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**PROGRAM MATERIALS**

**Program #30174**

**July 21, 2020**

## **The Intersection between Executive Comp and Corporate Transactions**

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## The Intersection of Corporate M&A and Executive Compensation

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### Biographies

#### **Moderator:**



**Dr. Sharon Meit Abrahams** is President of Legal Talent Advisors, LLC. Dr. Abrahams is a legal talent development expert with over 25 years of experience in success coaching for attorneys and executing high impact programs for law firms. She has created and implemented firm wide initiatives that help attorneys maximize their productivity while maintaining engagement. When individuals produce, a firm increases its profitability. As a talent development leader for three major firms she has handled every aspect of an attorneys' firm life from onboarding and integration, through mentoring and substantive training to succession planning and retirement.

Dr. Abrahams has published three books with the American Bar Association and regularly publishes articles for Thomson Reuters and American Legal Media on professional and business development. Known for engaging and educational programs, Dr. Abrahams is a sought-after keynote speaker, program facilitator and law firm advisor. She gives back to the community by conducting complimentary programs and workshops for 501(c)(3) organizations. She can be reached at [sharon@legaltalentadvisors.com](mailto:sharon@legaltalentadvisors.com).

#### **Panelists:**



**Stephen E. Fox** is a partner in the Uniondale, Long Island, New York office of Ruskin Moscou Faltischek PC and a member of the Corporate & Securities, International and Corporate Governance practices at the Firm. He has over 22 years of experience specializing as a corporate and securities lawyer and acting as outside counsel and a trusted adviser to companies, individuals and investment funds. He has advised both strategic and financial clients across numerous industries, including technology, medical device, manufacturing, entertainment, real estate, energy, food and beverage, media, and financial services. Additionally, as transaction counsel, he has led or has taken an active role in hundreds of transactions, ranging from less than \$1 million to more than \$1 billion. He prides himself in his application of practical, creative and real-world guidance and

solutions to client issues, not simply reciting the law or falling back to customary practice.



**Robert M. Fields** has 40 years of legal experience in employee benefits and executive compensation matters. He is a former associate and partner at a number of large, international law firms, and currently maintains a solo practice. He works directly with many individuals and business entities, as well as with a network of law and accounting firms, investment banks and compensation consultants which need the expertise Mr. Fields has in providing services to their clients, but on a less than full-time basis. Mr. Fields is accomplished in assisting his personal, business and professional clients with the following:

The design and establishment of equity-based and non-equity-based executive and director compensation programs, including short and long-term incentive plans, stock-option, restricted stock, restricted stock unit and phantom stock plans, LLC profits interest arrangements, contributory and non-contributory deferred compensation programs, equity deferral plans and similar arrangements. He also provides an analysis of the applicable securities and income tax rules and regulations associated with such programs.

- Negotiating and drafting executive employment contracts and severance agreements.
- Addressing with the employee benefits and executive compensation aspects of corporate mergers, spin-offs, acquisitions, asset transactions and IPOs.
- Assisting clients with the sale of their businesses to ESOPs, including drafting the ESOP plan and trust documentation, addressing the federal income tax aspects of leveraged and non-leveraged ESOP transactions, and assisting with designing the financial structure of ESOP transactions.

Mr. Fields has appeared on several cable news shows, multiple times as a guest on CNBC, and has repeatedly been quoted in the *Wall Street Journal* and other periodicals as an expert on executive compensation. He also has been a guest lecturer at the Cornell Law School on matters relating to the practice of law.

## **General Considerations Regarding M&A Transactions Involving Closely Held Companies**

- 1) Initial Consideration – to bring in separate benefits counsel or not?
  - a) Size, structure and complexity
    - i) Treatment of existing awards under contemplated transaction structure
  - b) Client legal budget
  - c) Due Diligence
    - i) Existing benefits plans and arrangements
    - ii) Number of employees
    - iii) Early recognition of potential liabilities
  - d) Employment terms of employees to be hired or retained by the Buyer
  - e) Buyer-side or Seller-side
  - f) Benefits counsel v. Labor & Employment counsel
- 2) Stock Sale v. Asset Sale
  - a) Stock Sale
    - i) Buyer assumes all liabilities and acquires all assets of the Seller company
    - ii) No transfer of employees that are being retained by Buyer
    - iii) Employment terms can still be renegotiated
  - b) Asset Sale
    - i) Buyer cherry-picks assets to purchase and liabilities to assume
    - ii) Limited exceptions to exclusion of liabilities
    - iii) Treatment of compensation and benefit liabilities and obligations of seller post-closing
- 3) Potential Liabilities
  - a) Outstanding equity and cash awards

