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A Quarterly Exchange to Power Your M&A Deals



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Executive Compensation: Trends and Best Practices

June 24, 2008

12:00 p.m. – 1:30 p.m. EST

Carolyn T. Long
Leigh C. Riley

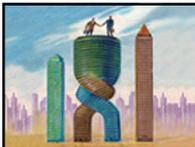
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Today's Presenters

- **Carolyn T. Long**



- **Leigh C. Riley**



- **Timothy L. Voigtman**



- **David S. Sanders**





Internal Revenue Code Section 409A

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Internal Revenue Code Section 409A

- Good faith compliance from January 1, 2005 through December 31, 2008
- Final regulations effective January 1, 2009
- Imposes accelerated tax, additional taxes, and interest on nonqualified deferred compensation arrangements that do not comply in both form and operation
- Fundamentally limits the discretion companies previously enjoyed to amend, terminate, delay and restructure deferred compensation arrangements upon a C of C
- Scope is very broad – not just traditional elective deferrals

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Time and Form, Not Amounts

- Generally governs time and form of payments, but not amounts
- Permitted payments:
 - Separation from service
 - Disability
 - Death
 - Specified time or fixed schedule
 - Change of control
 - Unforeseeable emergency



Can I Pay Out on the C of C Date (Accelerate Payment)?

If exempt from 409A, yes

- Short-term deferrals: Amounts paid within 2½ months following the year the payment is no longer subject to a substantial risk of forfeiture
- Example: Company has annual performance bonus plan that would normally be paid by March 15 of the year following the performance year. A change of control occurs in September. The Company can authorize that the bonus be paid (accelerated) upon the change of control.
- Involuntary separation pay not in excess of 2x base salary (capped at 2x Code § 401(a)(17) limit) and paid out within 2 years following the year of separation from service
- Most stock options, SARs and restricted stock





Can I Pay Out on the C of C Date (Accelerate Payment)?

If not exempt from 409A, yes, in limited circumstances

- If arrangement requires payment on C of C, must make payment
- If arrangement is terminated under the following circumstances:
 - All other arrangements required to be aggregated are also terminated (ex. all elective deferral arrangements are terminated) with regard to individuals experiencing the C of C event
 - Termination occurs within 30 days prior or 12 months after the C of C



Can I Pay Out on the C of C Date (Accelerate Payment)? (cont'd)

- The C of C is a 409A-compliant C of C (sale of 50% equity value, sale of 30% voting control, change of board, sale of 40% of assets)
- All payments are made within 12 months of the termination date

* Plan or agreement does not need to specifically allow for this, but pay attention to amendment and termination provisions of arrangement





Can I Pay Out on the C of C Date (Accelerate Payment)?

Be careful about substitutions!

- If a payment is made as a substitution for deferred compensation, it will be treated as payment of the deferred compensation
- Rebuttable presumption that new payment “proximate” to relinquishment of old payment is a substitution
- Can rebut by showing new payment would have been made regardless – amount paid is materially less than forfeited amount, OR payment is made in the normal course to others who did not forfeit (ex. payment of accrued vacation)



Can I Pay Out on the C of C Date (Accelerate Payment)? (cont'd)

- Example: Employment agreement provides for severance payments over three years. In asset sale, employee is terminated, triggering severance payments. The parties agree to cancel the employment agreement. The employee is instead paid a lump sum “change of control” bonus on asset sale. IRS may assert that bonus was paid in substitution of severance payments, resulting in impermissible acceleration of severance payments and violation of 409A.





Can I Delay Payout?

Only in very limited circumstances

- If payment due on separation from service, in an asset sale, can delay payment until the individual terminates employment from the buyer, but:
 - sale must be bona fide and arm's length
 - must be transfer of substantial assets (plant/division/substantially all assets of business)
 - must say so in writing before the asset sale is consummated
 - all services providers who will perform services for asset buyer are treated consistently under all nonqualified deferred comp plans*

*If assign employment agreements that contain severance subject to 409A, must SERP and elective deferred comp plans be amended to provide that payments may not be made until separation from service from buyer?

*If have grandfathered 409A arrangements, must they also be amended and if so, are the arrangements no longer grandfathered because they have been "materially modified"?



