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Treatment of Employee Equity Awards in Corporate Mergers and Acquisitions

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In this article, the authors explain that treatment of employee equity awards in the context of corporate transactions can raise complex issues involving business considerations and multiple areas of law. The authors conclude that careful structuring is required in order to ensure legal compliance and the achievement of the parties' intended business goals.

Treatment of equity awards in the context of any acquisition involves careful diligence and structuring in order to ensure the achievement of the parties' intended goals and to avoid adverse tax consequence and noncompliance with various laws. Parties have to carefully consider tax and securities law consequences, in addition to business goals (such as employee retention and morale) and

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contractual commitments. This article addresses some of the common issues that arise in respect of employee equity awards in the context of corporate transactions. Given the complexity of equity awards and the related issues, careful consideration must be given to all potential issues on a transaction-by-transaction basis.

DILIGENCE

Diligence of equity awards requires both buyer and target to be aware of the types of outstanding equity awards and to consider what must or may occur as a result of the transaction. Parties should review the equity plan, award agreements, employment agreements and any change in control severance arrangements to ascertain whether the transaction constitutes a change in control within the meaning of the applicable documents, and what treatment is permissible or required by these documents as a result of the transaction. This can occasionally involve significant complexity, or ambiguity if the award documents are not well drafted.

Additionally, care must be taken to ensure that both the buyer's and target's equity plans and awards are diligenced as, while not common, transactions have been arisen that result in a change in control for both the buyer's and target's plans (i.e., when a buyer plan has a less than 50 percent threshold and there is a merger of equals).

Most equity plans are structured to provide the plan administrator broad authority to take any necessary actions so that the most typical approaches to treatment of equity are usually permissible, absent other considerations or limitations.

TYPES OF EQUITY AWARDS

The most typical forms of equity awards are stock options, stock appreciation rights, restricted stock units ("RSUs"), restricted stock and, in the context of a partnership, profits interests. These awards usually are subject to service or performance-based vesting criteria, which, if they are not satisfied, result in the forfeiture of the award. Performance-based vesting criteria can require satisfaction of individual or corporate goals, and are often structured with a target number of awards that can be earned upon achievement of target-level performance, and a threshold below which nothing is earned, and a maximum number (e.g., 200 percent or 300 percent of target) that can be earned with achievement of exceptional performance. Although any employee equity award can be subject to performance-based vesting criteria, the most common form is performance stock units.

TREATMENT OF EQUITY

In a stock sale, where the buyer is purchasing the target as a whole, equity awards are usually either cashed out or rolled over.

Cash Out

The parties may agree to, or the applicable documents may require, that all or a portion of outstanding awards are cashed out in connection with the transaction, which entitles the holder to receive the cash intrinsic value of his/her award (i.e., the excess of the per share deal consideration over any exercise price). Consideration is typically in the form of cash, but may also be in the form of buyer equity, or a mix of both. In a cash out, equity award holders are typically treated the same as regular shareholders (i.e., as if they hold the underlying shares).

Private Company Transactions

When the buyer is a private company buying a public company, a cash out is the most common treatment of equity awards. Equity awards are granted with the intention that recipients will have the opportunity to liquidate the equity, which for a private company is almost always not an alternative prior to a sale of the company or initial public offering ("IPO") due to the illiquid nature of private company securities.

When the buyer is a private company buying a private company, a cash out is often required under the terms of the target's equity awards, usually for the same considerations enumerated above. If it is not, private company buyers will search for strategies to roll over the target company's equity awards (which are discussed in more detail below). For private equity buyers, often the goal is to do so in a manner that prevents undue dilution. In any event, senior management are often expected to roll over some of their equity awards, other equity interest or deal proceeds in order to align their ongoing interests with the company's future success.