- i) Acceleration of vesting
  - ii) Roll-over
- b) Unfunded pension liabilities
- c) Withdrawal liabilities
- d) COBRA
- e) Litigation
- f) Parachute Payments
- g) Government audits
- 4) Consent of Award holders of Seller
- 5) Buyer compensation plans and arrangements
- 6) Re-negotiate purchase price and/or increase indemnity obligations
- 7) Controlled Group Liability
- 8) Planning for a future sale of company

**Description of Executive Compensation Programs Utilized by Closely Held Businesses**

- 1) Equity-based Awards
  - a) Stock Options and Stock Appreciation Rights (no longer state-of-the-art)
  - b) Restricted Stock and Performance Shares
  - c) Restricted Stock Units and Performance Stock Units
  - d) LLC or Partnership Profits Interests
- 2) Cash-based Awards
  - a) Multi-Year Cycle Performance Bonus Programs (“LTIPs”)
  - b) Phantom Stock

**Increased emphasis on Pay for Performance for Closely Held Companies.**

- 1) Benefits continue to be “time vested” (i.e., employees must provide a minimum amount of service prior to becoming eligible to receive benefits).
- 2) However, the current standard is to also impose “performance vesting” on all forms of benefits. Thus, options, SARs, restricted stock, RSUs, profits interests and Phantom Stock (and other cash-based awards) will not vest until certain company-wide, division or individual performance goals are satisfied.
- 3) Carefully drafted time and performance-based programs will achieve two goals in M&A situations: (i) they will help “dress a company up” for sale and make it a more attractive acquisition (ii) will impose golden handcuffs on key individuals who will be incentivized to help achieve the highest purchase price possible and, if requested by the purchaser, stay with the company for a certain period after the closing of the acquisition.

### **Stock Options and Stock Appreciation Rights.**

- 1) Historically used by closely held business entities.
- 2) However, these are currently “out of style” and are not recommended in either case because they are not “full value awards” like restricted stock and RSUs and, accordingly, result in an excessive “burn rate” in stock available for awards under the programs.
- 3) Design Alternatives in the M&A Context
  - a) Vesting and acceleration of vesting (with an increased emphasis on the attainment of one or more company-wide and/or division or personal performance goals, as well as tenure with the company, as requirements for vesting in benefits)
  - b) Exercise price: Generally, the exercise price must be no less than the fair market value of the underlying stock on the date of grant. However, if certain requirements are satisfied, discounted options may be granted.
  - c) Dilution to existing stockholders
  - d) Tax Implications (Including ISO Rules):
    - i) Impact on Option Holders
      - (1) Grant. There is no federal income tax impact on the option holder solely by reason of the grant of Incentive Stock Options (“ISOs”) and Non-Qualified Options (“NQOs”).
      - (2) Exercise. The exercise of an ISO is not a taxable event for regular federal income tax purposes if certain requirements are satisfied. However, the

exercise may give rise to an alternative minimum tax liability. Upon the exercise of an NQO, the option holder generally will recognize ordinary income in an amount equal to the excess of the fair market value of the shares of the company's stock at the time of exercise over the amount paid as the exercise price. The ordinary income recognized in connection with the exercise by an option holder of an NQO will be subject to both wage and employment tax withholding. The option holder's tax basis in the shares acquired pursuant to the exercise of an option will be the amount paid upon exercise plus, in the case of an NQO, the amount of ordinary income recognized by the option holder upon exercise.

- (3) Dispositions. If an option holder disposes of shares of the company's stock acquired upon the exercise of an option in a taxable transaction, the option holder will recognize capital gain or loss in an amount equal to the difference between his or her basis in the shares sold and the total amount realized upon the disposition. Under current law, any capital gain or loss will be long-term depending on whether the shares of the company's stock were held for more than one year from the date the shares were transferred to the option holder.

ii) Impact on the Company

- (1) There is no federal income tax impact on the company by reason of the grant of ISOs or NQOs or, generally, upon the exercise of ISOs (other than disqualifying dispositions).
- (2) At the time the option holder recognizes ordinary income from the exercise of an NQO, the company will be entitled to a federal income tax deduction in the amount of the ordinary income so recognized (as described above), provided that the company timely satisfies the reporting and disclosure obligations described below.
- (3) The company will be required to report to the Internal Revenue Service any ordinary income recognized by an option holder by reason of the exercise of an NQO or certain dispositions of the company's stock acquired pursuant to an ISO.

