BankDirector

Lunch & Learn Session 4:
Sharing in the Dream: How to Structure Executive Compensation to Facilitate an M&A Event

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How to Create and Capture Wealth for Executives in an M&A Event

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Key Principles for Corporate Transaction-Related Compensation Design

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Shareholder Alignment

- Enable management to proactively seek, evaluate and execute corporate transactions that are in the best interest of shareholders
- Eliminate self-interest and promote objectivity and independence in decision making

Motivation

- While transaction is pending, ensure management remains focused and continues to deliver results to preserve and grow the value of the business
- Deliver to an acquirer "bargained and paid for" value at closing
- Critical to the company if transaction does not close

Talent Retention

- Retain key employees who are critical to success of overall transaction, interim transition and subsequent integration

Stability, Motivation, Retention = Successful Operations, Merger & Combined Company

Executive Contract Considerations

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- Duties section
  - 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
  - Addresses the executive's title, reporting responsibilities and job description/duties
  - Have the executive report to a position instead of a person
  - The Company has more flexibility f the duties section is drafted generically as opposed to specifically (*i.e.*, if later the executive's duties need to be changed)
    - Particularly important if the contract contains a Good Reason provision

Executive Contract Considerations (cont.)

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- Definition of “Cause” frequently includes:
  - A material breach of the executive’s obligations under the contract;
  - A willful or continuing failure to follow orders or perform duties;
  - A conviction or plea of no contest to a felony or a crime involving dishonesty or moral turpitude or which could reflect poorly on the Company;
    - This ties to banking statutes that likely will require termination of executive’s employment
  - Engaging in misconduct, negligence, etc. that is injurious to the Company;
  - A material breach of a written policy of the Company; and
  - Any other misconduct by the executive that is injurious to the financial condition of the Company or its reputation

- Consider the Company’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.)

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- Definition of “Good Reason” typically 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 in effect when the contract is effective;
  - The Company requiring the executive to relocate place of employment; or
  - A material breach by the Company of the contract.
    - A provision that a material breach includes failure of the Company to have a successor assume the obligations of the Company under the contract upon a change in control may provide significant leverage to the executive
- It is favorable to the Company to require both a notice and cure period before Good Reason can be triggered by the executive
  - Consider whether it is also fair to apply a mirror notice and cure provision with respect to Cause
- Consider a “claims run out” period, such that if a Good Reason occurs, the executive must provide notice within a period of time or the claim of Good Reason is waived
  - No saving a Good Reason claim for a rainy day
  - Consider whether Cause should contain a similar provision

Severance Pay

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- Typically triggered upon termination by the Company without Cause or by the executive for Good Reason
- Consider whether severance pay should be "bridge pay"
  - Act as a "bridge" between jobs
  - In the change in control context, severance pay encourages the executive to race towards executive's job elimination (and thus aligns with shareholder value)
  - Should the multiple of severance pay be higher in a change in control?
- Consider designing severance pay to take the form of salary continuation (and not a lump sum payout)
  - This allows the Company to potentially enforce restrictive covenants such as non-competes, non-disparagement, etc.

Severance Pay (cont.)

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- Require the executive to sign a waiver and release of all known and unknown claims as a condition to receiving any severance pay
  - Consider attaching the waiver and release as an exhibit to the contract
- Should severance pay wear away as wealth accumulation builds?
- Should any change in control payment 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)?

Change in Control Payment "Best Practices"

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- Cash severance no higher than 3.0x the sum of base salary and bonus (typically defined as target bonus or an average of two-to-three prior years' actual bonuses)
- "Double-trigger" severance and equity vesting acceleration (*i.e.*, benefits are only provided if: (1) the transaction is completed, and (2) there is an involuntary termination of employment)
  - For equity vesting acceleration, the second trigger may also be that the acquirer chooses not to assume, convert, or replace outstanding awards on an economically equivalent basis
    - But consider, how will the Company's shareholders get the benefit of "no second trigger"?
- Cash severance multiple applied to base salary and annual bonus only (*i.e.*, long-term incentives are not included)
- No excise tax gross-up

Other Terms

- Require an executive’s automatic resignation from the board and all committees upon termination of employment
- Include a survivability provision so that payment terms and restrictive covenants, for example, survive the termination of the contract
- Consider whether to contractually toll the restrictive covenants while the executive violates them (if permissible under state law)
  - Absent equitable tolling or contractual tolling, it may be difficult for the Company to enforce a shorter
- Consider a clawback provision (which may be required under applicable banking laws)
- Consider a “springing” contract that becomes effective only upon completion of a change in control

Equity Plan Considerations Before a Change in Control

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- Does the equity plan permit net exercises of stock options in addition to cash-out of stock options? If not, consider adding a net exercise feature to the change in control section of the plan
  - Implementing a net exercise feature with respect to ISOs within a change in control transaction (*i.e.*, in lieu of a cash out feature) may save money for both the Company the employees
  - And depending upon the structure of the equity 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

Equity Plan Considerations Before a Change in Control (cont.)

