O L S H A N
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Client Alert

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Section 409A in the Mergers and Acquisition Context

A number of articles have recently appeared concerning the potential adverse impact of Section 409A of the Internal Revenue Code on mergers and acquisitions and the possibility that the cost of acquiring a public or private company may increase if careful due diligence is not performed prior to signing the acquisition agreement. This memorandum describes certain aspects of the new rules that may be significant in this context.

Section 409A imposes a 20% excise tax and, in certain cases, interest on payments from "nonqualifed" deferred compensation plans. Deferred compensation under Section 409A is broadly defined to include any deferral of compensation from the year in which the related services are performed to a subsequent year, unless specifically excluded. With certain exceptions, the term "plan" is also broadly defined to include any agreement, method, or arrangement with a single employee, independent contractor or director of the service recipient. Based on this definition, a clause in an employment agreement with a single individual could constitute a "plan."

Although the penalties under Code Section 409A fall principally on executives, the companies that employ them are required to report deferred compensation and to withhold taxes and to pay and remit employment taxes. Employers may face penalties if they fail to report and withhold on the proper amounts.

Many acquisition agreements now require specific Section 409A representations. Some buyers are seeking unqualified Section 409A representations, as well as expansive indemnity and claims period provisions. The potential hidden costs to a buyer include liability for the target company's failure to satisfy its tax withholding obligations with respect to deferred amounts, possible breach of contract claims for amendments or terminations of benefits where a required consent of the employee was not obtained, and gross-up payments to executives of the target company as a result of the imposition of excise taxes under Section 409A.

Sellers, on the other hand, may attempt to qualify their Section 409A representations and indemnity or limit escrow amounts and periods, and may try to eliminate the buyer's right to terminate an agreement for a breach of the Section 409A representations.

<u>Gross Ups</u>. Probably the greatest monetary exposure in the mergers and acquisition context occurs when an employee has a "gross up" provision for payments characterized as excess parachute payments. If the payments are also subject to Section 409A, the cost to the company can triple. For example, if an executive has a $100 golden parachute excise tax and is in a 50% tax bracket, the gross up would be approximately $333 ($333 – (333 x (50% + 20%)) = $100). If the payment were also subject to Section 409A, the gross up payment would be $1,000 ($1,000 - (1,000 x (50% + 20% + 20%)) = $100). To avoid a 409A issue, such payment must be made by the end of the year following the year the employee remits the tax payment.

Stock Options/SARs and Restricted Stock/RSUs. Stock options (both incentive stock options and nonqualified stock options) issued with an exercise price equal to the underlying stock's fair market value on the date of grant are not subject to Section 409A. A similar rule applies to stock appreciation rights (SARs). A grant of restricted stock is not subject to Section 409A, but grants of restricted stock units (RSUs), which represent a promise to make a transfer of property in the future, are subject to Section 409A. Determining whether the exercise price of the stock, particularly stock of a private company, has a fair market value exercise price can be problematic. While the incentive stock option rules provide for a good faith determination of fair market value, the Section 409A rules use a more stringent test, i.e., a "reasonable valuation method, reasonably applied" for private companies. While the regulations provide safe harbor valuation methods, one of these requires independent appraisals, and one of which applies to illiquid startup.

The final regulations provide that extension of the right to exercise will not be treated as a modification of the extension as to the original term of the option or, if earlier, ten years from the date of grant.

Severance Payments. One area of great uncertainty concerns the treatment of severance pay. This is particularly important in the public company context, because a severance payment to a "key employee" of a public company, generally the top 50 officers, if treated as deferred compensation, cannot be paid for six months from separation from service. Regulations indicate that severance pay attributable to involuntary terminations (which are not "vested" rights), including a fairly narrowly defined voluntary termination for "good reason," will not be treated as deferred compensation subject to Section 409A if paid within 2 ½ months after the close of the year (a so-called "short term deferral"). The six month deferral rule can also be avoided if the payment is made upon an involuntary separation from service, the amount does not exceed $490,000 (as indexed) and is paid no later than the end of the second year after the separation from service occurs. Further, the two rules can be "stacked", i.e., applied sequentially, so that a determination is first made as to whether any or all of the payment qualifies as a so-called short term deferral, and, as to any remaining amount, a determination is made as to whether it falls within the "severance pay" exception described above.

Payments of deferred compensation will be subject to Section 409A unless certain qualification requirements are met. One important requirement provides that distributions can be made only upon certain specified events; one such event is a "change in control" event. The definition of "change in control" is narrower than the definition of change in control for Section 280G ("golden parachute") provisions and strict rules regarding multiple change of control events will apply. Single trigger benefits can generally be designed to satisfy Section 409A requirements assuming the payment is subject to a substantial risk of forfeiture, vesting is tied to the change in control and the payment is made within 2 ½ months of the end of the year. Double trigger benefits, however, can be more problematic, particularly if the double trigger has a "good reason" termination feature that is not within the safe harbor provided by the regulations.

Earn-outs. Earn-out payments to employees holding options or stock rights can, under some circumstances, be treated as subject to Section 409A. Regulations provide, however, that there will be no violation if the option holders are paid at the same time as other shareholders, if all payments are completed within five years after the change in control event.

Due Diligence Issues. Potential buyers should consider the following due diligence issues:

- Are any compensation plans or agreements "nonqualified deferred compensation plans" under Section 409A?
- If so, has the target company satisfied all of its tax withholding obligations?
- Are any severance provisions included in employment agreements and other severance arrangements (including those not publicly filed) subject to Section 409A? Have any such severance provisions been renegotiated or will be renegotiated?
- Is the service provider entitled to a gross-up payment from, or other indemnity right granted by, the target company?

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