As an alternative applicable to both public and private targets that combines elements of both a cash out and rollover, the buyer may negotiate for the target equity awards to be converted into cash awards based upon the value of the stock underlying the target's equity awards, and subject to the same vesting schedule, which provides the target employee with liquidity and the buyer with continued retentive value while preventing dilution.[1] This, of course, is only attractive if the buyer has sufficient cash to fund the

awards. Occasionally a buyer can negotiate a provision in the purchase agreement requiring the target to fund these awards, sometimes accompanied by a mechanism by which any forfeited portion is returned to the target shareholders.

Public Company Transactions

In a deal between two public companies, a full cash out is generally considered aggressive since it results in the buyer losing the retention and incentive value of the target company's equity awards. The buyer may then have the additional cost of funding new equity arrangements after the closing to incentivize and retain employees. Nevertheless, a public company buyer may agree to a cash out of awards for numerous reasons – the governing documents (the applicable award agreement, an employment agreement or arrangement, or some sort of change-in-control plan) may provide for acceleration of the unvested equity awards in connection with the transaction, the target's equity awards may be incompatible with the buyer's incentive arrangements or the buyer may simply agree in order to make its offer more attractive in a competitive process. In the event a cash out is required by the governing documents, this is typically respected, although occasionally a buyer may attempt to obtain a waiver of the requirement to accelerate vesting in connection with the transaction and to retain the original vesting schedule, usually by offering some increased incentive opportunity.

Cancellation of Underwater Options

Underwater options are typically cancelled for no consideration. The plan documents must be carefully reviewed to ensure a cash out and cancellation of stock options is permissible, since courts applying normal rules of contract interpretation to ambiguous plan language have found that option holders may be entitled to some value for out of the money options.[2] If the plan language is ambiguous, the parties will have to consider whether to bear the litigation risk or to attempt to mitigate by seeking the holders' consent.

Treatment of Performance-Vesting Conditions

If the awards being cashed out are subject to performance-vesting conditions, the applicable level of performance will need to be determined by the parties. The applicable award documents must be reviewed to determine whether any particular level is required. For example, the awards could be settled assuming maximum or target level performance, or the awards could be settled based upon actual

performance measured as of the closing. If awards are silent as to deemed performance in a change of control, then the plan administrator usually would have discretion under the applicable plan documents to determine deemed achievement and care must be given to reviewing the "authorities" and "adjustments" sections of the applicable equity plan.

Certain Tax Considerations

A cash out is a taxable event, so the purchase agreement should specify that the funds for employees' cashed out equity awards are run through payroll. Any funds paid to award holders who are directors and independent contractors are usually also run through payroll to ensure proper 1099 tax reporting but theoretically could be paid via a paying/transfer agent. The purchase agreement is typically drafted to provide for the cash payment to be net of any applicable exercise price or withholding taxes. Since a cash out is not deemed to be the exercise of an option followed by the sale of the share issued in settlement, the cash out of incentive stock options ("ISOs") results in the award holder's obligation to pay social security taxes and the company to withhold, unless the parties agree to the exercise and settlement of the ISOs prior to the closing.[3]

Certain Section 409A Considerations

Equity awards need to be examined to determine if they are structured as non-qualified deferred compensation ("NQDC") subject to Section 409A ("Section 409A") of the Internal Revenue Code[4] (the "Code"). The most typical example would be fully vested RSUs that are scheduled to settle more than two-and-one-half months following the year in which they vest.[5] Such RSUs can be subject to accelerated vesting, but generally must be settled in accordance with the original schedule, although careful planning may result in a permissible accelerated payment. A "change in control" is a permissible payment event under Section 409A, so RSUs that are NQDC could vest and be cashed out if the transaction constitutes a "change in control event" within the meaning of Section 409A and is a payment event under the applicable award agreement.[6] However not every change in control transaction constitutes a "change in control event" under Section 409A, so legal guidance should be sought to confirm all the requirements are met prior to accelerating settlement and payout for any RSUs that constitute NQDC.[7]

