



Comp Talks: Negotiating and Implementing Executive Employment Agreements

June 27, 2017

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attorney advertisement

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The Big Picture

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Preparing the offer

- Role of a term sheet
- Internal pay equity (what do other executives' agreements say and why?)
- External pay equity (peer group benchmarking)
- Prior public disclosure (review CD&A and other public disclosure for consistency with stated goals, policies and commitments)
- Consider institutional investor and proxy advisory firm positions
- Enlist outside counsel to flag legal/tax issues early
- Do the math to understand 162(m) impact and severance/change in control payout

Corporate governance and disclosure

- Who has authority to approve?
- Managing the process with the compensation committee and in some cases, full board
- Best practices re: type of information and timing provided to directors
- Remembering all public disclosure requirements and what triggers each one to avoid missing a requirement or triggering disclosure earlier than desired

Structuring the agreement

- Employment agreement vs no written agreement
- Omnibus agreement vs incorporating by reference
 - Severance & bonus plans, indemnification agreement, confidentiality and invention assignment agreement
- Fixed term vs no term vs fixed term + auto renewal
- Rationale to depart from standard key terms and definitions
 - Especially cause, good reason, severance
- Technical issues: Section 409A and change in control/Section 280G

Salary, Bonus and Equity Terms

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Base salary and annual target bonus

- Base Salary
 - Guaranteed increases unusual and are disfavored by institutional investors/proxy advisory firms
 - What sort of decrease, if any, should trigger “Good Reason” to resign?
 - \$1 dollar salary club (Warren Buffett, Mark Zuckerberg, John Mackey)
- Annual bonus
 - Prorated or guaranteed bonus for partial year?
 - Earned as of bonus year-end or only if employed when paid?
 - Performance criteria

Signing bonus

- Often used as sweetener, or for “make whole” payment for amounts executive will forfeit to prior employer
- Institutional investors/proxy advisory firms will scrutinize
- Consider disclosure optics – rationale and magnitude
 - Alternative arrangement to achieve desired economic result
 - Additional make whole equity award tied to vesting
- Clawback if resignation or for cause termination within minimum period (usually 12 months)

Initial equity grant

- Check applicable limits/constraints
 - Available shares
 - Limits on grant size in equity plan for 162(m) or other purposes
 - Separate requirements under equity grant policy
- Inducement grant as alternative
 - But don't forget special requirements and disclosure obligations
- Equity award mix as tool to manage optics
 - Break up large grant between time and performance-based

Ongoing annual equity awards

- Discretion of board (best practice) vs multi-year guarantees
 - Disfavored by institutional investors/proxy advisory firms (tying vesting/payout to performance goals, may mitigate concerns)
 - Include cut-off/expiration of commitment and caveat for compliance with securities law

Ongoing annual equity awards (cont'd)

- Watch out for language that conflicts with equity plan/existing awards
 - Commitment subject to plan/award document terms
 - Caveats for M&A treatment, “cause” termination, forfeiture for competition clause
 - Later-added changes to existing awards may result in accounting charges

Employee Benefit Terms

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Participation in benefit plans

- Avoid implied “most favored nation” clauses

“Executive shall be entitled to participate in all employee benefit programs ...on a basis that is no less favorable than provided to similarly situated executives”

- Include caveat about ability to change benefit arrangements

“The Company reserves the right to cancel or change the benefit plans or programs it offers to its employees at any time”

- Protects against claims triggered by common business decisions – e.g. change to group health insurance provider
- Does “good reason” definition include diminution of benefits as a trigger?

Relocation benefits

“Subject to your relocation to the [city] metropolitan area by [date] and your continued employment through the time of relocation [and for _____ months thereafter], the Company will reimburse you for your reasonable relocation expenses, subject to the terms of the Company’s relocation policy, up to a maximum of \$_____.”

Red Flag: Taxable relocation benefits must comply with Section 409A rules for expense reimbursements. Common issue: amounts reimbursed in one year cannot affect amounts eligible for reimbursement in another year.

