Executive Compensation Issues in Corporate Transactions Involving Public Companies

A Practical Guidance® Practice Note by Debra B. Hoffman, Mayer Brown LLP

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This practice note provides guidance on the executive compensation issues that frequently arise in corporate transactions involving public companies. It explains how to handle the most important executive compensation issues in a typical merger, acquisition, or other corporate transaction. In addition to general transaction-related matters, tax-related considerations are discussed pertaining to parachute payments under I.R.C. §§ 280G and 4999 (Section 280G) and nonqualified deferred compensation under I.R.C. § 409A (Section 409A) and relevant considerations relating to the compensation deduction limitation for public companies under I.R.C. § 162(m) (Section 162(m)), which was significantly modified for tax years beginning after 2017 by the Tax Cuts and Jobs Act (Pub. L. No. 115-97) (the 2017 Tax Act).

The practice note discusses the following topics:

- Initial Considerations
- Due Diligence Considerations
- Section 280G Parachute Payments
- Section 409A Nonqualified Deferred Compensation
- Section 162(m) Compensation Deduction Limitation
- Equity Award Considerations

For discussion of employee retirement plan benefits in corporate transactions, see Retirement Plan Issues in Corporate Transactions.

Initial Considerations

When approaching a corporate transaction involving a public company, you should first identify a few critical characteristics of the transaction that will help you understand the overall structure and determine the relevant considerations and alternatives relating to executive compensation matters. These considerations include the structure of the transaction, the types of parties (i.e., the parties' organizational structure and whether they are public or private), and the business purpose of the transaction.

Structure of the Transaction

First, you will need to consider the structure of the transaction. Public company transactions can take many forms, including equity acquisitions/dispositions, asset acquisitions/dispositions, mergers, spin-offs, and combinations of the foregoing. One of the most important distinctions between these different deal structures is whether the assets and liabilities will transfer automatically to the buyer or surviving entity as a matter of law.

Common types of corporate transactions include:

- **Stock sale.** This transaction occurs when one company acquires the stock or other equity interests of another company. This may be the stock of the seller/target or of a subsidiary or other related entity.
- **Asset sale.** This transaction occurs when one company acquires all or a portion of the assets of another company. Counsel should note that assets can include stock in a subsidiary or another entity, which raises many of the same issues that are raised by a stock transaction.

- **Merger.** This transaction occurs when one company merges into another company. This raises many of the same issues as a stock transaction. Mergers are structured in different ways and it is important to understand the structure of the merger to determine how to address executive compensation matters during and following the merger. Common types of mergers include:
  - **Direct merger.** A direct merger occurs when the target company merges into the acquiring company, without using a merger subsidiary. This is not a very common structure in public company transactions.
  - **Forward triangular merger.** A forward triangular merger occurs when a subsidiary of the acquiring company merges with the target company and the subsidiary is the surviving entity after the merger.
  - **Reverse triangular merger.** A reverse triangular merger occurs when the acquiring company creates a subsidiary to merge with the target and the target is the surviving entity after the merger. This is easier to accomplish than a direct merger because the subsidiary has only one shareholder and the identity of the target does not change. This is a very common structure for public company transactions.
- **Spin-off.** This transaction occurs with the creation of an independent company through the sale or distribution of shares of an existing business or division of a parent company.

All of these types of transactions can raise issues with executive compensation arrangements. For convenience, this practice note describes all transactions involving equity as stock transactions, but the same considerations generally will also apply in the context of transactions involving the sale or disposition of other types of equity interests, such as partnership interests.

Stock Transactions

In a stock transaction where the target company employs the employees and maintains the benefit plans, the target company will continue to employ the employees and maintain the compensation and benefit plans, absent some agreement of the parties to the contrary. Similarly, in a merger of the target company into another entity, the surviving entity (which may also be the target company depending on the structure of the transaction) will step into the shoes of the target company and will, as a matter of law, become the employer of the employees and will maintain the compensation and benefit plans.

In a stock transaction or merger where the employees are employed—and the compensation and benefit plans are maintained—at a parent level or by another affiliated company, the compensation and benefits matters will typically be addressed in a manner like an asset transaction.

Asset Transactions

In an asset transaction, the employees and the compensation and benefit plans generally will not move to the buyer as a matter of law and instead the parties will negotiate the treatment of those matters and reflect the outcome in the operative documents. Employees of the target company who transfer to the buyer (or any affiliate of the buyer) will experience a technical termination of employment with the seller. Such termination of employment will impact the alternatives that may be available with respect to the benefits of such individuals. Although the buyer may agree to assume certain compensation and benefits obligations of the target company, this is not legally required and would be subject to the negotiation of the parties. A spin-off may be treated like an asset transaction depending on the actions taken prior to the spin-off to divide up benefit plans and employees.

Types of Parties

In addition to identifying the structure of the transaction, you should ascertain the types of parties involved in the transaction. It is important to determine whether the buyer and seller/target are public or private companies and the organizational structure of the companies, such as corporations, partnerships, limited liability companies (and whether such LLCs are taxed as a partnership or corporation), disregarded entities, etc.

As described later in this practice note, there are specific considerations that apply to public companies for purposes of the parachute payment rules of Section 280G, the deferred compensation rules of Section 409A, and the compensation deduction limitation rules of Section 162(m) of the Internal Revenue Code (the Code). Further, in certain cases, the rules discussed in this practice note do not apply unless the entity in question is a corporation. This practice note discusses these issues in the context of transactions where one or both parties to the transaction are publicly traded.

Business Purposes

Counsel should understand the parties' purposes for entering into the transaction. For example, is the buyer purchasing a business for primarily strategic reasons (i.e., an operational business) or is the buyer a financial investor (e.g., private equity fund)? You will be in a better position to advise your client as to certain positions to take on

executive compensation and other benefit issues when you know the intent of the parties with respect to the business. This knowledge will help you to develop a strategy for employees and compensation and benefit plans that will work for all parties to the transaction.

Due Diligence Considerations

Due diligence is an important part of any corporate transaction from the buyer's perspective. In addition to identifying the target's major compensation-related liabilities, you must review the buyer's compensation arrangements to identify any tax or other compliance issues implicated by the anticipated transaction. This section discusses the following important due diligence considerations:

- Review of change-in-control and severance provisions
- Where to look for relevant executive compensation documents
- Reliance on indemnification versus due diligence in corporate transactions
- Addressing executive compensation issues in the transaction documents

For more information on how to identify major compensation-related liabilities in a transaction, see Severance and Change-in-Control Agreement Liabilities in Corporate Transactions.

Review of Change-in-Control and Severance Provisions

You must determine whether the contemplated transaction will constitute a change in control for purposes of triggering contractual obligations or tax-related issues. There are special definitions of change in control that are used for various purposes under the Code and these definitions are not the same in all respects. Examine the applicable Code definition for various issues that could arise to determine the treatment for tax purposes. In this regard, see Section 280G/409A Change-In-Control Event Comparison Chart. Note that Section 162(m) does not include a definition of change in control, although you still need to consider pre- and post-change-in-control periods in a change-in-control situation as further discussed later in this practice note.

In addition to tax considerations, several types of company documents may have change-in-control and/or severance provisions that are relevant in a corporate transaction, such as an equity plan, employment agreement, change-in-control agreement, or severance plan or agreement. Carefully review each of the change-in-control definitions in all the relevant documents (which definitions may or may not be similar) to determine whether the transaction will invoke any change-in-control terms under the applicable company arrangements.