Subjecting cash out proceeds to a typical "earn-out" or "holdback" applicable to shareholders generally that is completed within five years is usually permissible.[8]

Rollover/Substitution

The parties may agree to roll over the target awards into buyer awards of equivalent value, usually of the same type and subject to the same vesting conditions but in respect of buyer equity. This can be done by the buyer either assuming the target awards (and target equity plan) or by substituting new awards in respect of buyer equity in replacement of the old target awards under the buyer's plan. For public companies, assuming both the awards and plan of the target is the more common approach as this allows the buyer to avoid seeking shareholder approval for new equity awards for a longer period, since under both the New York Stock Exchange ("NYSE") or National Association of Securities Dealers Automated Quotations ("NASDAQ") listing rules, the shares issued in settlement of the assumed awards do not need to count against the buyer plan's share reserve.[9] Additionally, assuming the target's equity plan allows a public buyer to assume the unused shares under the target plans and grant future awards to either new employees post-closing or historic employees of the target (but not to pre-closing employees of buyer).

Private Company Transactions

This alternative is less common with a private buyer, as noted above, since many employees receive illiquid private company equity with the goal of remaining with the target at least through a sale or IPO so that they can liquidate their awards. Senior management in private equity deals, however, are often expected to roll over some of their proceeds in order to align their interests with the post-acquisition success of the company. A typical formulation would require the executives to roll over between 25 percent to 50 percent of the value of their equity awards (or all aggregate proceeds from all equity held by an executive) on an after-tax basis in the buyer's equity, which often is subject to forfeiture or repurchase at less than fair market value upon certain terminations of employment. The executives would also usually participate in the buyer's new incentive plan, which often represents 10 percent of the buyer's fully diluted equity, with about 70 percent to 80 percent allocated at the closing of the transaction.[10]

Careful consideration should be given to the tax consequences of a rollover so that the parties can achieve their goals in a tax efficient manner.

Public Company Transactions

If the buyer is a public company, the buyer often prefers a rollover/substitution to a cash out because it prevents the target's employees

from receiving a windfall payout and permits the buyer to leverage the retention and possibly performance incentives of the outstanding unvested awards.[11] The provisions in the plan and related awards must be reviewed to determine if a rollover is permissible. It is also becoming more common to cash out vested awards and rollover/substitute unvested awards as this serves to preserve the retentive value of unvested awards while not causing too much dilution to buyer stock. This is also common where shareholders in the deal are receiving cash but a buyer wants to preserve retentive value of unvested awards.

Certain Drafting Considerations

For a rollover there is some complexity in drafting the applicable purchase agreement provisions that govern the treatment of equity in order to preserve the value of the awards and, in the case of options and SARs, their intrinsic value and to comply with Section 409A.[12] Typically, the awards are rolled over based upon an "exchange ratio," which is a way of calculating the relative value of the buyer and target shares and is generally the ratio that is the quotient produced by dividing the per share value of the buyer shares by the per share value of the target shares. The method of deriving the per share value can vary depending on the type of consideration received by the target's regular shareholders. For example, if the regular target shareholders of a public company are receiving stock (or a mix of cash and stock) of a public-company buyer in the transaction, the per share value used for the exchange ratio is often based upon the average weighted trading price for some period prior to the closing. For a private company target, the parties will often need to determine whether to include the shares underlying the rolled over awards in calculating the fully diluted shares used to determine the target per share value, with the buyer favoring inclusion, since that will result in a lower per share value.

Permitted Adjustment to Shares/Exercise Price

Practitioners need to be mindful of compliance with the requirements of the Code in rolling over options and SARs. If target options are structured as ISOs, the Code sets out very specific requirements that must be met in order for the rolled over options to continue to be eligible for favorable ISO tax treatment, that include (i) the new option cannot provide additional benefits not provided for under the prior option; (ii) the new option must be granted by the employer or a related entity;[13] and (iii) the adjustment of the number of shares and exercise price must meet both the spread and

ratio tests (i.e., the aggregate spread of the new option cannot be greater than that of the old option, and the share-by-share ratio of the exercise price to the fair market value per share of the new option cannot be less than the old option) (the "ISO Tests").[14] Using the exchange ratio approach outlined above complies with the ISO Tests.