Solution: Designate single calendar year in which amounts are reimbursed:

Example 1: *“Relocation expenses must be incurred not later than [end of year of start date].”*

Example 2: *“To comply with Section 409A of the US Internal Revenue Code, any taxable reimbursements will be paid to you in [Year following year of hire].”*

Perks

- Institutional investors and proxy advisory firms strictly scrutinize these
 - Tax gross ups, including for 280G excise taxes
 - Home loss buyout and other extraordinary relocation benefits
- When in doubt, assume they are taxable
 - Commuting costs \neq business travel expenses
- Tracking and disclosing – recent SEC enforcement action against former CEO for failure to disclose perks

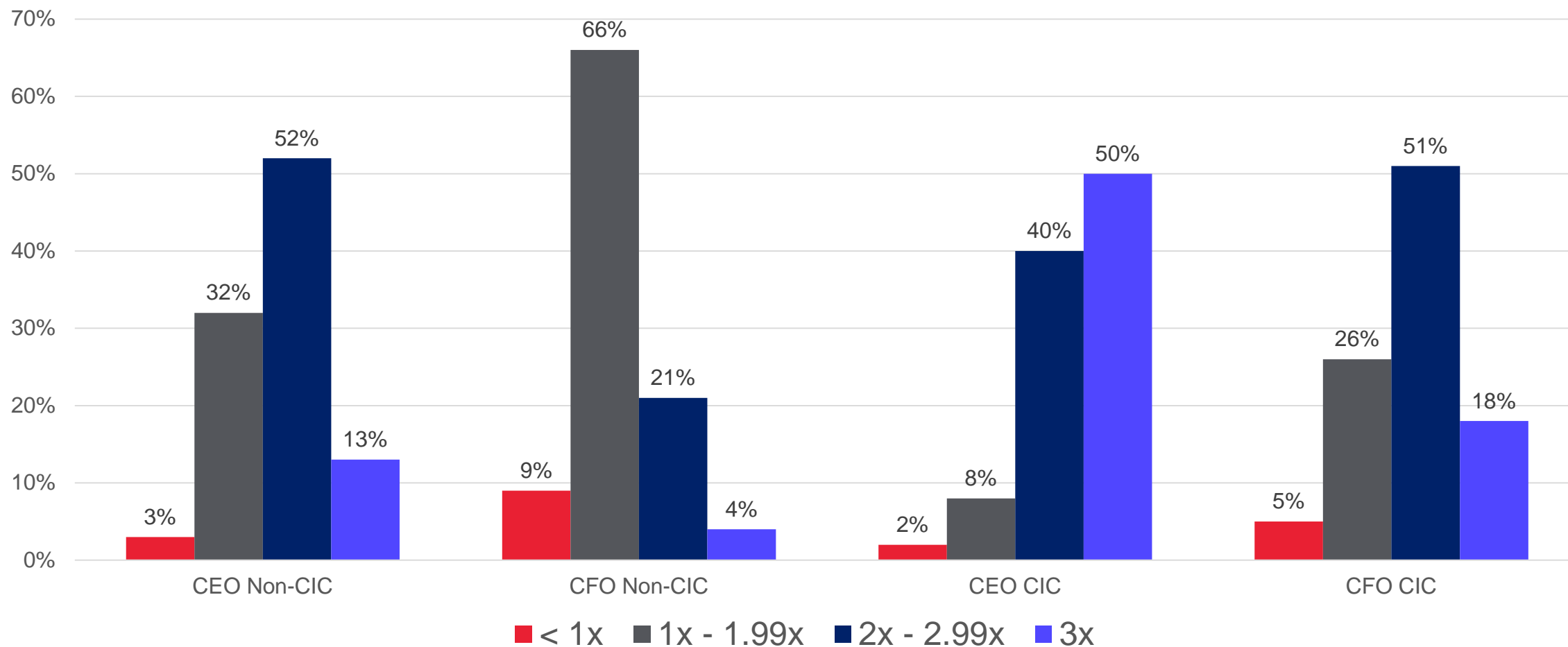
Severance Provisions

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Cash severance: lump sum vs installments

