Ideas to Create Value Within Transformative Events

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Issues to Create Value within Transformative Events

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About Anthony “Tony” Eppert

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- 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

Shrinking Labor Market – Succession Strategy Thought

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- The cost of retaining key employees may increase as the baby boomers continue to exit the workforce
- It is anticipated that a thinning labor market will become the norm even in the face of, or during, an economic downturn
- Consider performing an assessment to determine whether retention gaps exist within the issuer's compensation structure. For example:
  - Consider adding a "retirement" provision within equity award agreements and key employee employment agreements that allow for accelerated vesting (all or some) if the key employee terminates his or her employment due to retirement
  - BUT . . . Require advance notice (e.g., 6 months, 12 months) advance written notice before the key employee can effectuate such retirement
  - Such advance notice could help an issuer with its succession strategies by providing the issuer with time to find and train a successor key employee
  - As another example, consider having "retirement" provisions (with advance notice provisions) within any separation pay packages, BOLI packages, etc.

Designing Competitive Pay Practices

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- To properly conduct an analysis of competitive pay, the Board should:
  - Step 1 – Decide on a compensation philosophy (written or unwritten) that aligns with the interests of the Company’s long-term equity holders, and aligns with the rights of each executive under his or her existing compensation package and executive contract;
  - Step 2 – Collect competitive levels of compensation within the market; and
  - Step 3 – Analyze the collected market data for pay levels and delivery methods
- In developing a compensation philosophy, a first step is to determine whether there is an exit strategy for the corporation or whether the strategy is for the current structure to exist long-term

Develop the Company's Compensation Philosophy

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- How does the Board intend to motivate the Company's executives? Decisions to make include:
  - Should the weighting of the compensation favor short-term or long-term compensation?
  - Should the weighting of the compensation favor cash or equity awards?
  - What percentage of the Company should be allotted towards equity incentives for the executives and key employees? 5%/10%/more?
  - What form of equity or synthetic equity awards should be provided to executives?
  - Are there any 409(p) limitations to the design (applicable if the Company sponsors an Employee Stock Ownership Plan and the Company is an S corporation)
  - In order to help executives behave solely in the interests of the Company's equity holders without regard to their personal financial situation, should the Board provide the executives with downside protection in the event their employment is terminated by the Company without Cause, they quit for Good Reason, or there is a change-in-control of the Company (i.e., severance pay)?

Go-Forward Compensatory Framework

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- After developing a compensation philosophy (whether formal or informal), the Board should then develop a go-forward compensatory framework
  - In order to tie the interests of the executives with the interests of the Company's long-term equity holders, and in order to have compensatory elements that are competitive with market practices, the Board should consider the following for the Company's executives:
    - Annual cash compensation competitive to the [__] percentile;
    - Annual target cash bonus levels competitive to the [__] percentile;
    - Long-term equity awards competitive to the [__] – [__] percentile;
    - Executive contracts that provide for severance pay protection in an amount equal to a [6 months] to [24] months of base salary plus annual target bonus (i.e., 6 months to 12-months depending upon title and position of the executive);
    - Perquisites (*e.g.*, company-owned vehicles, golf memberships);
    - Employee benefits (*e.g.*, 401(k) and medical plan coverage); and
    - Restrictive covenants such as non-compete and non-solicitation provisions (typically 6 months to 18 months, subject to state limitations), confidentiality provisions, invention assignments, and waivers and releases

Key Executive Contract Triggers

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- Addressing the section entitled “Duties”
  - This is a key provision on when or if:
    - The executive can later terminate for Good Reason and receive severance pay, or
    - The company later seeks to terminate the executive’s employment for Cause
  - The purpose of this provision is to address the executive’s title, reporting responsibilities and job description duties
  - The Company has the greatest flexibility if the Duties section is drafted generically (as opposed to highly specific duties), thus providing the Company with flexibility if in the future the executive’s duties need to change
    - Retaining flexibility in favor of the company is particularly important if the employment agreement contains a Good Reason trigger for termination of employment

Key Executive Contract Triggers (cont.)

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- 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 or nolo contendere to any felony or a crime involving dishonesty or moral turpitude or which could reflect poorly on the company,
  - An 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 explanation under Good Reason
- In the new hire situation, modifiers to the above are typically negotiated (e.g., materiality, continued, etc.)

Key Executive Contract Triggers (cont.)