### **Restricted Stock and Performance Shares**

- 1) Restricted Stock and Performance Shares basically are grants of stock that are subject to time and/or performance vesting. It currently is the practice to grant Performance Shares much more often than traditional Restricted Stock.
- 2) Design Alternatives in the M&A Context

- a) Vesting and acceleration of vesting (See comment above regarding Options and SARs)
  - b) Dilution to existing stockholders
- 3) Tax Implications – Section 83
- i) Impact on the Individual
    - (1) The value of the restricted stock generally will be includable in the individual's gross income as of the date the restrictions lapse and the stock is no longer subject to a substantial risk of forfeiture. The individual will recognize ordinary income equal to the fair market value of the stock determined as of that date. Under certain circumstances, however, the individual may wish to make a so-called "Section 83(b) election" to have the value of the stock determined and includible in his or her gross income at the time of grant, regardless of any vesting restrictions on the stock. If the election is made, any appreciation in the value of the stock after the date of grant will be taxed at capital gains rates if and when the stock is sold by the individual. Thus, a Section 83(b) election may be worthwhile if (i) the value of the stock is relatively small on the date of grant, (ii) significant appreciation is expected between the date of grant and the date the restrictions expire **and** (iii) if the individual reasonably expects that he or she will eventually vest in the shares of restricted stock.
  - ii) Impact on the Company
    - (1) At the time the individual recognizes ordinary income upon the vesting of the restricted stock (or, if earlier, when the Section 83(b) election is made), the company generally will be entitled to a federal income tax deduction in the amount of the ordinary income so recognized, provided that the company timely reports to the Internal Revenue Service the ordinary income recognized by the individual pursuant to the award. Any dividends paid on restricted stock prior to the earlier of (i) the date the restrictions lapse or (ii) the date a Section 83(b) election is made will be deductible by the company as a compensation expense.

### **Restricted Stock Units and Performance Stock Units**

- 1) RSUs and PSUs constitute an unsecured promise to deliver a number of shares of stock in the future if certain time vesting requirements are satisfied (for RSUs) and, in the case of PSUs, performance vesting requirements as well as time vesting restrictions.



Thus, RSUs and PSUs may constitute “deferred compensation” for purposes of Section 409A (see below).

- 2) Design Alternatives in the M&A Context: See above regarding vesting (but with a great emphasis on use of performance-vesting goals for PSUs). Furthermore, many RSU/PSU Plans are drafted to provide for a “bonus” amount of RSUs/PSUs to be paid out if performance results are stellar.
- 3) Tax Implications:
  - a) Impact on the Individual
    - i) An award payable in the form of RSUs and PSUs generally will be includable in the individual’s gross income as of the date the underlying shares of stock are transferred to the individual or, if later, the earlier of the date the underlying stock awarded to the individual (i) is subsequently transferable by him or her or (ii) is not subject to a substantial risk of forfeiture.
    - ii) At the time the stock underlying an RSU or PSU is distributed to an individual (or, if later, when the stock becomes non-forfeitable), he or she will recognize ordinary income to the extent of the excess of the fair market value of the stock on the date of delivery (or, if later, the date the substantial risk of forfeiture terminates) over the individual’s cost (if any) of the stock.
    - iii) If an individual disposes his or her shares of the company’s stock received under an award in a taxable transaction, the individual will recognize capital gain or loss in an amount equal to the difference between his basis (generally, the amount included as ordinary income pursuant to the award and the amount, if any, paid for the stock) in the shares sold and the total amount realized upon the disposition. Any capital gain or loss will be long-term so long as the shares of the company's stock was held for more than one year from the date the shares were granted to the individual.
  - b) Impact on the Company
    - i) At the time the individual recognizes ordinary income upon the receipt of the stock underlying RSUs or PSUs, the company generally will be entitled to a federal income tax deduction in the amount of the ordinary income so recognized.