- Installments may ensure compliance with continuing obligations
- Lump sum may avoid Section 409A 6-month payment delay
- Hybrid approach: paid in installments *except* on change in control, death, disability – OK under Section 409A if:
 - Section 409A-compliant definitions of CIC and disability (if applicable)
 - CIC severance provisions only apply to terminations within 2 years following CIC

Cash Severance Multiples



Cash severance: Section 409A impact

- Will the benefits be compliant or exempt?
 - 6 month delay required for non-exempt benefits payable to “specified employees”
 - Limited ability to change timing of non-exempt severance payments
 - Limited payout triggers are permitted for exemption to be available

Cash severance: target vs actual earned bonus

- Target is simpler – less potential for disputes, payable in lump sum (more common for CIC severance)
- BUT: consider Section 162(m) results
 - Restrict bonus payment to amount earned based on actual performance during the performance period to preserve Section 162(m) treatment of bonus program?
 - Prorate payment for days employed during period and paid on normal schedule after determination of performance?

Post-termination health coverage

- Company has **fully insured** health plans
 - May not be able to provide coverage beyond COBRA period
 - Under ACA, special benefits to executives may be subject to penalties
 - \$100/day times number of employees not receiving same benefit, BUT no requirement to comply unless/until IRS guidance issued
- Company has **self-insured** health plans
 - More flexibility to define eligibility
 - If premiums treated as non-taxable, then *benefits* paid out under plan will be taxed
- **Drafting Tip:** Simplest solution is to provide a taxable cash payment

Timing of payments conditioned on a release

“The Severance will be paid in a lump sum ...

... on the sixtieth (60th) day following Executive’s Separation from Service, provided the Release has become effective”

“... within [X] days following the effectiveness of the Release; provided that if the Release Execution Period begins in one taxable year and ends in another taxable year, payment shall not be made until the beginning of the second taxable year”

- **Drafting Tip:** Generally, executive cannot control timing of severance subject to Section 409A as between tax years – either sample above removes ability to control in which year severance begins

Change in Control Provisions

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Definition of change in control

- What is a change in control?
 - Should require a true ownership change (consider what is right %)
 - Change in board composition prong – proxy battles
 - Avoid “liberal” CIC definition where triggered prior to actual closing (e.g., at signing or commencement of tender offer)
 - Exceptions to CIC (e.g., “top hat” or “double dummy” structure for “acquirer” company)