Can I Delay Payout?

Only in very limited circumstances

- Generally, extending the vesting date of a deferred compensation right will violate 409A by causing an impermissible delay in payments
- In C of C context, however, if compensation would vest upon C of C, can extend or delay vesting before and in connection with the C of C
 - C of C must be 50% equity value or 40% asset sale – NOT 30% voting control or change in board
- Example: Bonus arrangement provides for 3 years of installment payments beginning upon vesting, which is earlier of January 1, 2011 (provided individual remains in employment) or C of C. Upon C of C, do not want to vest and start payout. Can "waive" that vesting provision such that January 1, 2011 is only vesting date. Does NOT result in impermissible delay of payments.





Special Rules for Stock Rights (Options and SARs)

- Options and SARs are exempt from 409A if exercise price is at or above FMV on the grant date and no other deferral feature (plus other conditions)
- Certain modifications of an option and SAR can be considered new grant, which requires the option and SAR's exercise price to be at or above FMV on the modification (new grant) date to continue to be exempt

It is NOT a modification to:

- Accelerate vesting upon a C of C
- Cash out awards upon a C of C
- Issue substitute options or SARs, provided ratio of exercise price to FMV after transaction is not greater than ratio before
- Permit cashless exercises
- It would be problematic to delay exercise period beyond the expiration date of the award or 10 years from the grant date, whichever is shorter



Special Rules for Equity-Related Awards

- Can delay payment of equity related awards (restricted stock, options, SARs, RSUs, etc.), including awards subject to 409A and that would otherwise be paid upon a C of C if:
 - C of C event is either 50% equity sale or sale of 40% assets (but NOT 30% voting control or change in board)
 - Paid on same terms and pursuant to same conditions a shareholders with respect to equity
 - Paid within 5 years of C of C event OR subject to substantial risk of forfeiture similar to shareholders
- Example: Employee has RSUs that vest and are paid out upon C of C. In C of C transaction, shareholders subject to a 3-year earnout. RSUs can also be made subject to 3-year earnout. This is not treated as an impermissible delay in payments.





Other 409A Considerations – Identifying Specified Employees

- Under arrangements subject to 409A, payments due upon separation from service must be delayed for six months if paid to “specified employees” of public companies
- Specified employees generally means officers of public companies (including foreign exchange traded) and subsidiaries who are the top 50 paid, plus 1% and 5% owners
- In some cases, individuals identified on specific date (“identification date”), e.g., individuals identified on December 31 are considered “specified employees” for next year
- If two public companies merge, the acquirer must combine lists of both companies, re-rank by compensation, and create new top 50 list which remains in effect until next identification date
- If private company acquired by public company, no private company employee is specified employee until next identification date; by that time, private company arrangements must be amended to add 6-month delay



Section 280G: Golden Parachute

- Section 409A focuses on *time* and *manner* of payment
- Section 280G focuses on *amount* of payment





Section 280G Basics

- C corporations only (public and private)
- Payments to “disqualified individuals”
- Payments made in connection with or closely associated with a change of control
- Corporate consequence: loss of deduction
- Executive consequence: 20% excise tax



Terminology and the Cliff

- Base Amount: Average taxable compensation from prior five prior calendar years (W-2 income)
- Parachute Payments: Payments or enhancements made in connection with C of C
- Safe Harbor Amount: Three times base amount (minus \$1)
- Excess Parachute Payment: Any amount over Base Amount (if total parachute payments exceed Safe Harbor Amount)





Examples

- Executive has Base Amount of \$300,000
- No benefits other than stay bonus
- Situation #1: Executive receives stay bonus of \$899,999
- Situation #2: Executive receives stay bonus of \$900,001



Examples (cont'd)

- Executive benefit for Situation #1: \$540,000 @40% income tax
- Executive benefit for Situation #2: \$420,000 @40% tax plus 20% excise
- Corporate cost for Situation #1: \$540,000 assuming tax benefit @40%
- Corporate cost for Situation #2: \$780,000 assuming tax benefit @40%





Practical Insight – Improved Disclosure

- New SEC disclosure rules for public companies
- Pro forma disclosure in compensation discussion and analysis
- Now requires quantification of gross up payments
- Increased scrutiny by compensation committees and shareholders



