Ready for a Sale? Part 2: Change in Control Provisions and Treatment of Outstanding Equity Compensation

A Practical Guidance® Article by
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This article is Part 2 in the "Ready for a Sale?" series, which is aimed at getting the human resources, benefits, and executive compensation functions of your organization ready for a potential sale or similar corporate transaction. Part 1 provided general guidelines and suggestions on how to get organized and start the process. This second part will address key considerations in the process that often arise early: (1) identifying, assembling, and analyzing documents that will be automatically triggered or impacted by the potential sale, and (2) determining the expected impact of the transaction on any outstanding equity compensation.

Trust us, if your company enters a potential sale, there will be a day when all of your proactive efforts on the items below will pay off!

Practical Tips

- Identify each agreement, benefit plan, or other arrangement that has a change in control trigger in it to determine how these arrangements will be treated in the deal.
- Consider whether it is preferrable to implement any new change in control, transaction, "thank you" or retention bonuses or plans, or severance plans, entitlements, or protections.

Once all of the definitive copies of executive compensation and employee benefit plan materials are compiled as described in Part 1, a good next step is to do a deep dive to determine what the impact of the proposed transaction will be on those arrangements and plans. Most often, triggers that may be impacted by a proposed transaction will be provisions that are impacted by, or triggered by, a "change in control," although any particular plan or arrangement may refer to a "sale of the company," a "liquidity event," or a "corporate transaction," or use similar terminology.

The most common arrangements with change in control triggers are a company's equity plan (described in further detail below) and individual employment agreements with senior executives, but there can also be change in control triggers in long-term cash incentive plans, deferred compensation plans, and even broad-based employee benefit plans. There also can be anti-assignment clauses in employment agreements that could impact a proposed transaction. Each company is different so working with outside counsel to do a thorough review is recommended, although the following box of specific considerations will hopefully serve as a starting point for this process.

Specific Considerations: Identifying Potential CIC Arrangements

How does the equity compensation plan treat outstanding awards and do any individual award agreements deviate from the default treatment under the plan?

- Do any individual employment or compensation agreements provide for change in control or transaction bonuses? Do they provide for any retention bonuses for the period following a transaction or that would be accelerated by a transaction?
- Will the proposed transaction impact deferred compensation arrangements either by accelerating amounts that would otherwise be deferred or by requiring the company to fund a rabbi trust?
- Will the proposed transaction limit the ability to amend any employee benefit plans? As a protection for employees, some plans provide that for a specified number of months or years following a change in control, the plan may not be modified or amended in a way that would impair the rights of participants. Most commonly, these protections are found in severance plans, but very rarely similar provisions or triggers can be found in retirement or other broad-based benefit plans.
- Does the company utilize a third-party professional employer organization (PEO), and, if so, does the services agreement with the PEO have a change in control trigger in it?

Once you and your outside legal counsel have a handle on what will happen under compensation arrangements, benefit plans, and services agreements with benefit plan vendors, the next natural questions are "is that enough to reward, retain, and incentivize key employees?" and, if not, "does the company want to implement any other arrangements, plans, or bonuses?"

Below is a non-exhaustive list of considerations for heightening employee protections and entitlements in the transaction context. Companies should work closely with outside counsel on whether any of the considerations listed below should drive them to implement any new arrangement and what form those arrangements should take.

Specific Considerations: Implementing New Arrangements

- Is the company engaging any special or one-off advisors to assist with the proposed transaction? If so, how will they be compensated?
- Are any in-house members of the team expected to take on additional work related to the transaction? If so, should they be entitled to additional compensation?
- Would it be advantageous to set up a retention program to ease any concerns among the employees? Should the retention program pay out at the time of the transaction or after a specified period of time following the transaction (e.g., six or 12 months)?
- Did the company expect to implement an equity plan and never formalize the arrangements or were employees expecting greater value increase in respect of their equity awards prior to a sale? If so, should employees be "made whole" by new transaction awards?

Equity Compensation Plans and Awards

As noted above, one of the most common compensation arrangements that includes a change in control trigger is the company's equity plan. In reviewing the equity plan, determine whether the equity plan provides for automatic treatment on a change in control (such as accelerated vesting of any unvested awards) or whether the plan provides a list of discretionary alternative courses of action that the plan administrator can take with respect to equity awards. The company and its advisors should determine whether any individual award documentation deviates from, or overrides, the treatment provided for in the plan (i.e., the plan does not provide for specific treatment, but some individual award holders have individual agreements that provide accelerated vesting). Treatment of equity awards in the context of a transaction are described in a prior ML BeneBits blog post in more detail.

In addition to considering how outstanding awards will be treated, there are several considerations listed in the following practical tips box that may come up in a proposed transaction. The following specific considerations involve complex legal implications and nuanced economic impacts so consider bringing in outside advisors in early and often.

Specific Considerations: Equity Compensation Plans, Awards and Agreements

- Is there “dry powder” in your equity plan (i.e., unused share or unit pool reserved and allocated to the equity plan)? If so, is it preferrable to grant remaining awards or set up a cash transaction bonus program that represents the economic equivalent of the dry powder so that the value is not left on the table?
- Are there any outstanding offer letters that promise to provide an equity grant to the offeree who has not started or that has not otherwise been granted?
- If your company has granted options or stock appreciation rights (SARs), do you have records of valuations or other materials supporting the determination that exercise prices were based on fair market value at the time of grant?
- If your company has granted restricted stock, restricted capital interests or profits interests, do you have records of all 83(b) elections filed by the company’s employees (and if not filed, clear reasoning for why they were not required)?

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