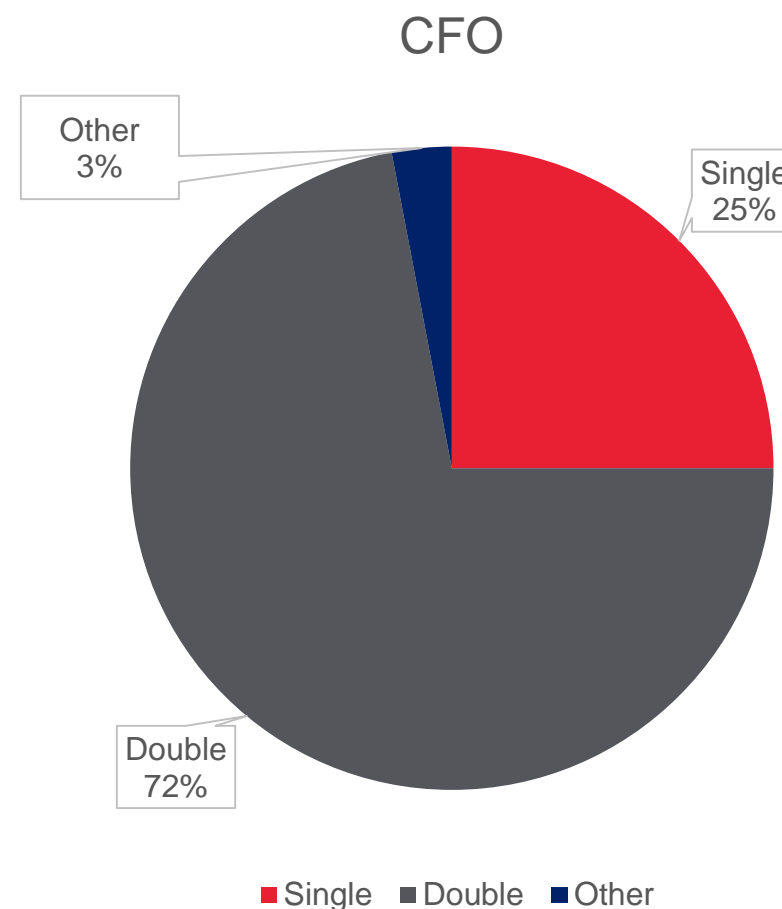
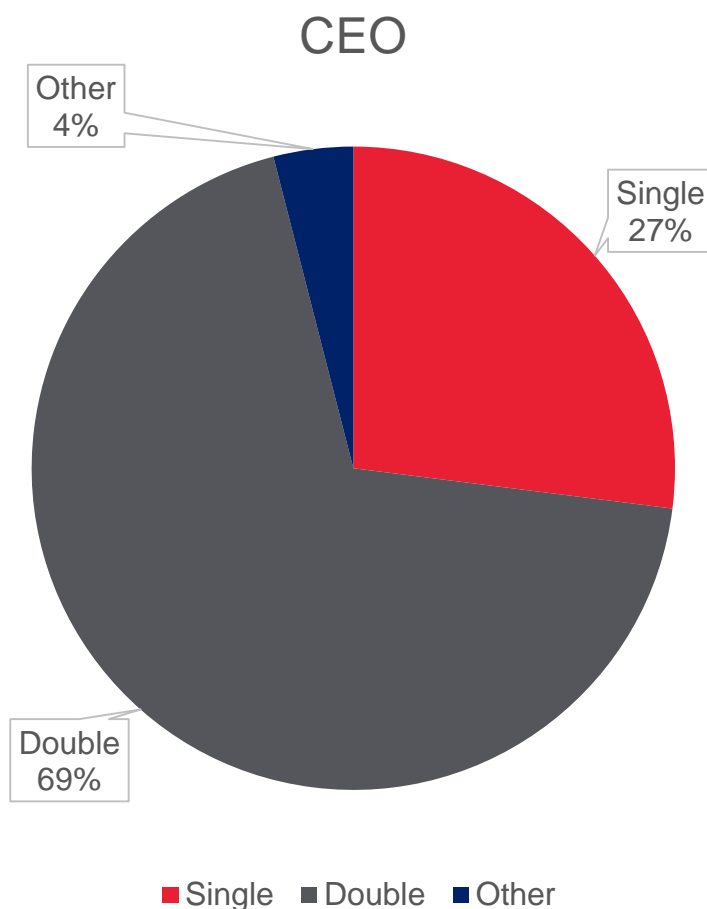
Definition of good reason

- Diminution of duties, authority or responsibilities prong
 - Will this always be triggered for certain people (e.g., CEO)?
- Carve-out for no practical job change
 - Consider impact of post-closing restructuring
- Relevant for CIC severance only?
- Section 409A safe harbor definition
 - Matters for ability to change payment terms – must be real constructive termination (i.e., not a walk right)

Equity vesting considerations

- Single trigger – disfavored by institutional investors & proxy advisory firms
- Only if award not assumed/replaced?
 - Prevalence of assumption of awards by acquirer
 - What does replaced mean?
 - Check equity plan (many older plans have this provision for all awards)
- Consistency issues
 - Different cause/good reason/CIC definitions in plan, award agreements, employment agreements can wreak havoc

