Tackling Equity Compensation in Merger & Acquisition Transactions

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REVIEW OF DIFFERENT FORMS OF EQUITY
A Refresher: Forms of Equity

- Restricted Stock
- Restricted Stock Units
- Stock Options
- Stock Appreciation Rights

Equity compensation plans or agreements often contain change in control provisions ("single trigger" or "double trigger").
Mergers & Acquisitions Transactions

• Parties to the Transaction
  • Public/Public Transactions
  • Public/Private Transactions
  • Private/Private Transactions

• Types of Transactions
  • Merger
    • “One Step”
    • “Two Step”
  • Stock Acquisition
  • Asset Purchase
  • Going Private
  • Spin-off Transaction

• Purpose of transaction may also be driven by talent acquisition
The Current M&A Landscape

• Just a few facts to put discussion in context:
  ➢ S&P 500 Index is up 13.28% YTD (5 yr. avg. is 2.11) – Morningstar
  ➢ QQQ is up 20.23% YTD (5yr. Avg. is 7.68) – MarketWatch
  ➢ DIA is up 6.7% YTD (5yr. Avg. is 1.82) – Yahoo Finance

• Private Equity Firms currently have in excess of $500 Billion in reserves – Economy Watch

• M&A Activity Q1 was down to $436 billion from a 2011 level of $737 billion (Reuters)

• M&A Activity Q2 – Deal Volume at lowest level in 3 years – Thomson Reuters
The Current M&A Landscape

• M&A Deal Value Up 48% from Q1

• US M&A Deal Value up 80% from Q1

• Globally – number is most impacted by large deals
  • Eaton-Cooper
  • Nestle – Pfizer
  • AB Inbev – Grupo Modello (Thomson Reuters)
TREATMENT OF OUSTANDING EQUITY AWARDS IN A CHANGE IN CONTROL TRANSACTION
Assumption v. Cash Out of Outstanding Equity Awards in a Merger or Stock Purchase Transaction

Considerations for assumption v. cash out include:

• business decisions / use of cash
• dilution of Buyer’s shareholders
• retention goals
• terms of the applicable equity compensation plans
• administrative burden considerations (to be further discussed)
Assumption v. Cash Out of Outstanding Equity Awards in a Merger or Stock Purchase Transaction

• Determine whether the proposed treatment is permitted by the underlying equity plan.
  
  • Equity plans typically provide for the assumption of outstanding awards and may or may not provide for the cash out of options.
  
  • If the proposed treatment is not permitted by the terms of the equity plan, the target company may need to obtain the consent of the award holders prior to the closing of the deal.
Assumption v. Cash Out of Outstanding Equity Awards in a Merger or Stock Purchase Transaction

• Assumed awards are generally subject to terms of the original award, as adjusted by an exchange ratio.

  • Assumed awards are not rolled over on a 1:1 basis in shares of the Buyer, and instead, an exchange ratio is used to adjust the awards.

  • The exchange ratio is generally determined by multiplying the number of shares of the target company that are subject to an award by the quotient of the per share merger consideration in the deal (or per share value of the target company’s stock) divided by the fair market value of a share of the Buyer’s stock.

  • Any adjustments must also comply with the incentive stock option rules, if applicable, and Section 409A of the Internal Revenue Code, each to be discussed further.
Buyer Not Liable for Seller’s Outstanding Equity Awards in an Asset Sale

- Outstanding awards remain subject to Seller’s equity plan, and there is a termination of employment of Seller’s employees for purposes of equity plan.
  - Seller’s employees terminate employment with the Seller in an asset deal.
  - Outstanding equity awards will be subject to the terms of the underlying equity plan governing a termination of employment, e.g., unvested equity that is not otherwise vested in connection with the sale would be subject to forfeiture, limitations on the period of time to exercise vested options, etc.
Buyer Not Liable for Seller’s Outstanding Equity Awards in an Asset Sale

- Accelerated vesting of equity awards may still be triggered by the asset sale or otherwise provided for by the Seller.
  - Outstanding awards may become vested pursuant to the terms of the underlying equity plan as a result of the sale.
  - Otherwise, the Buyer may want Seller to vest outstanding awards or extend exercisability from an employee morale perspective.
More on Administrative Burden Considerations

- Equity tracking of assumed awards
- Tracking change in control-related triggers under assumed awards
- Employee communications
- Accounting and internal control issues
- SEC registration
  - Requires consent from auditor(s)
  - Legal and registration fees will be incurred
- Unique issues pertaining to foreign equity awards
COMPLIANCE WITH RELEVANT INTERNAL REVENUE CODE PROVISIONS:

Section 409A
Section 409A of the Internal Revenue Code

- Section 409A generally
  
  - Section 409A governs the timing of elections to defer compensation, the timing of distributions of deferred compensation and the reporting and taxation of deferred compensation.