Section 409A provides additional flexibility to make permissible adjustments to rolled over options and SARs that are not ISOs by permitting the option or SAR to relate to service recipient stock (or stock of a related corporation), as opposed to that of the employer.[15] It also permits the ratio test to be satisfied if the ratio of the exercise price to the fair market value of the stock is no greater than the ratio of the old options.[16] Effectively, this permits the adjustment of the options so that the number of shares remains the same, but adjusting the exercise price so that the aggregate spread value is retained, and could result in the options and SARs being more "in-the-money" since the exercise price could be adjusted downward.

The most common method used to making adjustments is to satisfy the ISO Tests, but the exchange ratio test outlined above could be used, for example, to prevent potential dilution by adjusting the options or SARs so that the number of shares underlying the awards does not increase as a result of the transaction. This has become very typical in private equity transactions.

Additional Adjustment Considerations

If any of the equity awards are subject to performance vesting conditions, the parties will have to determine how those will be treated in the transaction. The first step here, of course, is to review the applicable award documents to determine if any particular treatment is required. If it is not, the parties need to determine if the performance vesting conditions will remain in effect; quite often, however, the target performance conditions are not easily integrated into the buyer's business approach. As a result, the parties often agree to deem performance conditions satisfied at some performance level, such a maximum or target performance, or actual performance determined as of closing, so that rolled over awards are only subject to service-based vesting going forward. Targets will often take an aggressive position and propose using maximum performance, arguing that employees should not lose the opportunity to earn the maximum number of awards. Unsurprisingly, buyers will typically propose using target or actual performance (depending, in part, how performance is trending as of signing), arguing that maximum performance results in an undue windfall for the employees without achieving the required

performance conditions, and that target or actual performance is more fundamentally fair to both parties since it represents either the average expected achievable performance (in the case of target) or rewards actual performance through the date of closing (in the case of actual).

Most often, all other conditions of the equity awards, other than adjustments to the number of underlying shares, exercise price and performance-based vesting conditions described above, remain intact following the rollover. Any other adjustments should be carefully analyzed to ensure they comply with applicable laws.

CERTAIN SECURITIES LAWS CONSIDERATIONS

Form S-8

In the event of a rollover where a public company buyer assumes the awards and target's equity plan, the buyer may need to file a registration statement on Form S-8 with the Securities and Exchange Commission, and prepare the related Section 10(a) prospectus required under part 1 of Form S-8 to deliver to participants, unless an exemption applies.[17]

Section 16 of the Securities Exchange Act of 1934

The parties should consider the applicability of Section 16 of the Securities Exchange Act of 1934 ("Section 16") to the treatment of equity in the transaction. Section 16 requires "insiders" (generally officers, directors and 10 percent shareholders) to disgorge profits realized from the purchase and sale of issuer securities within a six-month period unless an exemption applies.[18] Absent an exemption, Section 16 liability could arise for a Section 16 insider of a public target company who receives value for equity awards in a transaction that is matched to an acquisition of target company equity awards within six months prior to the transaction, or for a person who becomes a Section 16 insider who receives buyer equity awards which are matched with a disposition within six months.

In such a scenario the target and buyer, as applicable, will usually avail themselves of the "advance approval" exemption that exempts dispositions to the directors or officers if the disposition was previously approved by issuer's board of directors or a committee consisting of at least two non-employee directors or a majority of the issuer's shareholders.[19] Any resolutions or consents adopted to exempt these

transactions should be drafted with sufficient specificity and typically include the name of each insider and the number and type of each security, with at least a direct reference to the appropriate sections of the purchase agreement governing the treatment of equity.