Change in Control Equity Acceleration Trigger



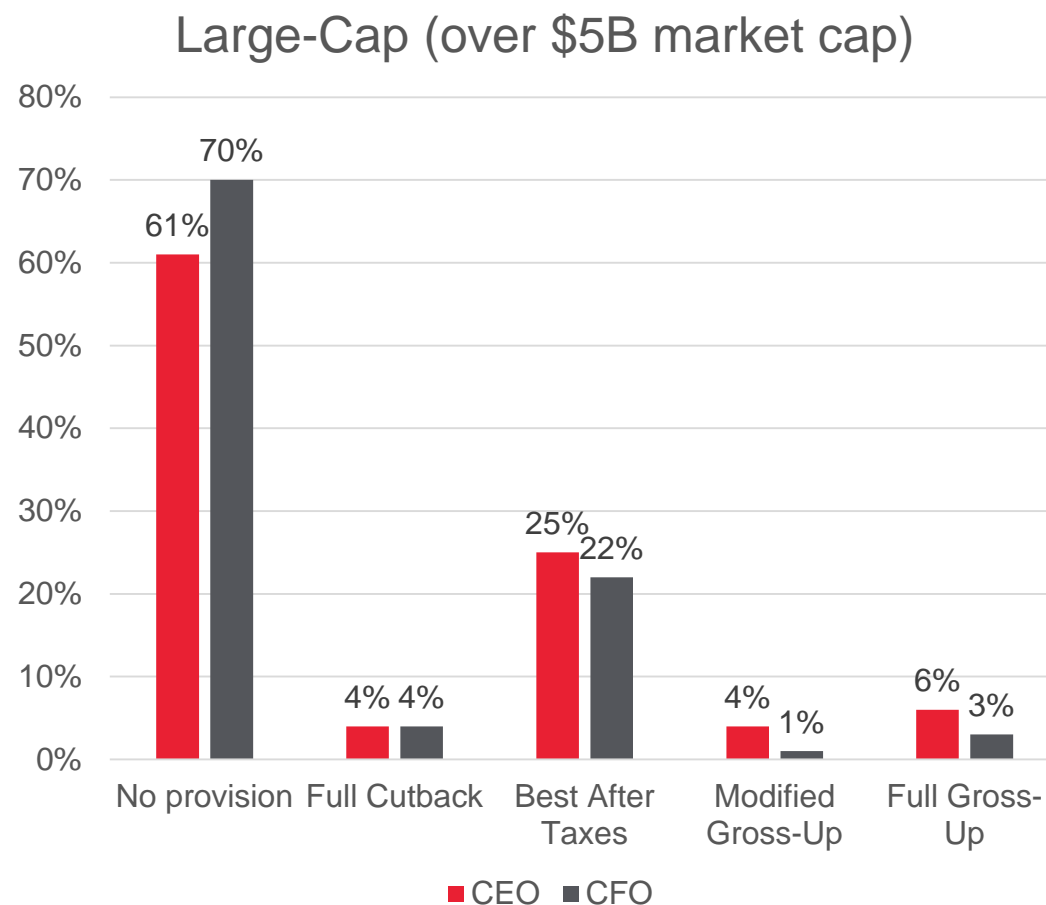