  - Amounts are generally considered to be deferred if an individual obtains a legally binding right in one tax year to receive compensation in a later tax year.

  - A violation of Section 409A results in immediate inclusion in income of the vested deferred amounts and additional “penalty” taxes and interest.
Section 409A of the Internal Revenue Code

• Restricted stock is excluded from Section 409A.

• Stock options and stock appreciation rights are excluded from Section 409A if certain requirements are met.
  • The exclusion for stock options and stock appreciation rights applies so long as the awards were granted with an exercise price that can never be less than the fair market value of the underlying shares as of the date of grant and generally if the awards are made on the common stock of the employer receiving the services.

• Restricted stock units may or may not be excluded from Section 409A, depending on their terms.
Section 409A of the Internal Revenue Code

- Assumption of options and stock appreciation rights must be structured to preserve the aggregate spread in order to comply with Section 409A.
  - Options and stock appreciation rights may generally be exchanged and adjusted for equivalent rights in a transaction and will not violate Section 409A so long as the aggregate spread on the options or stock appreciation rights is preserved.
  - Exchanging options or stock appreciation rights for another form of compensation or the use of escrows and earnouts warrants further analysis and considerations.
Section 409A of the Internal Revenue Code

- Cash out of options and stock appreciation rights generally do not violate Section 409A.

- Canceling stock options and stock appreciation rights in exchange for a cash payment that is generally equal to the excess of the per share transaction price over the applicable exercise price does not violate Section 409A. However, payment of “cash out” amounts over multiple years raises Section 409A issues. Further, earnouts and escrows should be structured to comply with Section 409A.

- Practitioners take the view that cashing out “underwater” awards for a specified price is also permitted under the rules of Section 409A.
Section 409A of the Internal Revenue Code

- **Restricted stock units**
  - Restricted stock units are subject to Section 409A unless there is an applicable exemption, e.g., short-term deferral where they are settled at the time of vesting.
  - Typically, where unvested restricted stock units are being assumed pursuant to the same vesting terms or cashed out in a transaction, such treatment does not violate Section 409A.
    - RSUs designed (intentionally or inadvertently) to comply with Section 409A may create Section 409A issues if plan or award agreements give discretion whether to assume or fully vest and settle such awards.
  - Review of ancillary documents (e.g., change in control agreements) is warranted.
COMPLIANCE WITH RELEVANT INTERNAL REVENUE CODE PROVISIONS:
Incentive Stock Options
Preserving the Status of Incentive Stock Options

• Incentive stock options generally

• Incentive Stock Options are tax-qualified options under Section 422 of the Internal Revenue Code that are not taxed on exercise but at the time of the disposition of the shares that were acquired on exercise, and at capital gains rates if the requisite holding period is met.
Preserving the Status of Incentive Stock Options

• Incentive stock options are subject to their own exception from Section 409A.
  
  • Although most incentive stock options would likely qualify for the general exception from Section 409A for stock options granted at fair market value, incentive stock options are subject to their own exception from Section 409A.

  • In this regard, it is doubly important to preserve their status, and language should be included in the transaction document permitting the adjustment of assumed incentive stock options in a manner that complies with the relevant provisions of the Internal Revenue Code.
Preserving the Status of Incentive Stock Options

- Preserving the status of incentive stock options in an assumption requires compliance with Section 424 of the Internal Revenue Code.

- In being assumed, incentive stock options must meet the requirements under Section 424 in order to preserve their status, which requirements include that the option is assumed by an employer corporation, that the assumed option does not give the holder additional rights and contains all the terms of the original option, and that the aggregate spread of the options is preserved, so long as the exercise price of an option is not otherwise decreased.
Preserving the Status of Incentive Stock Options

- **Accelerating the vesting and/or a cash out of incentive stock options would not preserve tax benefits.**

  - Accelerating the vesting of incentive stock options may have the effect of disqualifying the options if the $100,000 per year limitation on the aggregate fair market value of the stock on which incentive stock options are exercisable for the first time by any individual during any calendar is exceeded.

  - The tax benefits applicable to incentive stock options would not be preserved in a cash out of shares in respect of incentive stock options exercised immediately before the closing of the transaction or in a cash out of incentive stock options.
COMPLIANCE WITH RELEVANT INTERNAL REVENUE CODE PROVISIONS:
Section 280G
Excess Parachute Payments
and Section 280G of the Internal Revenue Code

• Applies to payments made to “disqualified individuals” that are contingent on a change in ownership or control of a corporation, a change in the effective control of a corporation or a change in the ownership of a substantial portion of a corporation’s assets.

  • “Disqualified individuals” include an officer, certain shareholders, or a group of highly-compensated individuals determined pursuant to a formula.