Also, carefully review the applicable company arrangements to determine what types of actions give rise to severance payments, the level of severance payments, and whether the severance amounts may be increased during a period following a change in control. In order to quantify the amount of the potential liabilities, it will be necessary to obtain compensation and other related data (such as length of service) from the seller/target company. For purposes of determining whether there are any issues under Section 280G and the magnitude of any such issues, it will most likely be necessary to engage the services of an accountant due to the complexity of the calculations that must be performed. Lawyers sometimes will do a "back of the envelope" calculation to determine the likelihood of issues before an accountant is engaged (e.g., if an executive will receive change-in-control payments that are clearly significantly below the Section 280G threshold, it may not be necessary to involve an accountant).

Where to Look for Relevant Executive Compensation Documents

A public company's equity plans, award agreements, and individual executive agreements must be publicly filed, and the underlying securities must be properly registered with the Securities and Exchange Commission (SEC). In addition, the applicable equity plans require approval of the company's shareholders. Relevant documents are typically available on the company's investor relations web page or via the SEC's EDGAR search tool.

In addition, relevant documents are often described in and/or attached as an exhibit to one of the following:

- Form DEF 14A (definitive proxy statement)
- Form 10-K (annual report)
- Form 10-Q (quarterly report)
- Form 8-K (material event important to shareholders)
- Form S-8 (registration of securities)

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Additional details about outstanding equity awards may also be found in the company's financial statements, individual executive agreements, and the equity compensation table of the company's proxy statement. Executive arrangements are also described in the Compensation Discussion and Analysis (CD&A) section of the company's proxy statement.

Although none of these sources will provide a complete view of all the company's executive compensation arrangements, it is a good starting point for determining the types of plans and arrangements maintained and equity awards outstanding, as well as a view into the company's philosophy regarding executive compensation. Counsel should note that in public company transactions, it is quite common for most of the due diligence to be obtained from publicly available documents with very little additional information being provided by the public companies involved in the transaction. Buyer's counsel should, however, verify whether it is missing any relevant documents covering executive compensation issues that are not addressed in the publicly available documents and seek them directly from the seller as part of its due diligence review.

Reliance on Indemnification versus Due Diligence in Corporate Transactions

In the transaction agreement of any corporate transaction, the buyer will insist that the seller agree to indemnify the buyer against the breach of its (and the target company's) representations and warranties. In most acquisitions of public companies, however, the buyer cannot rely on indemnification as a recourse for a breach of representations and warranties because the transaction consideration is distributed to the seller's or target's shareholders at the closing, leaving no source of funding to stand behind the representations and warranties. As a result, it is not uncommon for there to be no indemnification in public company transactions.

In such deals, buyers should push to satisfy detailed diligence requests and to include very specific representations to draw out information before the transaction is signed and the specific transaction provisions are finalized. Buyers should also consider maintaining a walk-away right for a material breach of the representations and warranties or a breach that would result in a material adverse effect between signing and closing.

For a detailed due diligence request list for use in a corporate transaction, see Due Diligence Request List (Executive Compensation and Employee Benefits). For checklists useful in conducting due diligence on executive compensation arrangements, see Due Diligence Checklist (Employment Agreements), Due Diligence Checklist (Incentive Plans), and Due Diligence Checklist (Award Agreements).

Addressing Executive Compensation Issues in the Purchase Agreement

In addition to indemnity provisions, several other provisions of transaction agreements commonly address executive compensation issues pursuant to an agreement between the parties regarding those matters. In many cases, these provisions relate not just to executives but also to employees generally. Common executive provisions in transaction documents include the following:

- **Equity award treatment.** The transaction documents in a stock transaction or merger will typically address the vesting of outstanding equity and equity-based awards in connection with the transaction and whether the awards will be cancelled (in exchange for consideration or no consideration) or will be adjusted and substituted with corresponding awards under a buyer's equity incentive plan. It is important to review the underlying award agreements and equity plans prior to drafting these provisions of the transaction documents to ensure that the desired treatment is permitted under the operative documents. In an asset transaction, it is less common to include provisions relating to equity awards as the equity awards will remain with the seller, the treatment of such awards will be governed by the applicable plans, and a buyer is not likely to assume any liabilities with respect to the equity-based awards.
- **Compensation and benefit representations.** The transaction documents will likely include representations relating to actions taken during a period prior to the signing of the documents and these representations often address matters relating to compensation and benefits for executives and other employees. The purpose of these representations is to highlight actions that might have been taken to increase compensation or benefits in anticipation of a transaction or otherwise outside the ordinary course of business. This type of information is important from a due diligence perspective, particularly if you represent the buyer and there will be some obligation to maintain compensation and benefit levels post-closing. Changes in the compensation and benefits may also be relevant for purposes of determining whether and to what extent Section 280G issues may result from actions taken in anticipation of a change in control. The transaction document will also include representations relating to the substantive compliance of various benefit arrangements, including executive compensation

arrangements, with applicable laws and disclosure as to any deviations from such compliance. In light of the novel coronavirus (COVID-19) pandemic, it is also becoming common to include representations regarding any actions taken regarding executive compensation and executive compensation arrangements, such as salary reductions, plan amendments, and participation in relief programs.

- **Interim operating covenants.** If there will be a period of time between signing of the transaction documents and the closing of the transaction, it is common to include provisions relating to the actions that may or may not be taken by the seller or target in the interim period, including matters relating to employee compensation and benefits. The usual import of these provisions is to limit the actions that may be taken by the seller/target outside the ordinary course of business without the consent of the buyer and may even provide for specified limits (such as capping the aggregate amount of salary increases) during the interim period. For example, the interim operating covenants will typically address the target's ability to make changes to salary and other compensation, the ability to implement or pay retention bonuses to incentivize executives to remain employed through the closing (and beyond), the ability to grant additional equity-based awards, the ability to make changes to employee benefit plans and employment arrangements, including severance and change-in-control arrangements, and the ability to make changes in executive compensation and executive compensation arrangements in light of the COVID-19 pandemic. This section should be carefully discussed with the client (whether buyer or seller) to ensure that it meets the business needs of the client and that the client understands the possible costs of the matters that are addressed.
- **Post-closing covenants.** It is common to include provisions relating to the treatment of employees, including executives, for some period after the closing of the transaction. Typically, these provisions address compensation levels, benefit plan participation, service-crediting provisions and, if applicable based on the structure, whether and to what extent the buyer would be assuming any employee and benefit liabilities. The common length of post-closing protection for employees is between 12 and 24 months and, if employees have change-in-control agreements or if severance is otherwise payable if an employee is terminated during a specified post-closing period, the protection period would typically mirror the protection period under the applicable arrangements. As with the interim operating covenants, this section should be carefully discussed with the client to ensure that it is workable from an administrative perspective and that the promises made, particularly taking into account actions that may be taken pursuant to the interim operating covenants, do not adversely impact the cost projections for the transaction. In addition, these provisions should be reviewed in light of any outstanding severance or change-in-control plans or agreements to ensure that payments and benefits under those arrangements are not inadvertently triggered as a result of what is promised for the post-closing period. For example, if a severance plan provides that severance is triggered if there is a relocation of more than 50 miles and the intent is that all of the employees will be moved 100 miles from the current location, it would be important to take that into account in determining the effect of the post-closing covenants.
- **Third-party beneficiary provisions.** You should consider including a separate "no third-party beneficiary" provision in the transaction documents relating to employees and benefit plans (even if there is a more general provision of the same type elsewhere in the documents) as there has been litigation relating to whether employees and benefit plan participants can be third-party beneficiaries to transaction document provisions providing for employee protections and/or whether the transaction document constitutes an amendment of the underlying benefit plan documents. Halliburton Co. Bens. Committee v. Graves, 463 F. 3rd (5th Cir. 2006). Although a no third-party beneficiary provision cannot override rights that an employee or benefit plan participant may have under the terms of a benefit plan or other agreement or applicable law (including ERISA), it may limit the types of actions that can be successfully brought by disgruntled employees and benefit plan participants relating solely to rights described in the transaction documents.
- **Closing conditions.** Transaction documents almost always include certain conditions that must be satisfied before the parties will have an obligation to close the transaction. Sometimes these conditions involve the executives. A common closing condition of this type is that a specified executive or group of executives has entered into employment agreements providing for continued employment for some period post-closing. Some thought needs to be given to this type of provision prior to including it, however, because it provides the applicable executive(s) with considerable leverage in negotiating the terms of the employment agreement if they know that the entire transaction is conditioned on the agreement. If possible, it would be better to negotiate all such agreements prior to signing

the documents so that a small group of individuals cannot hold up the entire transaction.