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- [Cause, continued from prior slide]
- Consider defining the term "cause" to include a substantial under-performance (e.g., failure to achieve minimum financial goals for two consecutive fiscal years)
  - Such a provision is not typical and would subject the executive to elements that could be outside his or her control
  - A similar provision that is more veiled could include: (i) the executive failed to comply with the expectations of the Company or (ii) the executive failed to follow the directions of the Board
- Consider adding an after-acquired evidence clause to allow the Board, after a termination of the executive's employment without Cause, to retroactively re-characterize such termination as a termination for Cause. Otherwise, evidence supporting a termination for Cause that is found after the executive's termination would not likely be used to retroactively re-characterize the executive's termination (thus, a payout of severance benefits would likely continue)
  - And from the executive's perspective, if an after-acquired evidence clause is used, then add language to provide that any such use of an after-acquired evidence clause would negate any previously executed waiver and release that was previously signed near the time of the executive's termination of employment

Key Executive Contract Triggers (cont.)

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- A typical definition of Good Reason includes:
  - A material diminution in the executive's base salary or failure by the company to pay 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 as of the Effective Date of this Agreement;
  - The Company requiring the executive to be based at any office or location more than [__] miles from [___________]; or
  - A material breach by the Company of any term or provision of this Agreement

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

Key Executive Contract Triggers (cont.)

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- [Good Reason cont. from prior Slide]
- Should there also be a claims run out period, such that if Good Reason exists, the executive must provide notice within [90] days of such initial existence, otherwise, the claim giving rise to Good Reason is considered waived by the executive
  - The purpose of such a provision is to prevent the executive from “saving” the Good Reason trigger for a rainy day 6 months or a year after-the-fact
  - Consider whether Cause should contain a mirror provision
- And too, should the above 90 day period (or whatever period of days is chosen) be substantially extended in the context of a change-in-control transaction, such that the executive can save the trigger for a later rainy day?
  - Example, once the condition giving rise to Good Reason becomes known to the executive, and if such condition occurs within the 90 day period preceding the change-in-control transaction and the 180 day period immediately following such transaction, then the 90 day period is extended to 365 days such that the executive must trigger Good Reason (if at all) within 365 of the facts giving rise to Good Reason becoming known to the executive
  - The foregoing is related to the last bullet on Slide 13

Structuring Severance Pay

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- Generally, severance pay is only contractually provided if the executive is terminated by the company for Cause or by the executive for Good Reason
  - Severance pay includes accelerated vesting of equity awards
- Consider that severance pay should be “bridge pay” (i.e., a bridge between jobs)
  - Consider whether it makes sense to offset the amount of any future severance pay by the amount of any income the executive earns from his or her new employer, if applicable

Structuring Severance Pay (cont.)

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- Should severance be a multiple of base salary? A multiple of base and bonus?
- Should severance wear-away over time as the executive builds internal wealth due to equity awards?
- Should severance pay be higher in change-in-control situations?
  - What is the policy reason?
- Should severance pay be provided in any of the following situations?
  - Disability
  - Death
  - A failure by the Company to renew the employment agreement

Structuring Severance Pay (cont.)

- Consider designing severance pay in the form of salary continuation (as opposed to lump sum payout)
  - Such allows the Board to hold the "purse strings" necessary to enforce any post-employment restrictive covenants such as non-competes, non-disparagement clauses, etc.
  - Should salary continuation stop to the extent the executive found a replacement job?
- Require that the executive execute a waiver and release of all known and unknown claims as a condition precedent to receiving severance pay
  - A form of such release should be attached to the executive contract as an exhibit (*i.e.*, ". . ., substantially in the form attached hereto as Exhibit A.")

Structuring Severance Pay (cont.)

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- Should severance pay in the change-in-control situation be double trigger or single trigger?
  - Single trigger = change-in-control alone triggers payout
  - Double trigger = change-in-control and a termination of employment for Good Reason or without Cause is required
    - A related thought is whether there should be a post-change-in-control protection period? Idea being that after a certain amount of time (*e.g.*, 1 year), any termination is likely the result of the executive and less the result of the change-in-control, and so related severance protection should end abruptly or phase out over time

CIC Sought: Retention Objectives

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- An effective retention tool should address one or both of the following:
  - To provide employees with termination protection (*i.e.*, reducing personal risk due to a CIC maximizes value to the employer), and/or
  - Provide employees with prospective financial upside for remaining employed with the employer through consummation of the CIC
- Additionally, the retention strategy should be aligned with the interests of the employer's shareholders
  - Ensure continuity of key employees pending consummation of the transaction (or during a transition period following the close of the transaction)
  - Ensure impartiality and objectivity of key members of management during the transaction process by mitigating the consequences of potential job loss (i.e., reduce personal risk)
  - If applicable, designed to maximize the realization of any earnout/holdback payment to shareholders (i.e., a CIC bonus that is designed to maximize the efforts of certain key employees after the sale transaction in order to preserve the value and payout of any earnout or holdback to shareholders)

CIC Sought: Retention Alternatives

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- Stay bonuses typically provide for a cash payment upon completion of a specified period of service or closing of a subsequent transaction
  - Typically provide full or partial payment in event the employee is terminated by the employer without Cause or by the employee for Good Reason within x months of the CIC
  - Stay bonuses could also provide a performance-based element, such as ultimate success of the deal (*e.g.*, the size of the deal) or the satisfaction of other performance criteria such as attaining EBITDA goals
  - Stay bonuses could also be in the form of restricted stock units ("*RSUs*") that similarly could have time or performance-based vesting

- Severance pay typically provides a payout if the employee is terminated by the employer after the transaction without Cause or by the employee for Good Reason
  - What should be the amount?
  - Consider having the benefit expire after [__] months following the transaction

CIC Sought: Retention Alternatives (cont.)