Practical Insights – Understanding the Cost

- Understand true costs and benefits of gross-ups
- Recommend analysis of after-tax cost to corporation
- Compare to after-tax benefit to executive





Practical Considerations – Making C of C Payments

- Cashing out equity awards in an amount equal to the amount “received” by shareholders in the c of c transaction (dealing with earn outs and escrow)
- Severance arrangements that promise continued insurance benefits after termination of employment
- Severance arrangements that pay the amount the individual would have received for the next “x” years under the company’s qualified retirement plans
 - 401(k) deferrals
 - Matching contributions
 - Earnings



Practical Considerations – Making C of C Payments (cont’d)

- Valuing non-cash benefits for purposes of 280G calculations
- Determining tax gross-up amounts
- Making pro-rata payments of bonus amount (minimum, target or maximum?), including when pro-rata amount already paid upon c of c event
- Transferring nonqualified deferred compensation arrangements to asset buyers
 - Asset buyer may not be entitled to deduction when paid because services not rendered for asset buyer





Practical Insight – Live Transactions

- In live transactions, agree to project payments based on common assumptions
- Buyer's and seller's computations should match
- Better to resolve differences in front of deal



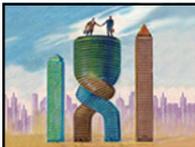
Practical Insights – Renegotiating the Deal

- Substitutions of awards now restricted by Section 409A
- Previously standard practice to renegotiate form and timing of awards in front of transaction
- Assume payouts will be made in accordance with agreements



Practical Considerations – Gross-Ups

- Timing of gross-up payments under Section 409A
- What happens with post-closing dispute of gross-up amount on audit



Practical Insights – 280G Exception

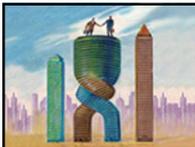
- Shareholder Approval Exception
 - Requires full and adequate disclosure
 - Must determine if executive receives benefit
 - Look through rule for entity shareholders
 - Must be able to approve the transaction separately
 - Not available to public companies





Practical Considerations – Best Practices

- Best practice to address prior to adoption of plan or at time of amendment
- Clarify remaining issues before signing transaction to the extent possible
- Get individual consent if necessary
- Lessens indemnification risk of seller, provides protection and clarity to buyer



Non-Competition Agreements

- General Principles
- Trends

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Basic Considerations

- **Protectible Interest/Rule of Reason Analysis**
- How Courts/Juries View Non-Competes
- One Size Does Not Fit All
 - State/Jurisdiction Specific (For example, CA v. GA v. NY)
 - Industry Specific (Internet business v. bricks & mortar)
 - Activity Specific (R&D v. salespersons)

This presentation does not convey the complexity of the laws of each state/jurisdiction. You should always do a "reality check" and research the actual case law of each state/jurisdiction. Other factors can also affect the analysis.



Protectible Interest/Rule of Reason Approach

- Is the restraint reasonably limited in terms of:
 - Time
 - Territory or market
 - Activity?
 - Look at the executive's duties, location(s) and other relevant items (e.g., customer cycle). Be able to show reasonableness.
- Courts will generally go back to this element when assessing the reasonableness of a non-compete.





Employment Covenants

- 2 years is the norm, although 1 year may be more appropriate in some states (e.g., AZ)
- Geographic Scope:
 - Local business: 50 miles or a group of local counties, boroughs or parishes (if the customer base makes that reasonable) is a general guideline
 - National/International business: some states have enforced nationwide or worldwide covenants
 - But the protectible interest test would have to be satisfied



Geographic Scope – Employment Agreements

- Consider:
 - Expansive geographic scope/narrow business description.
 - Limited geographic scope/general description of business.
- Look at definition of the business (more to come on this).
- Look at the maximum geographic scope if the locations are based on where an individual works (Connecticut).
- No right answer for every situation – always come back to the protectible interest/rule of reason.