- **Purchase price adjustments.** In some transactions, purchase price adjustments may be used to allocate financial liability among the parties for certain executive compensation matters, such as severance, transaction, or change-in-control bonuses, retention bonuses, and noncompliance issues. In a transaction where the stock of a public company is being acquired, the ability to use a purchase price adjustment is less viable due to the fact that the consideration paid for the stock of the public company is generally negotiated at the beginning of the transaction and there is limited ability to change that price after the documents are finalized and possibly approved by the public company stockholders. Where a non-public company is being acquired or assets of a public company purchased, however, a purchase price adjustment could be used to provide for the intended allocation of the liabilities.

For annotated clauses addressing executive compensation issues in purchase agreements, see Employee Benefits and Labor Clauses (Stock Purchase Agreement) (Pro-buyer), Employee Benefits and Labor Clauses (Stock Purchase Agreement) (Pro-seller), Employee Benefits and Labor Clauses (Asset Purchase Agreement) (Pro-buyer), and Employee Benefits and Labor Clauses (Asset Purchase Agreement) (Pro-seller).

Section 280G Parachute Payments

In a transaction involving the change in control of a corporation, you will need to consider the application of Section 280G, which disallows a deduction by a corporation for any excess parachute payments (as defined under I.R.C. § 280G(b)(1)) paid to a disqualified individual and imposes on such individuals a 20% excise tax on the amount of any such payments. The principal guidance relating to these rules is referred to herein as the Parachute Rules. I.R.C. §§ 280G and 4999; Treas. Reg. § 1.280G-1.

An overview of the Parachute Rules follows.

Definition of Corporation

In determining whether the Parachute Rules apply to a transaction, you first need to determine whether a corporation is undergoing a change in control. Usually this will be obvious. For purposes of the Parachute Rules, however, the term corporation has the meaning described in I.R.C. § 7701(a)(3) and Treas. Reg. § 301.7701-2(b). It therefore includes some entities not commonly thought of as corporations, including LLCs taxed as corporations and real estate investment trusts (REITs), among others. It does not include tax-exempt entities, foreign corporations, or S corporations (including corporations that meet the criteria of an S corporation even if an S corporation election has not been made). Partnerships are also generally excluded, except for publicly traded partnerships. Generally, all members of the same controlled group (determined under I.R.C. § 1504) are treated as one corporation. Treas. Reg. § 1.280G-1, Q/A-45.

Payments Contingent on a Change in Ownership or Effective Control

The only payments that are considered for purpose of the Parachute Rules are those that are contingent on a change in control of a corporation using the change-in-control definition under Section 280G. See Treas. Reg. § 1.280G-1, Q/A 27—29, and the discussion above under Due Diligence Considerations. Once you determine that the Parachute Rules may apply in your transaction, you need to determine whether any payments of compensation being made in connection with the transaction are considered contingent on a Section 280G change in control (change-in-control payments).

Generally, a payment of compensation is considered to be a change-in-control payment if the right to receive the payment arises or the timing of the payment accelerates either (1) because of the change in control, (2) because of events closely related to the change in control, or (3) pursuant to a contract entered into, or amended within, one year before the change in control (unless the facts and circumstances would rebut this presumption). Change-in-control payments may be paid, directly or indirectly, by (1) the corporation undergoing the change in control, (2) the buyer of the corporation undergoing the change in control, or (3) persons who are attributed with stock ownership of the corporation undergoing the change in control. Treas. Reg. § 1.280G-1, Q/A-22.

Typical types of payments that constitute change-in-control payments include:

- Severance payments
- Change-in-control bonuses
- The present value of equity award vesting acceleration
- Payments promised under new agreements (or amendments to existing agreements) entered in anticipation of the transaction, such as retention payments, new equity awards, or increased compensation

Disqualified Individuals

You must also determine whether the recipients of the payments are disqualified individuals under Section 280G. Generally, the Parachute Rules apply only with respect to payments to persons who are disqualified individuals. Disqualified individuals include (1) officers (determined based on the facts and circumstances, including the individual's title, duties, and scope of authority); (2) individual shareholders who own more than 1% of the total fair market value (FMV) of the outstanding shares of all classes of stock of the corporation; and (3) highly compensated individuals, defined as the lesser of the highest paid 1% or the highest paid 250 individuals, based on compensation earned during the applicable period. Treas. Reg. § 1.280G-1, Q/A-15.

Excess Parachute Payments

If change-in-control payments paid to a disqualified individual equal or exceed three times the individual's base amount (as described below), then such payments are referred to as parachute payments. The amount of the individual's parachute payments that exceeds one times the individual's base amount is an excess parachute payment and is subject to the excise tax and loss of deduction Parachute Rules. Treas. Reg. § 1.280G-1, Q/A-38.

An individual's base amount is generally the individual's average annual W-2 compensation from the corporation for the five calendar years ending with the year prior to the year in which the change in control occurs (or the individual's period of service with the corporation for such period, if less). This calculation includes amounts that would have been taxable compensation if the individual had been a U.S. citizen or resident for such period. Treas. Reg. § 1.280G-1, Q/A-34.

Example. Assume C Corp, a corporation, has a change in control (pursuant to the Section 280G definition) on March 1, 2017, and Pat, a C Corp officer at the time of the transaction, earned an average of $200,000 per year from C Corp over the calendar years 2012 through 2016. Then, Pat is a disqualified individual whose base amount is $200,000. Pat entered an agreement in 2013 that provides for a $1,000,000 lump-sum payment upon the consummation of a change in control of C Corp (using a definition triggered by the transaction) but receives no other change-in-control payments. The lump-sum payment constitutes a change-in-control payment (because it is contingent on a Section 280G change in control) and a parachute payment (because it exceeds three times Pat's base amount (i.e., 3 x $200,000 = $600,000)). The amount of the parachute payment that exceeds Pat's base amount ($1,000,000 – $200,000 = $800,000) constitutes an excess parachute payment. The excess parachute payment is not deductible by C Corp, and Pat is subject to a $160,000 excise tax ($800,000 x 20%) under the Parachute Rules.