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- Change-in-control agreements
  - Provide various types of payments of cash or equity upon a CIC (*e.g.*, accelerated vesting upon a CIC, enhanced severance benefits upon a termination after a CIC, etc.)
- Consider whether to implement a springing employment agreement that becomes effective upon the closing of the CIC
- Consider certain post-closing incentives such as 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)

Change-in-Control Bonus Program

- The following slides address the design choices associated with change-in-control bonus programs

Pointer No. 1 – Preliminary Considerations

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- 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 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 that otherwise could be paid to 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 should be 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

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- Determining which key employees should receive an award depends upon highly specific facts. Typical thoughts to consider include:
  - 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 stockholder value?
  - Will any of the key employees be necessary to transition with the Company to a buyer?
  - Assuming there is contingent consideration in the CIC Transaction (*e.g.*, earn-out), are any of the key employees likely to have an ability to increase the value of such contingent consideration?

Pointer No. 3 – Determine Type of Funding Trigger

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- What types of transactions should trigger payouts? 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 when 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?
- Consummation of a merger or consolidation in which the Company is not the surviving entity
  - 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?
  - Note: Considering the monetization of intellectual property rights as a funding trigger is often a missed issue

Pointer No. 4 – Determine Value of the Award

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- 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 management carve-out bonus be reduced by payments the key employee receives with respect to his/her common shares?
- Determine individual awards 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
- Create a pool (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 employees 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 plan 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 to participate in the pool
  - As a result, the Company would be unlikely to divide the pool into percentages and award those percentages
  - 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 consummating the CIC Transaction
    - **F =** The number of Units held by the Key Employee

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

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- 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 = or is less than $15mm, then the pool = $1mm
  - But if the CIC Transaction proceeds is less than $40mm but greater than $15mm, then the pool = $3mm
  - And if the CIC Transaction proceeds = or exceeds $40mm, then the pool = $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 management carve-outs or change-in-control bonus plans share equally (vis-à-vis the stockholders) in the costs of the CIC Transaction?
  - Example: 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

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- 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 management carve-out or change-in-control bonus plan is for the key employee to be present upon a CIC Transaction
  - 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 employee
  - 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 employee 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, then the Waiver and Release could be signed at closing of the CIC Transaction without regard to the 45-day/7-day requirements

Pointer No. 6 – Form and Timing of Payment

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- 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% buyer stock and 30% cash
- Unless the consideration 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 – Taxation

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- All ordinary taxable income to the key employee
- 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 in 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 (*e.g.*, short-term deferral rule), or comply with, Section 409A

Pointer No. 8 – Ability to Amend or Terminate Contract

- After the management carve-out or change-in-control bonus is distributed to a key employee, should the Company have the ability to amend or terminate such plan without the consent of the key employee?

- During the time period prior to 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 management carve-out or change-in-control bonus plan automatically terminates
  - Should the award terminate upon the earlier of an IPO or a 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 stockholders who sold in the CIC Transaction

Pointer No. 9 – Ensure Compliance with 409(p)

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- This Slide assumes the Company sponsors an ESOP and is an S corporation
- As a gross over-simplification, Section 409(p) applies to S corporation ESOPs and is designed to prevent "disqualified persons" from owning (in the aggregate, and determined on both an actual and synthetic basis) 50% or more of the S corporation's stock
- If the corporation has a valid S election, then compliance with 409(p) is important, otherwise:
  - The ESOP loses its exemption from the unrelated business income tax rules, and
  - Excise taxes may apply

Pointer No. 10 – Set Up 280G Mitigation in Advance

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- Even where mitigation techniques are employed, it continues to be a problem where a buyer will use 280G negotiation as leverage for decreasing payouts to a target's executive(s), resulting in the buyer having a lower cash outlay at closing (or more cash on hand at closing)
- This often results in an indirect downward adjustment to the purchase price
- From the perspective of the target Company, one way to defend against this happening is to require within the executive contract that any parachute payment be determined by a tax advisor hired by the Company prior to consummation of the change-in-control transaction. And too, perhaps require mutual consent of the target Company and the executive