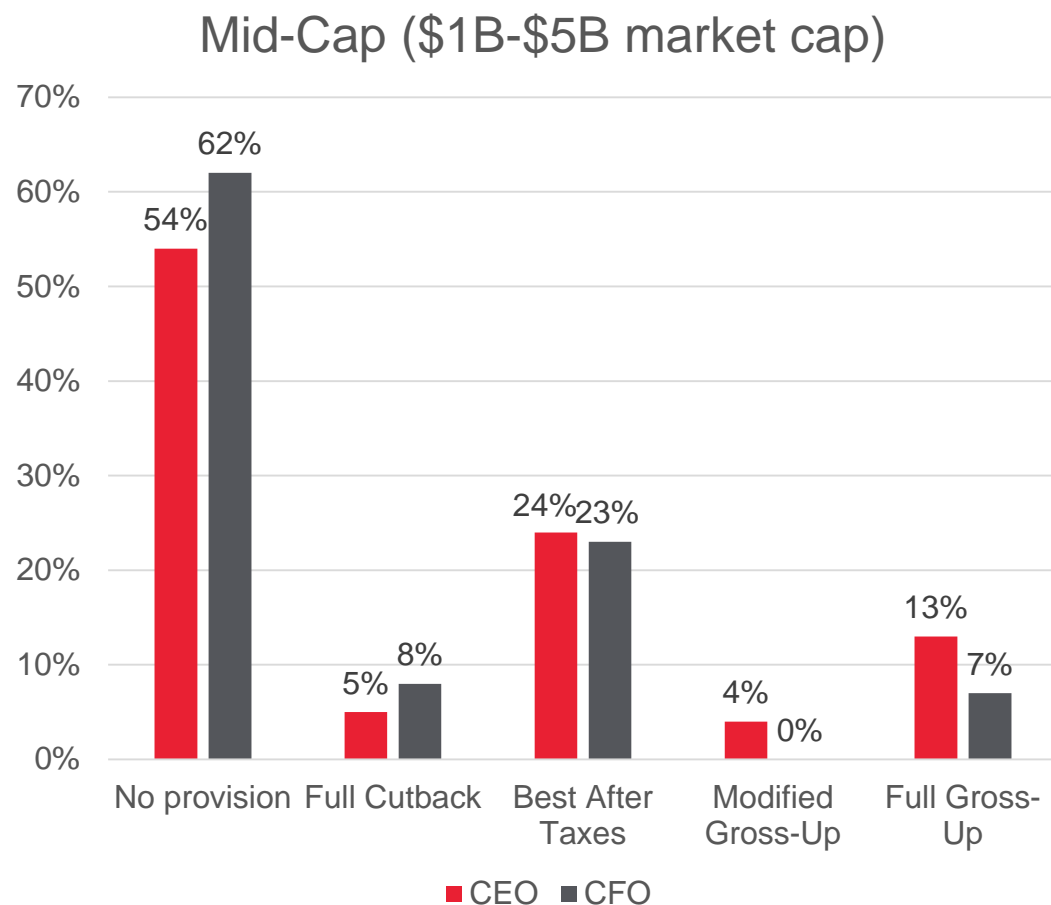
Treatment of performance-based equity awards