Possible Reduction or Avoidance of Excess Parachute Payments

Companies and individuals try to avoid or minimize the application of the Parachute Rules by various methods. Review all the documents and the structure of the transaction to see if it is possible to reduce or eliminate the parachute payments and/or increase the base amount (and thus reduce or eliminate the excess parachute payments). Some common alternatives include:

- **Careful application of the Parachute Rules.** The Parachute Rules include provisions in which certain change-in-control payments are not considered in determining the amount of any parachute payments and other provisions that may be used to reduce the amount of any excess parachute payments. For example:
  - Payments that are properly characterized as reasonable compensation for services actually rendered by the individual before the date of the change in control may reduce the amount of any excess parachute payments.
  - Similar to the point above, certain payments of reasonable compensation for services to be rendered on or after a change in control are not considered parachute payments. Where the vesting of an award is based solely on the completion of a specified period of service, without any performance-based vesting, only a portion of the value of the award will generally be includible as a parachute payment.
  - Other exceptions and exclusions may also be available.

  Treas. Reg. § 1.280G-1, Q/A-24, 39–43.

- **Shareholder approval.** If the corporation undergoing a change in control is a private company, it may be possible to subject the payments that would otherwise constitute parachute payments to shareholder approval. If the payments receive shareholder approval, they are not considered parachute payments for purposes of the Parachute Rules. There are several requirements that must be satisfied to obtain effective shareholder approval. Carefully review the regulations if this alternative is to be followed to ensure that the shareholder approval is properly obtained. This alternative is not available if the corporation undergoing the change in control is a public company. Treas. Reg. § 1.280G-1, Q/A-7.

- **Limit payments.** Often, the operative documents relating to change-in-control payments set a limit on the amount of parachute payments that can be received such that the total amount of the permitted payments is less than an amount that would result in an excess parachute payment. If such limits are not included in the applicable documents, the disqualified individual could waive his or her right to some of the payments to avoid imposition of the excise tax. If there will be a waiver, take care as to the payments the waiver will apply to (and the ordering in which reductions are made) if any of the payments are nonqualified deferred compensation amounts subject to Section 409A. Unless properly structured, such waivers may result in a Section 409A violation due to a deemed impermissible acceleration or substitution. In addition, consider that, unless the waiver results in a net tax benefit for the employee, there is little incentive for the individual to waive payments just to preserve a deduction for the company.
- **Variations on limits on payments.** As a variation on the limitation discussed above, the operative documents relating to change-in-control payments may permit the employee to receive the better of (1) the full change-in-control payment subject to the excise tax or (2) the change-in-control payment cut back to an amount less than an amount that would result in excess parachute payments. This is generally more palatable to an employee than waiving all the excess parachute payments.
- **Gross-up.** It is possible to provide a gross-up payment to the individual for any excise taxes owed with respect to excess parachute payments. This used to be a very common practice, but it is extremely expensive to the company (and does not solve, but rather exacerbates, the company's deduction issues). Section 280G gross-ups are now considered a problematic pay practice by public company shareholders and related advisors. Therefore, this is not likely to be included in already existing documents (unless they are quite old), but could need to be implemented at the time of the change in control. If a gross-up is to be added, give careful consideration as to whether the addition of such a provision would cause issues with the company's shareholders, particularly if the applicable transaction is subject to shareholder approval.

For more information on Section 280G, see Section 280G Parachute Payment Rules and Taxation of Executive Compensation § 3.11. For more information on Section 280G's shareholder approval exception, see Section 280G for Private Companies.

Section 409A Nonqualified Deferred Compensation

The nonqualified deferred compensation rules under Section 409A and the implementing regulations are an important consideration in most transactions because there are potential enormous tax consequences for individuals with noncompliant agreements, described below. Although the adverse tax effects fall mainly on the individual, employers frequently make adversely affected individuals whole, particularly in the context of corporate transactions where a buyer desires a smooth transition for the continuing workforce. Therefore, considering the severe consequences of Section 409A violations, best practices are to confirm compliance with Section 409A and ensure that the compensation arrangements are structured to comply with, or be exempt from, Section 409A before and after the corporate transaction.

Application of Section 409A

Section 409A applies to all arrangements (including individual agreements) that provide for a deferral of compensation and not just to executives, but to all service providers (including all employees, directors, and independent contractors). Generally, an arrangement will be treated as providing a deferral of compensation if, pursuant to such arrangement, a service provider has a legally binding right during one taxable year to compensation that may or will be paid in a later taxable year. A service provider will generally have a legally binding right to compensation at the first time he or she has an enforceable contractual right to the compensation, even if such contractual right is subject to the occurrence of specified future events (such as vesting) that might not occur. Treas. Reg. § 1.409A-1(b)(1).

Violations of Section 409A trigger adverse tax consequences for the employee or other service provider, including the immediate taxation of the service provider's vested accrued benefit (even if those benefits have not yet been distributed to him or her) and the imposition of a 20% additional income tax on non-complying amounts. Penalty interest may also be imposed under Section 409A under certain circumstances. Although Section 409A violations do not directly result in penalties for the company, the rules require the company to report Section 409A violations and require the company to withhold payroll taxes on income accelerated under Section 409A. A company also may be subject to regular tax penalties for failure to properly report or withhold amounts when it has an obligation to do so.

Arrangements subject to Section 409A include not only traditional deferred compensation plans, but many types of arrangements not typically thought of as deferred compensation, including certain equity-based compensation and severance benefits. While reviewing equity plans and other compensation arrangements in connection with a corporate transaction, you must consider whether the arrangement complies with Section 409A—including, importantly, whether arrangements subject to Section 409A are only payable upon one of the six permissible payment events (including, if applicable, an event that satisfies Section 409A's change-in-control definition).

Payment Events

You should determine whether the anticipated transaction is a payment event under each applicable Section 409A arrangement to ensure that the expectations of the parties and the employees are aligned with the terms of the agreement. This includes not only making sure that anticipated transaction-based payments are actually triggered under the plan's change-in-control definition, but also consideration of the effect the transaction may have on severance arrangements, supplemental executive retirement plans (SERPs), and other nonqualified deferred compensation plans (e.g., whether the transaction triggers or partially triggers a payment event and whether those events comply with Section 409A).

For example, as noted above, in an asset purchase transaction, a separation from service typically occurs by operation of law, even if employees of the seller or target continue providing the same services for the buyer post-closing. This could trigger unintended severance payments under a contractual agreement subject to Section 409A. To avoid this result, the regulations provide that the parties to a sale of substantially all of the assets of the seller may choose to specify whether employees will experience a separation from service for purposes of Section 409A in connection with the transaction. In order to exercise this discretion, all of the following requirements must be met:

- The transaction must be the result of bona fide, arm's length negotiations.
- All employees must be treated consistently from the seller to the buyer for purposes of applying the provisions of any nonqualified deferred compensation plan.
- Such treatment must be specified in writing by the closing date of the transaction.

Treas. Reg. § 1.409A-1(h)(4).

The IRS has clarified that stock sales that are deemed to be asset sales under I.R.C. § 338 are not considered asset sales for purposes of determining whether an employee has a separation from service for purposes of Section 409A. Prop. Treas. Reg. § 1.409A-1(h)(4), 81 Fed. Reg. 40,569, 40,580 (June 22, 2016).

For general information on Section 409A, see Section 409A Fundamentals. For information on transaction-related Section 409A topics, see Section 409A and Severance Arrangements, Section 409A Change-in-Control Payment Events, and Section 280G/409A Change-In-Control Event Comparison Chart. The impact of Section 409A in connection with a company's equity compensation arrangements is discussed below under Equity Award Considerations.

Section 162(m) Compensation Deduction Limitation

Section 162 of the Code generally allows a deduction for all the ordinary and necessary expenses of carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services. I.R.C. § 162(a).

