upon the earlier of:
 - The key employee terminating employment with the buyer for Good Reason;
 - The buyer terminating the employment of the key employee for other than Cause; and
 - A set number of days after the CIC Transaction (e.g., on the 180th day that immediately follows consummation of the CIC Transaction)

Pointer No. 7 – Ability to Amend or Terminate Contract

- After the change-in-control bonus agreement is distributed to a key employee, should the Company have the ability to amend or terminate such agreement without the consent of the key employee?
- With respect to the period of time that precedes the CIC Transaction, one thought is that the Company should retain the discretion and flexibility to terminate the arrangement without the key employee's consent if, for example, there is an inability to consummate the CIC Transaction (*i.e.*, the program cannot live forever)
 - However, the presence of such discretion could result in the key employees viewing the program as illusory
 - And if this discretion is not retained, then minimally the plan should contain an automatic sunset, such that if a CIC Transaction is not consummated within a set period of time, that the change-in-control bonus automatically terminates
 - Should the award terminate upon the earlier of an IPO or financing?
- And if any payouts are to occur after the CIC Transaction, then consider having a provision in the document that requires the key employee's consent before any amendment can be effectuated. Alternatively, consider having a provision that requires any non-payouts to be remitted to the selling stockholders in the CIC Transaction

Pointer No. 8 – Taxation

- All ordinary taxable income to the key employees
- Who or which entity is entitled to the compensatory deduction depends upon which person or entity is the “service recipient”
 - This question is particularly important in the factual scenario where a key employee is sharing an earnout on a post-CIC Transaction basis (*i.e.*, the buyer is likely the service recipient)
 - The service recipient is the one who receives the services related to the award
 - The service recipient is the one entitled to the compensatory deduction
 - The service recipient is the one required to satisfy any income tax withholding, and pay the employer portion of any FICA or FUTA
- If the Company is a C corporation, the amounts paid to the key employee could be subject to the golden parachute payment rules of Section 280G (assuming the key employee is a disqualified individual)
 - Mitigation techniques could apply to the extent an “excess parachute payment” exists
- The award should be structured to either:
 - Avoid the application of Section 409A via the “short-term deferral rule” or
 - Comply with Section 409A

Pointer No. 9 – 280G Mitigation – Overview

- 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 CIC that are paid to a “disqualified individual” are subject to adverse tax consequences under 280G
 - Negate any of these 4 elements and 280G would not apply to that particular payment

- Once the above adverse tax consequences are triggered, the 20% excise tax (and corresponding disallowed deduction) applies to parachute payments that exceed 1x the base amount

Pointer No. 9 – 280G Mitigation – Alternatives

- Alternative No. 1 – Do nothing
 - Deduction would be disallowed and the disqualified individual would be subject to an excise tax
- Alternative No. 2 – Allow the payment but provide the disqualified individual with protection through a full or partial gross-up
 - Not a favorable design with ISS and certain other institutional shareholders
- Alternative No. 3 – Implement a cutback so that the parachute payment would not exceed 2.99x base amount (*i.e.*, the threshold test is NEVER satisfied)
 - May not be ideal for a disqualified individual who could be financially better off paying the excise tax (instance where payment would otherwise equal, for example, 7x base amount)
 - Conversely, a cutback could be financially advantageous to a disqualified individual if the payment exceeding 2.99x base amount would otherwise be less than the amount of the excise tax (instance where payment would otherwise equal, for example, 3x base amount)
 - Remember, the excise tax applies to amounts exceeding 1x base amount

Pointer No. 9 – 280G Mitigation – Alternatives (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 (only applicable to privately-held corporations), which generally means:
 - The disqualified individual irrevocably waives his/her right to the parachute payment that exceeds 2.99x his/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,
 - The vote must establish the right of the disqualified individual to receive the payment
- Alternative No. 7 – Same as Alternative 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 gaining stockholder approval due to the disclaimer requirement)

Pointer No. 9 – 280G Mitigation – Alternatives (cont.)

- Alternative No. 8 – In the year preceding the year in which the CIC occurs, increase the disqualified individual’s base amount in order to increase his/her 5 year average (thus increasing the 2.99x amount)
 - Accelerate vesting of equity awards,
 - Exercise non-statutory stock options,
 - Payout deferred compensation,
 - Increase bonus, and
 - Payout LTIP

- Alternative No. 9 – Structure the payment to be reasonable compensation paid for services rendered before the CIC
 - Burden of proof is clear and convincing evidence
 - 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,
 - Individual’s historic compensation for such services, and
 - Compensation for those performing similar services where payment is not contingent on a CIC

Pointer No. 9 – 280G Mitigation – Alternatives (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. Addressing this point:
 - The payment does not have to be directly tied to the non-compete provision
 - Such payment represents compensation for services to be rendered after the CIC 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