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- Consider whether to add a Skype-type provision that would, immediately before the change in control, allow the Company to repurchase stock held by former employee optionees at the exercise price
  - This would apply only to former employees who previously terminated employment and exercised in conjunction with the change in control transaction
  - Should the former employees be permitted to benefit even though they previously "jumped ship"?
  - Shouldn't the employees be treated comparable to shareholders by requiring them to be "present to win"?
- 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.)

Common CIC Provisions – Top 200 Companies

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Practices have evolved over the past few years…

CIC Provision(s)	2013/2014	2021/2022
CEO Severance Multiple	• ≥2 and <3: 43% • ≥3: 42% • CEO Average: 2.5x	• ≥2 and <3: 48% • ≥3: 33% • CEO Average: 2.3x
Definition: Salary plus _____ Bonus	• Target: 51% • Actual/Avg.: 21% • Higher of: 28%	• Target: 63% • Actual/Avg.: 18% • Higher of: 22%
Equity Vesting Trigger	• Double: 63% • Single: 85%	• Double: 97% • Single: 20%
Excise Tax Gross-Up Treatment	• Gross-Up: 30% • Cut Back: 5% • Best Net: 27% • None: 38%	• Gross-Up: 5% • Cut Back: 3% • Best Net: 31% • None: 60%

Source: Alvarez & Marsal 2013/14 and 2021/22 Executive Change in Control Reports with Equilar

Golden Parachutes - Background

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- 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
  - Disqualified individuals include directors, officers, 1%+ stockholders
- 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
- 280G does not apply to S corporations (or corporations eligible to elect S corporation status)

Golden Parachutes (Continued)

- What amounts are included?
  - Change in Control payments
  - Stay Pay/Stay Put payments
  - Non-Standard Severance pay
  - Continuation of benefits post-closing
  - SERPs and Salary Continuation Plans
  - Vesting of unvested amounts
  - Deferred compensation
  - Stock options
  - Payments made or agreements entered into within 12 months preceding the change in control (rebuttable presumption)

Golden Parachutes – Mitigation Techniques

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- Alternative No. 1 – Do nothing
  - Deduction would be disallowed and the executive would be subject to an excise tax
- Alternative No. 2 – Allow for the payment but provide the executive 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
  - Not ideal for an executive who would be financially better off paying the excise tax
  - Conversely, a cutback could be beneficial to an executive 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.)

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- Alternative No. 4 – Implement a hybrid cutback whereby the executive receives the greater of a 2.99x cutback or payment of the excess parachute payment with the 20% excise tax
  - This is 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, the payment will not exceed a certain dollar amount
- Alternative No. 6 – Obtain stockholder approval (applicable only to privately-held corporations):
  - The executive must irrevocably waive the right to the parachute payment that exceeds 2.99x executive's 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 (excluding the executive); and
  - Adequate disclosure to the stockholders must be made of all material facts.
- 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 can't apply to the condition of receiving stockholder approval due to the disclaimer requirement)

Golden Parachutes – Mitigation Techniques (cont.)

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- Alternative No. 8 – In the year preceding the year in which the change in control occurs, increase the executive's base amount in order to increase the 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.)

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- 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
    - Note the Biden administrations recent actions regarding enforceability of non-competes

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 any 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 the 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 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 before the merger
- Sale of all or substantially all of the Company's assets

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 employees participate in any earn-out dollars? To state the opposite, is the value reduced by any earn-outs or holdbacks?
- 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.)

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- 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

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 = 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 change-in-control bonus plans share equally (with 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?

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 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 <u>after</u> the CIC Transaction and <u>before</u> 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, if the Waiver and Release includes claims with respect to age discrimination, then 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
  - If age discrimination alims are not included, then the Waiver and Release can 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 (subject to Section 409A considerations)
  - 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
- 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 change-in-control bonus is distributed to a key employee, should the Company have the ability to amend or terminate the plan without the consent of the key employee?
- Before 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 plan automatically terminates
  - Should the award terminate upon an IPO?
- 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

Questions?

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Lunch & Learn Session 4:
Sharing in the Dream: How to Structure Executive Compensation to Facilitate an M&A Event

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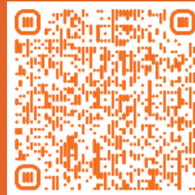

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