Prior to the enactment of the 2017 Tax Act, Section 162(m) limited the deduction to $1,000,000 for applicable employee remuneration (as defined below) paid to covered employees of public corporations. I.R.C. § 162(m)(1). The 2017 Tax Act, however, significantly modified Section 162(m) commencing with the 2018 tax year. The most material changes include:

- Elimination of the performance-based compensation and commission exception (except for payments made under grandfathered written binding contracts in effect on November 2, 2017, and not materially modified thereafter)
- Expansion of the scope of covered employees to include:
  - The principal financial officer (PFO)
  - Individuals who were covered employees in any tax year beginning in 2017 (i.e., individuals having covered employee status at any point after December 31, 2016, retain covered employee status for all future years, even after their compensation is no longer subject to proxy reporting) ("once a covered employee, always a covered employee")

- Expansion of the scope of publicly traded corporations beyond those with publicly traded equity securities to include, in addition, those that are required to file reports solely because they issue public debt
- Expansion of covered employee remuneration to include payments to (or includable in the income of) beneficiaries on behalf of covered employees

Pub. L. No. 115-97, Section 13601.

On March 11, 2021, the American Rescue Plan Act of 2021 (Pub. L. No. 117-2) (ARPA), was signed into law to provide additional relief in the wake of the novel coronavirus (COVID-19) pandemic. In addition, Section 9708 of ARPA further expanded the reach of Section 162(m) beginning with tax years beginning on or after January 1, 2027. In particular, ARPA expands the number of individuals who constitute covered employees to include the next five most highly compensated individuals (the "next top five group") over and above the principal executive officer (PEO), PFO, and the next three most highly compensation officers. The next top five group may include individuals who are not officers of the company. The "once a covered employee, always a covered employee" rule, however, does not extend to the individuals included in the next top five group. Rather, officers are included in the next top five group only so long as they are in that group.

The practical import of the ARPA changes will be that an employer will need to keep two lists of covered employees: (1) a "regular" list which will include the PEO, PFO, and the next three most highly compensated officers who will be covered employees into the future under the "once a covered employee, always a covered employee" rule and (2) an "annual" list which will include those individuals in the next top five group for the applicable year.

Application of Section 162(m)

Applicable Employee Remuneration

For purposes of Section 162(m), applicable employee remuneration subject to the potential deduction limitation includes any compensation paid to a covered employee (as defined below) during a year that the company otherwise believes would be deductible under Section 162(a) generally. Applicable employee remuneration does not include:

- Those amounts of compensation that constitute qualified performance-based compensation and that are grandfathered under the 2017 Tax Act
- Those commissions (income generated based on individual performance) that are grandfathered under the 2017 Tax Act
- Any compensation not treated as wages for the purposes of the Federal Insurance Contributions Act (FICA) (I.R.C. § 3121(a)) (e.g., qualified plan benefits)
- Any benefits provided to the employee that may be excluded from gross income (e.g., certain welfare plan benefits) –or–
- Compensation earned for services rendered while the individual was not serving as an employee of the company

Treas. Reg. § 1.162-27(c)(3); Treas. Reg. § 1.162-7(d); Treas. Reg. § 1.162-27(e).

Covered Employees

A company's covered employees include the company's PEO and PFO (or an employee acting in such capacities), and the company's three most highly compensated executive officers other than the principal executive officer and principal financial officer. Treas. Reg. § 1.162-27(c)(2). For tax years prior to 2018, the chief financial officer was (except in the case of certain smaller reporting companies) excluded as a covered employee regardless of whether he or she is among the highest three paid employees. Beginning with tax years commencing on or after January 1, 2027, a company's covered employees will be expanded to include the next five most highly compensated individuals over and above the PEO, PFO, and the next three most highly compensated officers to include individuals in the next top five group (whether or not the individuals in the next top five group are officers). ARPA, Pub. L. No. 117-2, § 9708.

An individual who is or becomes a covered employee in any of the above categories for any tax year beginning after December 31, 2016, will remain a covered employee for all future tax years under the "once a covered employee, always a covered employee" rule; provided, however, that individuals in the next top five group are not subject to this rule. . I.R.C. § 162(m)(3). Thus, in the case of a covered employee who is subject to the "once a covered employee, always a covered employee" rule, compensation payable to such an individual will be subject to the deduction limits of Section 162(m) for all future years, including payments following termination of employment and/or made to designated beneficiaries upon the former employee's death. Prior to 2018, an individual was not treated as a covered employee for a year unless he or she was employed on the last day of the tax year.

Following a transaction, the determination of who will qualify as a covered employee will be based on the newly combined entity. Proposed Regulations address when covered employee status can continue after a corporate

transaction for individuals who were covered employees of a predecessor publicly held corporation. See Prop. Treas. Reg. § 1.162-33(c)(2)(ii) (and Prop. Treas. Reg. § 1.162-33(h)(2)(ii)(B) for a special applicability date rule).

Special Transition Rules for Private Companies that Become Public Companies

For a private corporation that becomes publicly traded, the deduction limit does not apply to any compensation paid pursuant to a plan or agreement that existed during the period in which the company was a private company. Treas. Reg. § 1.162-27(f)(1). This special rule applies only for a transition period that ends on the earliest of:

- The expiration of the plan or agreement
- The material modification of the plan or agreement
- The issuance of all of the stock available for issuance under the plan or agreement –or–
- The first calendar year following the calendar year in which the corporation becomes public

Special rules apply in the case of a company that becomes public because of an initial public offering. Treas. Reg. § 1.162-27(f)(2).

The transition rules apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right (SAR), or the vesting of restricted stock granted under a plan or agreement to which the transition rules otherwise apply, if the grant of the award occurred prior to the expiration date of the transition rules. These rules do not apply to other forms of stock-based compensation, including stock units. Thus, to be within the transition rules, a company must actually pay compensation attributable to awards other than stock options, SARs or restricted stock, within the transition period. Treas. Reg. § 1.162-27(f)(3).

Covered Employee Expansion to Include Top-Five Highly Paid Employees in 2027

For tax years beginning after December 31, 2026, in addition to any individuals designated as covered employees under the categories described above, the company's five highest paid employees for the tax year (other than those indidviduals otherwise designated as covered employees for the year) will also be covered employees for that year, but these individuals do not automatically retain the status for future years. This expansion is pursuant to a provision in the COVID-19 relief American Rescue Plan Act of 2021. Pub. L. No. 117-2, § 9708.

Performance-Based Compensation Exception

Prior to the changes made by the 2017 Tax Act, compensation that satisfied the requirements for performance-based compensation was not considered for purposes of applying the $1,000,000 limit on deductibility. Treas. Reg. § 1.162-27(e). Even though the performance-based compensation exception was largely eliminated by the 2017 Tax Act, it is still important to understand the rules as they existed prior to the changes in order to determine whether a company's arrangements are covered by the 2017 Tax Act's grandfather rule and, if so, how such arrangements should be administered during the applicable grandfathered period.

Pre-2017 Tax Act Rules

The compensation arrangements of most public companies were structured to permit at least certain components of executive compensation to satisfy the requirements for the performance-based compensation exception and to preserve maximum deductibility. Review the relevant agreements to determine what provisions are made for payment of performance-based compensation to establish whether the deduction issues under Section 162(m) are raised in the transaction.

The most important requirement for compensation to be treated as performance-based compensation was that payment of the compensation must be contingent on satisfaction of the applicable performance criteria. If the facts and circumstances indicate that the employee would have received the compensation without regard to whether the performance criteria were met, the compensation did not constitute performance-based compensation. For example, an arrangement that provided that the compensation would be paid due to certain events, including a change in control, without regard to satisfaction of performance targets was not considered performance-based compensation for Section 162(m) purposes because the occurrence of such an event alone is not performance-based criteria.