Geographic Scope

- Statement that the Agreement is reasonable and not unduly harsh or oppressive
 - Reference to other gainful employment opportunities
 - Broad Territory v. Local Sales Route
 - **Example:** *Employee agrees that the restraint imposed under this paragraph __ is reasonable and not unduly harsh or oppressive and that, in the event that Employee is subject to the Non-Compete following the Employment Period, Employee would be able to find gainful employment within the Restricted Territory in the general field of _____, without providing the highly specialized _____ services and products that Employee is prohibited from providing during the Non-Compete Period.*



Sale of Business Covenants

- Courts give more latitude but still use the rule of reason/protectible interest test.
- Based on the sale of the goodwill of the business.
- There are reasons for reduced scrutiny:
 - Consideration could be substantial.
 - Sellers could be more sophisticated.
 - More likely to be counsel involved for both sides.
 - Less likely to be a disparity in bargaining power.
 - Promotes the transferability of property.
 - Person's ability to earn a living not necessarily at issue.



Sale of Business Covenants

- Longer Duration
 - Instead of 2 years being the norm, 5 years is considered reasonable
 - For an illustration, see Fla. Stat. § 542.335.
- Geographic Scope: still must be limited to the extent reasonably necessary to protect the interests of the buyer



Sale of Business Covenants

- Other Considerations
 - States like California that do not enforce employment non-competes will enforce non-competes in connection with a sale of a business
 - This includes an employment agreement with an individual seller.
 - Recent court decisions: Are the buyer's customers permitted to be included in the scope of the non-compete?





Sale of Business Covenants

- Consider whether the covenant should be based on the business purchased as of the closing date (fixed addresses, fixed lines of business) OR based on the date the seller/employee terminates employment (takes into account changes in locations and lines of business in the interim but adds less specificity and more uncertainty).
- Consider a sale of business non-compete fixed on the closing date PLUS an employment agreement covenant (based on the applicable law of the state of employment) that takes into account changes in locations and lines of business.
- Even minority owners can be bound by non-competes (unless the transaction is deemed to be a ruse to bind someone to a non-compete)



Sale of Business Covenants – Drafting Considerations

- Deal Terms
 - Separate from the purchase document, which the buyer may want to keep confidential
 - State Law (where the executive lives or works; not Delaware)
 - Public policy argument
 - Separate consideration
 - The non-compete should be a closing condition under the purchase agreement (the purchase agreement and non-compete agreement should reference each other)
 - Violation of the non-compete should invoke indemnification rights





Drafting Considerations (slide 1)

- Definition of Business
 - Is it specific?
 - Will someone be able to determine what the company does from the document?
 - Does it contain dangerous “catch-alls”?
 - “Any business in which **[the Company/Employee on the Company’s behalf]** is engaged...”
- Customer-Based Restrictions
 - Prospective (Identified?) v. Actual
 - Geographic limitation required?



Drafting Considerations (slide 2)

- Right to an Injunction/Equitable Relief
 - Seek v. obtain
- Forum Selection Clauses
 - An important consideration depending on the hardship to the executive
 - Beware of the public policy argument
- Jury Trial Waivers
 - Probably a good idea if they are enforced
 - Be Very Careful, although a better chance of being upheld in sale of business context
- Alternative Dispute Resolution Clauses
 - Good or bad for enforcing non-competes?
 - If there is an arbitration clause, is the right to seek an injunction for violation of non-compete/confidentiality included?
 - Current Issues regarding arbitration
 - **NOT NECESSARILY A GREAT SOLUTION – CHECK WITH LOCAL COUNSEL**





Drafting Considerations (slide 3)

- Assignment
 - Stock v. asset deals
 - State law differs
 - Do not assume enforceability of a pre-existing covenant
- Stay away from gender-specific pronouns.
- Remember that one size does not fit all!



Drafting Considerations (slide 4)

- Reformation and the Blue Pencil Doctrine – Three General Theories
 - All or Nothing
 - If the non-compete is a little overbroad, the whole non-compete is declared unenforceable
 - Blue Penciling
 - The court deletes grammatically severable provisions only
 - What does this mean?
 - Reformation
 - The court exercises broad powers to make the non-compete reasonable
 - State/Jurisdiction Differences



Questions and Answers



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Mark Your Calendars

- 2008 M&A Briefing Series continues
 - Keeping Your Deal on Track: Antitrust Issues in Mergers and Acquisitions on September 25, 2008
 - Distressed M&A: Issues and Opportunities on November 13, 2008



Thank You

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