- Early payout based on actual performance?
- Changes to performance targets at CIC for assumed awards?
 - Deemed achieved at target/maximum/actual performance through period?
 - Adjustment of criteria based on post-merger entity?
- Number of shares/payout value prorated for elapsed portion of period?
- Convert to purely time-based vesting post-closing?
- Different treatment depending on whether company is target or acquirer?

Section 280G implications and provisions

- No opportunity by public company to avoid 280G taxes with stockholder vote
- Tools to mitigate impact
 - May be able to allocate a portion of severance to value of a noncompete
 - Liquidated damages clause – but difficult in practice to meet 280G rules for exclusion
- Treatment of excess parachute payments
 - Tax gross-up – strongly disfavored by institutional investors and proxy advisory firms
 - Cutback or “best after tax”
 - Who makes determinations – company or acquirer? Executive input? Who pays for analysis?

Prevalence of Section 280G Provisions



Risk Mitigation Tools & Requirements

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Stock ownership guidelines and clawback policies

- Address existing or potential future stock ownership guidelines?
- Address existing clawback policy and any clawback policy the company is required to adopt or decides to adopt in the future
- Clawback provisions broader than to comply with SOX and the Dodd-Frank Act?

Restrictive Covenants & Recent Regulatory Action/Legislation

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Restrictive covenants

- If outside of California: consider post-employment restriction on customer solicitation and competition (include in PIIA, signed at outset of employment)
- Restrictive covenants are a matter of state law – engage local counsel to ensure enforceability
- Post-employment restriction on employee solicitation is enforceable in California and elsewhere

SEC whistleblower protections

- SEC adopted Rule 21F-17 in 2011 under Dodd-Frank Act
 - Rule prohibits taking any action to *impede* someone communicating with the SEC about potential securities law violations
- SEC has been cracking down on companies it believes fail to comply
 - Focus has been on confidentiality agreements and severance agreements (including nondisparagement provisions and releases) that prohibit disclosure of confidential information, or include a waiver of right to receive monetary rewards
- Recently plaintiffs' law firms have sent demand letters notifying companies of potential violations and alleging breach of fiduciary duties

Defend Trade Secrets Act and whistleblower immunity

- Employers required to provide written notice of DTSA immunity and retaliation provisions in every contract with employees, consultants and contractors after May 11, 2016 that governs trade secrets or confidential information
- PIIA should include carveout making clear that notwithstanding nondisclosure obligations, employees can report violations of law

Key takeaways for confidentiality provisions and releases

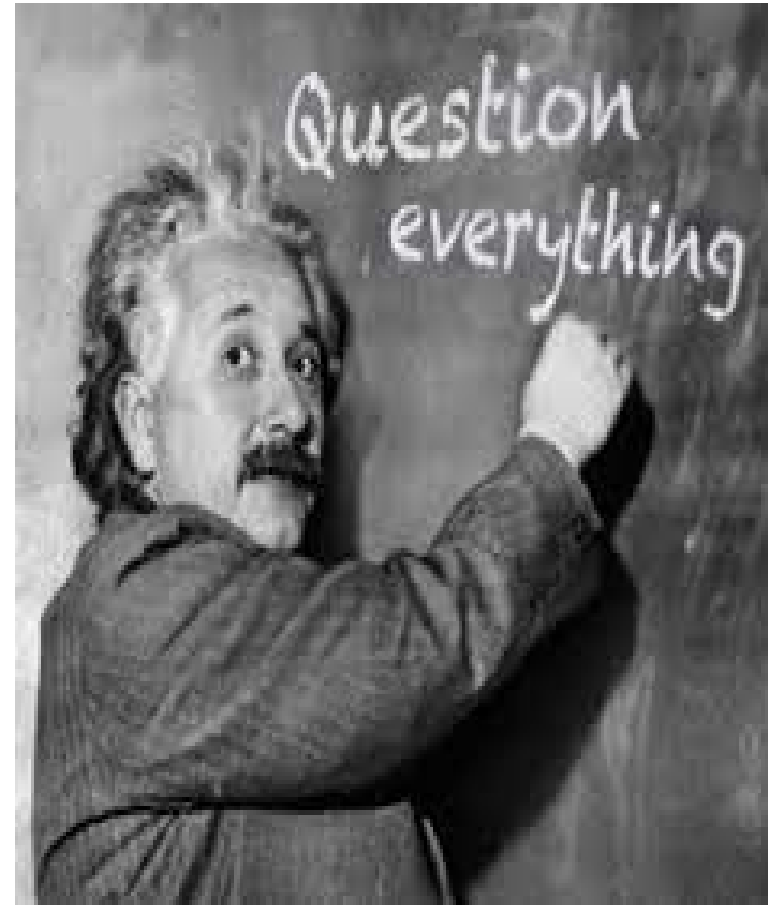
- Expect plaintiffs' firms are trolling public filings (8-Ks, etc.)
 - Separate forms of confidentiality agreements and releases
 - May not want to attach as exhibits to employment agreement
- Companies should review and update forms of employment, confidentiality and severance agreements, releases, and whistleblower-related policies to ensure appropriate carve outs for whistleblower activity

Questions????

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Thank you for joining us!

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