For stock options and SARs to qualify as performance-based compensation under Section 162(m), all of the following requirements must be met:

- The grant is made by the compensation committee consisting of outside directors (as defined in Section 162(m)).
- The plan under which the option or right is granted states the maximum number of shares with respect to which options or SARs may be granted during a specific period to any employee and such limit is approved by the company's shareholders.

- Under the terms of the option or SAR, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of grant.

Treas. Reg. § 1.162-27(e)(2)(vi).

For options or SARs, these requirements mean that the exercise price cannot be less than the FMV of a share of stock on the grant date and dividend equivalents cannot be payable upon the exercise of such option or SAR. Most stock options and SARs granted by public companies will satisfy the foregoing.

For equity awards to qualify for the performance-based compensation exemption under Section 162(m) prior to the 2017 Tax Act, the material terms of the performance goals were required to must be disclosed and approved by the shareholders before the compensation is paid and the compensation committee must certify the attainment of performance goals in writing prior to the payment of the compensation. Treas. Reg. § 1.162-27(e)(4).

2017 Tax Act Performance-Based Compensation Grandfather Rule

The performance-based compensation exception of Section 162(m) was eliminated by the 2017 Tax Act. The 2017 Tax Act, however, includes a grandfather rule that provides that the changes made by the Act to the performance-based compensation exception will not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and that is not materially modified on or after such date. Contracts that meet the foregoing requirements are often referred to as being grandfathered, and the rules of Section 162(m) in effect prior to the 2017 Tax Act will continue to apply to amounts payable under such contracts. On August 21, 2018, the IRS provided initial (and limited) guidance on the changes to Section 162(m) made by the 2017 Tax Act. I.R.S. Notice 2018-68. In 2019, the IRS issued proposed regulations that implemented the amendments to Section 162(m) made by the 2017 Tax Act. 84 Fed. Reg. 70,356 (Dec. 20, 2019). In general, the proposed regulations were to be effective as of the date that final regulations are published in the Federal Register although some provisions, as noted below where relevant, have different effective dates. Prop. Treas. Reg. § 1.162-33(h), 84 Fed. Reg. 70,356. In addition, except in very limited circumstances, since publication of the proposed regulations, taxpayers may not rely on Notice 2018-68, but may rely instead on the proposed regulations. Final regulations were issued on December 30, 2020, and generally apply to taxable years beginning on or after December 30, 2020 (subject to special dates for certain provisions covered by prior guidance) but a taxpayer may elect to apply them to a taxable year beginning after December 31, 2017, provided that any such election must be applied in a consistent manner to the taxable year elected and all subsequent tax years. 85 Fed. Reg. 86,481 (Dec. 30, 2020)

The proposed regulations provide the following guidance as to what constitutes a written binding contract for purposes of the grandfather rule, how to determine the amount of compensation that is subject to the grandfather rule, and provisions and actions that will take a contract out of the grandfather rule. Generally, the final regulations are consistent with the proposed regulations on these topics.

- An agreement that is renewed after November 2, 2017, is treated as materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable under the contract. A material modification also occurs if the contract is modified to accelerate the time of payment unless the accelerated payment is discounted to reasonably reflect the time value of money. The mere waiver of a substantial risk of forfeiture is not treated as a material modification.
- Compensation is subject to the grandfather rule only to the extent that, as of November 2, 2017, the corporation was and remains obligated under applicable law to pay the compensation if the employee performs the services or satisfies the applicable vesting conditions. A contract that is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other party is not treated as a binding written agreement for purposes of the grandfather rule (unless it can only be terminated or cancelled by terminating the employee's employment). In addition, a written binding contract that is terminable or cancelable by the company without the employee's consent after November 2, 2017, is treated as renewed (and thus outside of the grandfather rule) as of the earliest date that such termination or cancellation, if undertaken, would be effective. The proposed regulations contain several examples as to how the foregoing rules should be applied to contracts in existence on November 2, 2017, including plans that provide for the exercise of negative discretion in the payment of amounts. See, e.g., Treas. Reg. § 1.162-33(g)(3)(vii) (Example 8). The final regulations clarify that a corporation's discretionary right to recover compensation (e.g., under a clawback policy) will not affect the determination of the amount of compensation that a corporation is required to pay under applicable law under a written binding contract.

- The fact that a plan was in effect on November 2, 2017, is not, in and of itself, sufficient to constitute a written binding agreement for purposes of the grandfather rule.

If an arrangement falls within the grandfather rule, it would need to be administered in accordance with the performance-based compensation provisions of Section 162(m) as in effect prior to the effect date of the 2017 Tax Act's changes. For example, awards under the grandfathered arrangement would need to be administered by a committee that consists solely of outside directors.

For more information on Section 162(m), including further discussion of the effect of the 2017 Tax Act and the implementing regulations, see Section 162(m) Tax Deduction Limit for Public Company Executive Compensation. For a checklist useful in determining whether compensation meets the performance-based compensation exception to Section 162(m), see Section 162(m) Performance-Based Compensation Checklist.

Equity Award Considerations

Many employees of public companies receive compensation that is based on the company's stock. Equity awards and equity-based awards can take many forms, the most common of which include stock options, SARs, and full value awards (most commonly restricted stock, stock units, or performance awards).

The terms and conditions of the award are typically contained in a plan document with the specific details provided in separate individual award agreements. Occasionally, ancillary agreements, such as employment agreements, change-in-control agreements, change-in-control plans, and severance plans, will contain overriding provisions that affect the treatment of equity awards. You must conduct a thorough review of the equity documents in any corporate transaction in order to assess any taxation issues as well as to ensure proper treatment of the awards following the corporate transaction.

The following sections discuss Section 409A compliance as applied to equity awards, as well as the effect of the recapitalization and change-in-control provisions found in equity plan documents on the treatment of equity awards in a corporate transaction.

Section 409A Compliance as Applied to Equity Awards

As mentioned above, you will need to review Section 409A compliance, and also address any related issues in the context of the transaction, both by representations and appropriate due diligence. In particular, you must assess Section 409A compliance in the context of the various forms of equity awards granted by the seller or target company.

Stock Rights

Generally, for purposes of Section 409A, stock options are rights to purchase a specified number of shares of stock at a specified price, and SARs are rights to receive the appreciation on a specified number of shares of stock. Stock options and SARs are considered stock rights for purposes of Section 409A and are exempt from Section 409A if the following requirements are met:

- **No discount.** The exercise price can never be less than the FMV of the underlying stock at the time of grant.
- **No deferral feature.** The award cannot include any feature for the deferral of compensation other than the deferral of recognition of income until exercise (or vesting, if the stock subject to the award is subject to restrictions).
- **Fixed number of shares.** The number of shares covered by the award is fixed at the time of grant.
- **Service recipient stock.** The award is based on service recipient stock, as defined under Section 409A, generally including common stock of the company for which the employee provided services or of its direct or indirect parent company, but excluding:
  - o Stock of subsidiaries of the employer or corporations in a brother-sister relationship stock that is subject to a mandatory repurchase obligation (other than a right of first refusal) or, in certain cases, a put or call right –or–
  - o A class of stock that has any preference as to distributions other than distributions of service recipient stock or distributions in liquidation of the issuer of the stock

Treas. Reg. § 1.409A-1(b)(5).