Shareholder Vote

If the purchaser is a publicly listed company on the New York Stock Exchange or NASDAQ, the parties must determine whether the applicable exchange rules require shareholder approval of the rolled over award. Generally, shares reserved for issuance under a pre-existing target plan that has been approved by the target's shareholders will not require additional shareholder approval and can be used for post-transaction grants in respect of the purchaser's equity under the assumed plan or another plan, subject to certain exemptions including that the shares can only be used for target employees who transferred to the buyer or new hires.[20]

Disclosure

If a public company party to a transaction is required to solicit a shareholder vote to approve the transaction, it is required to disclose the interests of the directors and executive officers in the transaction, which typically involves describing the impact of the transaction on equity awards held by such individuals.[21] In addition, the applicable rules require such companies to solicit a non-binding shareholder advisory vote on potential "parachute payments" to the buyer's and target's named executive officers, which involves both tabular and narrative disclosure of such arrangements.[22] Parties to a transaction will want to consider how these disclosures will be received by shareholders, in particular by shareholder proxy advisory firms such as Institutional Shareholder Services and Glass Lewis. These firms will base their recommendation to approve a transaction in part upon whether insiders (such as officers and directors) are disproportionately and inappropriately benefitting from the transaction in a manner that may have influenced their decision to support the transaction, and their analysis will be based in part upon this disclosure.[23]

SECTIONS 280G AND 4999 OF THE CODE

Sections 280G ("Section 280G") of the Code and 4999 ("Section 4999") of the Code impose adverse tax consequences on certain

executives and employers if certain payments or benefits made to certain individual employees are deemed to be contingent upon a change in ownership or control as provided in Section 280G (i.e., "parachute payments") and the value of such payments or benefits equals or exceeds three times the individual "base amount" (i.e. the individual's average annual compensation with the company during the most recent five tax years).[24] These parachute payments include accelerated vesting of any equity awards, as well as severance payments and other benefits the employee would be entitled to receive upon your termination of employment and certain transaction-related bonuses, among other payments. Section 4999 imposes a 20 percent excise tax on the value of such payments or benefits that exceed the base amount, and the company is denied a corresponding deduction under Section 280G.[25]

For companies that are not publicly traded, Section 280G allows all such payments to be exempt from the penalties of Sections 280G and 4999 if the employee waives the right to receive or retain that portion of the potential parachute payments that would be equal to or exceed three times the "base amount", and notwithstanding such waiver, such payments are approved by 75% of the voting power of the outstanding stock of the company.[26]

Public companies that cannot avail themselves of the shareholder vote exemption must consider mitigation strategies to reduce or eliminate to adverse tax consequences of Sections 280G and 4999. With respect to equity awards that are accelerated as a result of the transaction, Section 280G prescribes a method to value the acceleration of equity awards that are subject solely to service-based vesting by calculating the amount by which the payment exceeds the present value of the equity award plus a certain amount for the lapse of the requirement to provide continued service.[27] Generally, equity awards that are also subject to performance-based vesting that accelerate in connection with the transaction are calculated at full value.[28]

If the closing of the transaction is expected to occur in a subsequent year, impacted employees could choose to exercise vested options. Any gain between the exercise and stock price realized upon exercise would then be included as part of the employee's compensation for that year, which in turn would increase the employee's base amount and Section 280G "three-times base amount" threshold.

This article, however, is not intended to provide a comprehensive analysis of Section 280G, which is very complex, and the reader should refer to other articles for an in-depth analysis.[29]

CONCLUSION

Treatment of employee equity awards in the context of corporate transactions can raise complex issues involving business considerations and multiple areas of law. Careful structuring is required in order to ensure legal compliance and the achievement of the parties' intended business goals.