  • Any payment made pursuant to an agreement entered into within one year before a change in control or otherwise is presumed to be contingent on that change in control, i.e., a parachute payment.
Excess Parachute Payments and Section 280G of the Internal Revenue Code

- **Calculating excess parachute payments as a function of base compensation.**
  - An excess parachute payment is the amount by which the parachute payments exceed the average taxable compensation received by an executive from the company during the five preceding years, which is the individual’s base compensation.

- **Lost tax deduction to corporation and excise tax on individual for excess parachute payments equal to or above three times base compensation.**
  - If the excess parachute payments equal or exceed three times the individual’s base compensation, Section 280G provides that no deduction is allowed to a corporation for excess parachute payments, i.e., everything in excess of one times base compensation, and Section 4999 imposes an excise tax on the recipient of any excess parachute payments, equal to 20% of such amount.
Excess Parachute Payments and Section 280G of the Internal Revenue Code

- The cash out of unvested equity awards would generally constitute a parachute payment.
  - A cash out of the unvested equity of a disqualified individual in connection with a transaction would be considered contingent upon a change in control and have the effect of increasing the payments to be received and triggering the excess parachute payment rules.

- Any portion of the cash out payment attributable to vested equity or attributable to the performance of services before the change in control is excluded.
  - Payments in respect of vested equity are excluded.
  - Any portion of the proceeds in respect of unvested equity that is attributable to the performance of services before the change in control is not treated as a parachute payment.
Excess Parachute Payments and Section 280G of the Internal Revenue Code

• Review of pre-closing offer letters providing for future compensation is warranted.

• Shareholder approval exception to the parachute rules for private companies.

  • Generally, where a private company discloses to its shareholders the parachute payments to be made, the affected individuals have waived their rights to a certain portion of the parachute payments and the payments are approved by more than 75% of shareholders, the payments will not be considered parachute payments.
ISSUES TO BE CONSIDERED GOING FORWARD FROM THE TRANSACTION
Issues to be Considered
Going Forward from the Transaction

• Structure of the transaction may undermine retention of employees and talent
  • Consider revising double trigger change in control provisions to restrict an employee’s ability to walk away and collect severance
  • Consider providing “top-up” awards
  • Consider having employees subject their awards to re-vesting

• Effective communication is key
SEC FILINGS AND STOCK EXCHANGE LISTING RULES
SEC Filings and Stock Exchange Listing Rules

• Proxy Statement or Information Statement for Shareholders to Vote on the Transaction

  • Following the signing of a deal, a proxy statement or information statement is prepared by the Seller for its shareholders and includes an Interest of Certain Persons section which discusses the treatment of outstanding equity of directors and executive officers in the deal.

  • In addition, there would be disclosure relating to the treatment of the outstanding equity of the Seller’s named executive officers as part of any disclosure required by Item 401(t) of Regulation S-K under the Securities Exchange Act of 1934.
SEC Filings and Stock Exchange Listing Rules

• Stock Exchange Listing Rules May Require Shareholder Approval in Connection with the Assumption of Equity Plans.

  • Where a Buyer listed on the NYSE or on the NASDAQ intends on assuming a Seller’s plan for purposes of granting future awards under plan, the Buyer needs to obtain approval by its shareholders for the assumption of the plan.

  • However, such shareholder approval would not generally be required if the awards under the assumed plan would not be granted to individuals who were employed by the Buyer at the time of transaction.

  • Shareholder approval is still required to grant incentive stock options under the assumed plan.
SEC Filings and Stock Exchange Listing Rules

Form 3 and Form 4 Filings by Section 16 Officers of the Seller.

- Section 16 officers of the Seller need to make Form 3 and/or Form 4 filings regarding their changes in beneficial ownership of securities in connection with either an assumption or cash out of equity awards in the transaction.

- To be filed within two days after the closing of the transaction.
SEC Filings and Stock Exchange Listing Rules

• Form S-8 Requirements in Connection with the Assumption of Equity Awards.

  • A Buyer that is a public company will generally register the shares underlying assumed equity awards on Form S-8.

  • Timing of filing depends on assumed equity awards, e.g., if only unvested options are assumed, the Form S-8 must be filed prior to the time that an assumed option is exercised.

  • The Buyer must also prepare and distribute to holders of assumed awards a prospectus pursuant to Section 10(a) of the Securities Act of 1933, which summarizes the terms of the applicable plan.
Additional Corporate Governance Considerations

• Insider trading and “blackout period” considerations

• Assumption of outstanding equity awards and plans must be considered in light of:
  
  • General ongoing compliance obligations and “orphan” plan issues
  
  • Ongoing Say-on-Pay and investor relations issues, including potential future analysis by Institutional Shareholder Services (ISS) and Glass Lewis
  
  • Historical grant practices and external views regarding past compensation committee and board practices
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