## **LLC or Partnership Profits Interests**

- 1) A “profits interest” is an interest in an LLC or partnership that is equal to the increase in the value of the company from the date of grant. Thus, at the time of grant, the value of the profits interest is \$0.00.
  - a) Design Alternatives in the M&A Context: See above regarding RSUs and PSUs. In addition, the company can design a profits interest plan to provide that benefits will be equal to the increase in the fair market value over an amount in excess of the value of the company on the date of grant.
  - b) Tax Implications:
    - i) Impact on the Individual:
      - (1) If carefully drafted, the grant of the profits interest will not be a taxable event and any gain received from the disposition of the right will be taxed at capital gains rates. Furthermore, these favorable tax consequences will apply even if the profits interests are subject to time and/or performance vesting requirements.
      - (2) The rules that must be followed to qualify for this advantageous tax treatment are quite simple:
        - (a) Again, the profits interest must only apply to the increase in the value of the LLC from the date of grant. Thus, it must have a \$0.00 value if the LLC was liquidated at the time the interest is granted. Although there is no legal requirement to do so, it would be wise to obtain a third-party valuation of the LLC as of the date of grant as an added layer of insurance that the IRS will respect the tax advantaged nature of the grant.
        - (b) The recipients must hold their profits interests for at least two years after the date of grant.
        - (c) The recipients must not be entitled to a certain stream of income from the LLC in conjunction with the profits interests. From an income / loss standpoint, they should be treated no better than any other equity owner.
    - ii) Impact on the Company
      - (1) The company is not entitled to an income tax deduction at the time the profits interest is granted nor at the time the LLC is liquidated.

## **Cash-Based Awards**

- 1) **LTIPs** are cash bonuses paid at the end of a multi-year (usually 3 year) performance period. The amount of the bonus is determined by the degree by which the predetermined performance goals are satisfied. Usually, 100% of a predetermined amount (often a multiple or percentage of base salary) is paid if the “target” goal is satisfied, with the payment being increased pursuant to a formula if the target goal is exceeded and, similarly, reduced by formula if the target goal is not met.
  - a) Design Alternatives in the M&A Context: Payment can be conditioned on virtually any type of objective and/or subjective performance goals chosen by company management. These often include amount of purchase and an agreement to continue providing services through the of the sale (and for a specified period thereafter if requested by the purchaser).
- 2) **Phantom Stock** is an unfunded right granted to employees or other service providers to receive a percentage of the proceeds of the employer upon the company’s sale or other liquidity event. Often, these rights are subject to both time and performance vesting requirements.
  - a) Design Alternatives in the M&A Context: As with LTIPs, payment can be conditioned on virtually any type of objective and/or subjective performance goals chosen by company management. These often include an agreement to continue providing services through the of the sale (and for a specified period thereafter if requested by the purchaser).
  - b) Tax Implications – 409A: Generally, if the requirements of Section 409A are satisfied (or if Section 409A does not apply in a particular situation), the employee / service provider is subject to ordinary income tax for the taxable year during which the cash benefit is paid and the company is entitled to a related tax deduction.

## **Equity-based Awards for Privately-Held Companies – Issues to Keep in Mind**

- 1) Determination of Fair Market Value for Benefit Determination / Tax Requirements
- 2) SEC Exemptions from Registration Requirements
  - a) Rule 701
  - b) Anti-fraud rules
  - c) State registration or qualification
  - d) Form S-8
  - e) Section 280G

- f) Stockholders' Agreements - Stock Restriction Agreements

### **Additional M&A Considerations Regarding Compensation and Benefits**

- 1) Employee Benefits / Executive Compensation Due Diligence
- 2) Drafting SPA / APA:
  - a) Representations and Warranties
  - b) Pre-Closing Covenants
    - i) Seller cannot/must terminate certain executives or employees prior to closing
    - ii) Seller cannot materially increase compensation or grant bonuses
    - iii) Seller cannot adopt new or amend existing benefits plans or awards
    - iv) Ordinary course practices
    - v) Post-Closing Covenants
      - (1) Compensation levels of and benefits to employees post-closing
      - (2) Recognition of pre-closing services
      - (3) Allocation of liabilities pre- and post- closing
      - (4) Shareholder approval for parachute payments
    - vi) Language depends on whether representing the Seller or Purchaser
  - c) Pre-Transaction Design Considerations:
    - i) Completion Bonus
    - ii) Success Fees
    - iii) Stay Bonus
    - iv) Post-Closing Incentive Programs and Employment Contracts
  - d) Employment Agreements
  - e) Use of ESOPs Rather than Selling a Closely Held Business to a Third Party: This is a very useful, but complicated, alternative. We are available to discuss this with you if you desire.

## Accounting Issues Related to Equity-Based Compensation

- 1) ASC – 718

## Section 409A

- 1) Implications throughout Executive Compensation
- 2) Regulations and Commentary Extremely Lengthy and Complicated
- 3) Proposed Regulations Have had a major impact on these rules.