Examples of situations in which a stock right does not meet the above requirements, and is therefore likely to provide for a deferral of compensation that is subject to Section 409A include:

- Stock rights granted relating to non-service recipient stock (e.g., stock of a subsidiary to the service recipient)
- An exercise price is or can become less than the FMV as of the date of grant (e.g., in-the-money options or options with a dividend right that indirectly serves to reduce the exercise price)
- Compensation payable upon exercise is or could be

greater than the spread between the FMV as of the exercise date and the exercise price (e.g., options with a dividend right that is payable contingent on exercise of the underlying award) –or–

- Additional deferral of compensation permitted past the date of exercise (e.g., a provision allowing the recipient to further defer option or SAR exercise gains)

If a stock right fails to satisfy the foregoing requirements, it will be treated as deferred compensation. In almost all cases, a typical stock option or SAR that does not qualify for the stock right exemption would fail to satisfy the requirements of Section 409A. This is because it will, among other things, typically not have a fixed payment date (discretionary exercise by the holder is not considered a fixed payment date for Section 409A purposes), thus subjecting the holder thereof to the Section 409A sanctions.

The good news is that most stock rights issued by public companies satisfy the requirements for the exemption from Section 409A. Stock rights issued by companies that are not public raise more challenging issues, particularly given that Section 409A includes specific rules about determining FMV in the context of private companies. Treas. Reg. § 1.409A-1(b)(5)(iv)(B).

Restricted Stock

Restricted stock (or other restricted property) is not treated as providing for a deferral of compensation for Section 409A purposes merely because the taxation of the property is deferred to the vesting date under I.R.C. § 83 or is included in income at the time of grant solely due to an election under I.R.C. § 83(b). Treas. Reg. § 1.409A-1(b)(6)(i). A promise to transfer property (or the equivalent amount of cash) in the future (such as a stock unit) is not property and may provide for a deferral of compensation within the meaning of Section 409A. Treas. Reg. § 1.409A-1(b)(6)(ii).

Stock Units

Stock units are awards based on the value of shares of stock where the stock (or equivalent amount of cash) is delivered on or after the date of vesting. Stock unit vesting may be contingent on continued service and/or the achievement of certain specified performance goals and the related income for federal income tax purposes is recognized on the date of settlement. Whether a stock unit is subject to Section 409A often depends on the timing of the payment as compared to the date the award is no longer subject to a substantial risk of forfeiture (within the meaning of Section 409A). Many stock unit awards are drafted to qualify for the short-term deferral exception to Section 409A to avoid its stringent requirements.

As with stock rights, it will be important to determine whether the stock units satisfy the requirements of Section 409A as to the time and form of payment (and any voluntary deferral elections). If the units fail to satisfy the requirements, their holders may be subject to the Section 409A sanctions described above.

Recapitalization and Change-in-Control Provisions

Almost all equity plans contain provisions relating to adjustments to outstanding equity awards in the case of certain corporation transactions. Often these provisions give broad authority to a company's board of directors (or a committee) to adjust (1) the number and type of shares available for issuance under the plan, (2) applicable limits under the plan, and (3) if applicable, the exercise price of outstanding awards. These provisions also generally provide broad authority in determining the treatment of outstanding awards in the event of a corporate transaction, such as whether the awards will be cancelled (with or without consideration) or substituted.

In addition to (or in lieu of) the general authority to determine the treatment of outstanding awards, equity plans and related award agreements typically contain specific change-in-control provisions that describe what will or may happen to the award in the event of a change in control. Such provisions are sometimes tailored to provide for different alternatives based on what happens with the underlying stock in the applicable transaction. For example, these provisions may provide for accelerated vesting or enhanced benefits either solely as a result of the transaction (known as a single trigger) or if the individual's employment is terminated for certain reasons within a period of time following the transaction (known as a double trigger). They may also provide for replacement or substitution of new awards for existing awards only under certain circumstances.

Parties to a transaction will almost always have a very definite idea of the treatment that should be afforded to equity plans and awards in corporate transaction. The two most common approaches are to cancel the awards for consideration or have the awards be assumed and replaced by the buyer or surviving entity. As a first step, you will need to determine what your client wants to happen with the equity awards, followed closely by the second step, which is to make sure that the relevant plan and award agreements permit the desired treatment. In addition, you will need to determine early in the process whether the transaction will constitute a change in control under the terms of the plan and applicable award agreements (and ancillary agreements, if applicable) and the consequences

of that determination. There may be differences of opinion between the buyer and the seller/target as to what is desired with respect to the treatment of the equity awards, so it is important that you are aware of available alternatives to properly advise your client.

Once the desired approach to the equity awards is determined and after you have confirmed that the approach is permitted under the terms of the governing documents, you will need to make sure that the applicable corporate documents reflect the desired approach and, if applicable, that the approach does not cause other issues, including Section 409A violations. Depending on the type of award, issues may arise in either of the two most common approaches—cancellation of awards or substitution of awards.

Substitution of Awards

If the parties want to replace the target's awards with corresponding awards on buyer or surviving entity shares, you will need to carefully consider the method used to calculate the substitute awards to avoid tax issues. Two of the most significant tax issues that might arise due to an improper substitution are modification or substitution of the award under Section 409A or the statutory option rules of I.R.C. § 422 that apply to incentive stock options (ISOs) and purchase rights under qualified employee stock purchase plans (ESPPs).

Section 409A Modification and Substitution Issues

As discussed earlier, stock rights must satisfy certain requirements to qualify for the stock rights exemption from Section 409A. Further, a modification of a stock right is treated as the grant of a new stock right under Section 409A, and whether the modified stock right (new stock right) would be exempt from Section 409A is determined based on whether the modified right satisfies all the requirements for the Section 409A exemption as of the date of the modification. For this purpose, a modification means any change in the terms of a stock right (or change in the terms of the plan under which the stock right is granted or any other agreement governing the stock right) that may provide the holder with a direct or indirect reduction in the exercise price, regardless of whether the holder benefits from the change in the terms. Treas. Reg. § 1.409A-1(b)(5)(v)(B).

Section 409A provides, however, that the substitution of an existing stock right relating to a corporate transaction will not be treated as the grant of a new stock right if certain requirements are satisfied. The specific requirements that must be satisfied are those contained in Treas. Reg. § 1.424-1 relating to modifications to statutory options (such as incentive stock options) with certain modifications. Generally, the issuance of a new stock right in substitution of an existing stock right in the context of a corporate transaction does not constitute a modification, renewal, or extension of the stock right (and, accordingly, is not treated as a new grant of a stock right) as long as all of the following conditions are met:

1. Immediately after the substitution, the individual does not have any additional benefits that he or she did not have prior to the substitution.
2. The excess of the FMV of the shares subject to the stock right over the exercise price immediately after the substitution does not exceed such spread immediately before the substitution.
3. The substitute stock right must contain all of the terms of the old stock right (other than those rendered inoperative due to the transaction).
4. On a share by share comparison, the ratio of the exercise price to the FMV after the change in the stock right cannot be more favorable to the holder than the ratio of the exercise price to the FMV of the stock subject to the stock right immediately before the change in the stock right.

Treas. Reg. § 1.409A-1(b)(5)(v)(D).

The regulations under Section 409A provide that the requirements of item (4) will be deemed to be satisfied if the ratio of the exercise price to the FMV of the shares subject to the stock right immediately after the change in control is not greater than the ratio of the exercise price to the FMV of the shares subject to the stock right immediately before the change in control. Id.