NOTES

1. Careful consideration of Section 409A compliance should be given in the event the parties wish to extend the vesting schedule beyond the original vesting schedule (*see* Treas. Reg. §1.409A-3(i)(5)(iv)(B)) or to roll over unvested options or SARs into cash awards that vest on the original schedule (although the conservative view is that this is impermissible under Section 409A (*See* Treas. Reg. §1.409A-1(b)(5)(v)(C)(1)). *See also* Regina Olshan and Erica F. Schohn, Section 409A Handbook §§ 17.IV.B-C, V.A.2 (3d ed. 2021), BNA. Occasionally this alternative may be attractive to a public company buyer as well in the event a rollover of target equity award's into awards in respect of buyer equity.

2. *See AT&T Corp. v. Lillis*, 953 A.2d 241 (Del. 2008).

3. *See* 26 U.S.C. § 422. Although the issue of ISOs and net exercise is subject to some debate, the view of some practitioners is that the use of net exercise for an ISO disqualifies the entire award from preferential tax treatment (i.e., tendering the option in exchange for stock equal to its value will produce the same result as a nonqualified stock option).

4. *See* 26 U.S.C. § 409A.

5. *See* 26 U.S.C. § 409A(a). Options and stock appreciation rights (or "SARs") are exempt from 409A if properly structured. *Id*.

6. *Id*.

7. *See* Treas. Reg. §1.409A-3(i)(5)(v)(A).

8. *See* Treas. Reg. §1.409A-3(i)(5). This is only permissible for a transaction in which either 50 percent of the target's vote or value or a substantial portion of the target's assets are acquired. Treas. Reg. §1.409A-3(i)(5)(v).

9. *See* NYSE Rule 303A.08; and NASDAQ Rule 5635, and IM-5635-1.

10. Lower-level management may participate in a phantom equity plan in order (or in part) to prevent additional dilution.

11. A target with a significant number of options that are underwater may also prefer a rollover to a cash out with the goal of realizing some value from the converted options.

12. *See* discussion in Permitted Adjustment to Shares/Exercise Price below.

13. *See* 26 C.F.R. § 1.424-1(a)(2) and (5).

14. *See* 26 C.F.R. § 1.424-1(a)(5)(ii) and (iii).

15. *See* Treas. Reg. §1.409A-1(b)(5)(v)(D).

16. *Id*.

17. *See* 15 U.S.C. § 78m.

18. *See* 15 U.S.C. § 78p(b).

19. *See* 17 C.F.R. § 240.16b-3(e). *See also* Skadden, Arps, Slate, Meagher & Flom LLP, SEC No-Action Letter, 1999 WL 11540 (Jan. 12, 1999); and *Gryl v. Shire Pharmaceuticals Group, PLC*, 298 F. 3d 136 (2d Cir. 2002).

20. *See* NYSE Rule 303A.08; and NASDAQ Rule 5635, IM 5635-1.

21. *See* 17 CFR § 240.14a-101, item 5.

22. *See* 17 CFR § 229.402(t).

23. *See* Inst. Shareholder Serv., U.S. Proxy Voting Guidelines Benchmark Policy Recommendations, 38 (Dec. 13, 2021); and Glass Lewis, 2022 Policy Guidelines – U.S., 49 (2022).

24. *See* 26 U.S.C. § 280G.

25. *See* 26 U.S.C. § 4999.

26. *See* 26 U.S.C. § 280G(b)(5); and 26 C.F.R. §1.280G-1, Q&A 6-7.

27. *See* 26 C.F.R. § 1.280G-1, Q&A 24(c)(2).

28. *See* 26 C.F.R. § 1.280G-1, Q&A 24(d)(3).

29. *See, e.g.*, Matthew M. Friestedt & J. Michael Snypes, Jr., Section 280G: The Law and Lore of the Golden Parachute Excise Tax, Part I: The Structure and Operation of Section 280G, J. of Compensation & Benefits 25-48 (2017); and Section 280G: The Law and Lore of the Golden Parachute Excise Tax, Part II: The Structure and Operation of Section 280G, J. of Compensation & Benefits 10-30 (2017).

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