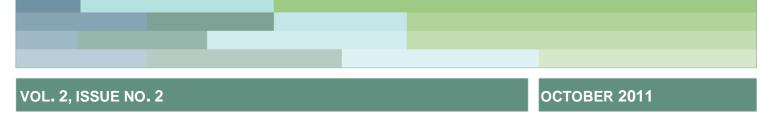
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Perspectives

Orrick's M&A Newsletter

RECENT COMPENSATION TRENDS IN MERGERS AND ACQUISITIONS AND SECTION 409A

This article discusses the traps for the unwary created by Section 409A of the Internal Revenue Code ("Section 409A") with respect to current trends in change-in-control compensation for public company executives and the structure of private company acquisitions. Although Section 409A is a deferred compensation statute, it potentially applies to many types of compensatory arrangements implicated in a change in control, including severance arrangements, stock options, incentive arrangements and certain other forms of compensation. The consequences to the executive of violating Section 409A are severe—accelerated income inclusion, interest and a 20% federal penalty tax (California imposes an additional 20% penalty).

Double-Trigger Severance Payments

In the last several years, we have observed a trend away from "single-trigger" change-in-control benefits for executive officers of publicly-traded companies. Single-trigger arrangements generally provide for the payment of benefits upon a change in control without a requirement that the executive be terminated at the time of the acquisition. As a result of heavy attack by various shareholder constituencies, these arrangements are quickly fading as an acceptable market-standard practice and are being replaced with "double-trigger" change-in-control protections. Unlike single-trigger arrangements, double-trigger arrangements require the executive to suffer an adverse employment action within a specified period of time following a change in control, such as an involuntary termination or a resignation for "good reason," in order for the executive to receive the benefits under the arrangement.

Double-trigger severance arrangements often provide severance protection both before and after a change-in-control. Typically, the pre-change-in-control severance is paid in installments (to help enforce post-employment restrictive covenants) and the post-change-in-control severance is paid in a lump sum (because post-employment restrictive covenants are less of a concern to the acquired company after a change-in-control and to protect the executive against the whims of the acquirer). Alternative payment methods for double-trigger severance arrangements have the potential to cause a Section 409A violation. This Section 409A concern is sometimes overlooked because pre-change-in-control and post-change-in-control severance are often set forth in different documents (such as in a company severance plan and an individual executive change-in-control severance agreement).

A double-trigger change-in-control arrangement will typically be subject to Section 409A if it either contains a good reason payment trigger that is too broad (e.g., it allows the executive to quit and receive severance following a minor reduction in authority or compensation) or it provides payments in installments that exceed \$490,000 (this limit is indexed every year) or extend more than 2 years after the year of separation of service. Any such installment/lump sum double-trigger will violate Section 409A unless the change-in-control definition meets certain requirements under Section 409A, which it often does not. The obvious way to avoid this issue is for the pre-and post-change-in-control payments to be payable in the same manner. Otherwise, companies and executive officers that enter into this type of arrangement should consult with their counsel to ensure compliance with Section 409A.

Earn-Out Arrangements

In the context of private company acquisitions, the uncertain future economic environment has corresponded with an increase in "earn-outs." An earn-out generally provides for future payments to the sellers of an acquired company if certain business-related milestones are achieved by the acquired business after the acquisition. Typical earn-out periods range from 2 to 5 years, however, in certain cases they can extend as long as 10 years or more. Earn-outs are not new but present complications under Section 409A.

Stock option cash-outs and management incentive plan payments that would otherwise be paid at the time of the acquisition can be made subject to the earn-out without violating Section 409A, as long as the payments are made at the same time and generally on the same terms and conditions as apply to payments to shareholders generally. Although this is a straightforward rule, certain arrangements may not comply. In addition, this rule only applies to the extent that the earn-out payments are made within 5 years of the date of the closing of the transaction. For earn-outs that exceed 5 years, there are limited alternatives under Section 409A that would need to be specifically crafted for each situation. Companies and executives should consult their counsel in this situation.

Of greater concern is the assumption of stock options in transactions with earn-outs. Stock options may be assumed in a corporate transaction without violating Section 409A if the assumption satisfies the rules that apply to the assumption of "incentive stock options" ("ISOs"). The ISO rules generally require that the economics of the assumed option be preserved, which requires valuing the consideration paid in the acquisition for the target company stock, potentially including the earn-out. By nature, earn-outs are speculative and difficult to value, but getting it wrong can have meaningful consequences—over-valuing the earn-out will potentially result in a Section 409A violation and under-valuing it will result in an economic detriment to the option holders. Companies have taken different approaches with respect to this problem. Some prefer to value the earn-out at the time of the assumption, while others prefer an "open transaction" approach that adjusts the option to reflect the earn-out only as the earn-out is paid. Yet another approach is to force option holders to exercise their options immediately prior to the transaction to avoid this Section 409A issue altogether. Each approach has its concerns, so acquisition parties faced with this situation should consult their counsel.

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