To ensure compliance with the foregoing rules, the formula for converting stock rights in a corporate transaction frequently provides for rounding down with respect to the number of new shares subject to the stock right and rounding up of the exercise price.

Finally, you must also ensure that the substitution of one stock right as consideration for another in a transaction does not result in an extension of the stock right for Section 409A purposes. An extension of a stock right refers to the provision to the holder of an additional period within which to exercise the stock right, the conversion of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any deferral of compensation except with certain limitations. An extension of a stock right results in the stock right being treated as having a deferral feature from the original date of grant (retroactively). It is very likely that such treatment would

result in the stock right failing to satisfy Section 409A, thus giving rise to serious penalties on the holder. Payment in accordance with the transaction-based compensation rules of Section 409A, discussed below under "Cancellation of Awards," will not, taken alone, result in an extension of the stock right.

ISO and ESPP Grant Modification and Substitution Issues

Incentive stock options are a type of stock option granted to an employee that receive favorable tax treatment if certain requirements are satisfied. Along with option rights granted under a qualified ESPP, ISOs constitute statutory stock options and any modification or substitution is treated as the grant of a new option. In the context of corporate transactions, however, a substitution or modification that satisfies the requirements of Treas. Reg. § 1.424-1 will not be treated as the grant of a new statutory option. For this purpose, the requirements of the regulations would be applied without regard to item (4) in the list above that applies for purposes of Section 409A. Notwithstanding that difference, the conversion formula that is used for both statutory options and Section 409A stock rights are almost always the same.

Cancellation of Awards

If the parties intend to cancel awards in exchange for consideration, you should ensure that the payment provisions relating to the consideration do not give rise to Section 409A issues (e.g., an impermissible acceleration of payment) and that any payments of the consideration that are permitted satisfy (or are exempt from) the requirements of Section 409A.

One of the most important considerations in this regard is to ensure that payment of the consideration does not result in a deferral of compensation that would constitute an extension of the stock right (discussed above) or otherwise constitute deferred compensation that does not satisfy Section 409A. This may arise, for example, where the stock right or other equity award is being cancelled pursuant to a corporate transaction where transaction-based payments are to be made over the course of time to coordinate with payments of the transaction consideration by the buyer to the seller, such as when an escrow is released under the deal documents. Conforming such arrangements to Section 409A can be difficult or impossible in some cases because the timing of the payments may be uncertain. However, Section 409A contains a special rule for this situation providing relief if certain requirements are met.

Under the special rule, amounts will be deemed to be paid on a designated date or specified schedule (one of Section 409A's permissible payment events) if the transaction-based payments:

- Relate to certain change-in-control events (as defined in Section 409A), including a change in ownership and a sale of substantial corporate assets, but excluding a change in effective control of a corporation (see Treas. Reg. § 1.409A-3(i)(5)(vi)—(vii))
- Are to cash out stock or stock rights held by the recipient or are calculated by reference to the value of the stock of the company
- Are paid on the same schedule and under the same terms and conditions as generally apply to payments to shareholders (or the company) with respect to stock of the company –and–
- Are paid not later than five years after the change-in-control event

Treas. Reg. § 1.409A-3(i)(5)(iv).

The IRS clarified that taxpayers may rely on the special rule for payments relating to statutory stock options and Section 409A exempt stock rights without causing such awards to be treated as having provided for the deferral of compensation from the original grant date under the Section 409A modification rules. Prop. Treas. Reg. § 1.409A-1(i)(5)(iv), 81 Fed. Reg. 40,569, 40,574–75 (June 22, 2016).

Other Considerations

Other issues to consider regarding equity awards relating to a change in control include:

- **Consent.** Often if an equity award holder would be adversely affected by a modification of the award that is not explicitly allowed by the documents, you would need to obtain consent for the change. In this regard, ensure that there is not an inadvertent deferral election that might be subject to Section 409A or other tax issues relating to the timing of payment.
- **Performance awards.** Consider whether modification of performance goals or measurements is necessary and who has the authority to approve the modification. Modifications under Section 162(m) in the context of a change in control are discussed above.
- **Accounting consequences.** You should be sure that your client's accountants are involved in determining the method of equity award adjustments and ensure the client understands the accounting treatment of any course of action taken.

- **Share reserves.** If the buyer plans to issue substitute awards under the buyer's equity plan, you should confirm that there are enough shares available for grant under the plan.
- **Disclosure obligations.** Assumption of a new equity plan or issuance of certain types of awards may require a filing with the SEC, such as a Form S-8 (registration of securities) or applicable state law (e.g., California blue sky law).
- **Shareholder approval.** Consider whether the assumption of a new equity plan, the desire to grant ISOs post-closing, or a need for additional shares under an existing plan will require shareholder approval under applicable stock exchange rules, such as Section 303A.08 (Shareholder Approval of Equity Compensation Plans) of the NYSE Manual or NASDAQ Rule 5635 (Shareholder Approval for Stock Option Plans or Other Equity Compensation Arrangements). For more information, see Corporate Governance: Law and Practice § 16.03.

Related Content

Practice Notes

- Severance and Change-in-Control Agreement Liabilities in Corporate Transactions
- Section 280G Parachute Payment Rules
- Section 409A Fundamentals
- Section 409A Change-in-Control Payment Events
- Section 409A and Severance Arrangements
- Section 162(m) Tax Deduction Limit for Public Company Executive Compensation

Checklists

- Section 280G/409A Change-In-Control Event Comparison Chart
- Due Diligence Checklist (Employment Agreements)
- Due Diligence Checklist (Incentive Plans)
- Due Diligence Checklist (Award Agreements)
- Section 162(m) Performance-Based Compensation Checklist

Annotated Form

- Due Diligence Request List (Executive Compensation and Employee Benefits)

Annotated Clauses

- Employee Benefits and Labor Clauses (Stock Purchase Agreement) (Pro-buyer)
- Employee Benefits and Labor Clauses (Stock Purchase Agreement) (Pro-seller)
- Employee Benefits and Labor Clauses (Asset Purchase Agreement) (Pro-buyer)
- Employee Benefits and Labor Clauses (Asset Purchase Agreement) (Pro-seller)

Debra B. Hoffman, Partner, Mayer Brown LLP

Debra B. Hoffman is a partner in the Firm of Mayer Brown LLP. She has practiced in the employee benefit and executive compensation area for over 30 years and had significant depth and breadth in all relevant areas, both in the domestic and international context. Her practice focuses exclusively in the areas of employee benefit plans and executive compensation and she advises both public and private clients daily with respect to on-going benefits and executive compensation matters, such as issues relating to employment agreements, equity and equity-based arrangements (including for LLCs and non-corporate entities), deferred compensation arrangements (including application of Code Section 409A), bonus and incentive arrangements (including application of Code Section 162(m)), severance agreements, change in control/golden parachute issues, governmental audits, pension de-risking, and compliance issues (including the IRS and DOL voluntary compliance submissions). Debra also advises creditors and debtors in connection with various types of financing structures, bankruptcy and reorganizations. In addition, Debra has extensive expertise with respect to issues arise in the context of corporate transactions, including divestures, acquisitions, mergers, spin-offs, and initial public offerings.

Debra has served as the practice leader of Mayer Brown's US Employment and Benefits group for several terms. She has been recognized by Chambers (2013-2016) as being "very levelheaded," "is very responsive", and "gives plain English, business-minded advice. In addition to Chambers, Debra has been recognized as a Best Lawyer in America, a Best Lawyer in Illinois, and a Super Lawyer for several consecutive years.

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