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## **CHANGE OF CONTROL ARRANGEMENTS**

By Wayne N. Outten<sup>1</sup>

In this era of mergers and acquisitions, many companies have implemented so-called change of control arrangements. This article outlines why such arrangements are implemented, how they are structured, and certain tax issues triggered by them.

In short, change of control arrangements provide that designated employees will receive substantial compensation and benefits if they lose their jobs under certain circumstances after control of their employer has changed hands.

Such arrangements protect the interests of employees, particularly senior executives, when a potential change of control could affect the employees' job security, authority, or compensation. Such arrangements also promote the interests of shareholders by mitigating executives' concerns about such personal matters and thereby assuring that management provides guidance to the board and shareholders that is divorced from such concerns. Moreover, such arrangements can help insure that the management team stays intact before, during, and after a change of control, thereby protecting the interests not only of the company's shareholders but also of any acquirer.

Typically, change of control arrangements arise under employment or severance agreements with senior executives. These are sometimes called "golden parachutes"

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because they provide generous protection for executives who “bail out” of the company – involuntarily or voluntarily – after a change of control. The severance benefits typically include severance pay for two or three years of compensation (sometimes including bonuses as well as salary), plus medical benefits for a like period and outplacement services. They may also include continued or accelerated vesting of restricted stock, stock options, deferred compensation, or supplemental or excess retirement benefits. And they may provide for legal fees and costs that the executive incurs in enforcing the agreement.

Sometimes, the executive is entitled to the severance benefits if his or her employment terminates for any reason during a certain period after the change of control (say, one to three years) - even if the employee simply quits the job; these are called “single trigger” arrangements. Under “double trigger” arrangements, the executive is entitled to the severance benefits only if the company terminates the executive involuntarily or the executive resigns for a good reason within a certain period after the change of control. (Good reason to resign usually includes a reduction in the executive’s duties, responsibilities, authority, title, compensation, or benefits, or a relocation beyond a certain distance.) Under a modified double trigger arrangement, a double trigger exists for a certain period (say, one year) and then a single trigger exists for a window period (say, thirty days), during which the executive can resign for any reason and collect the severance benefits. Such an arrangement provides economic incentives for an executive to stay for a transition period after the change of control and allows the company and the executive to negotiate for continued employment thereafter if they so choose.

Some companies adopt “tin parachutes” that provide similar, though less generous protection, for a broader range of employees when a change of control occurs. Tin parachutes typically arise under severance plans that provide enhanced severance benefits, such as more severance pay and a pro rata bonus, when an employee is terminated without cause or resigns for a good reason within a certain period after a change of control. Such arrangements, while potentially expensive, can help assure that employees stay during the uncertain periods leading up to and following a change of control. Retention bonus agreements and plans serve similar objectives and are sometimes used in conjunction with tin parachutes. In addition, many companies provide for accelerated vesting of employees’ restricted stock, stock options, deferred compensation, and supplemental or excess retirement benefits (under non-qualified plans) when a change of control occurs; and some qualified defined benefit plans provide that any excess funding must be used for enhanced benefits when a change of control occurs.

The threshold issue under any such arrangement is defining a “change of control.” A typical definition includes the following: (1) the purchase by a third party of a specified percentage (say, 20% or 30%) of the company’s stock; (2) a change in the majority of the board of directors; (3) a merger or consolidation, after which the company’s prior shareholders no longer control the company; or (4) the sale of all or substantially all of the company’s assets or the liquidation of the company.

For obvious reasons, the definition typically excludes certain transactions, such as those involving affiliates of the company that share a common control group. With respect to board composition, the “incumbent board” may include not only the members in place when the change of control arrangement was implemented but also any new or

replacement members elected by those incumbents. Typically, the effective date for a change of control is when the deal is consummated, not when the shareholders approve it; this helps assure that the affected executives will stay during any interim period.

Golden parachutes can trigger special tax issues. Under section 280G of the Internal Revenue Code, a company cannot deduct “excess parachute payments” made to “disqualified individuals.” And section 4999 of the Code imposes a nondeductible excise tax on the recipient of 20% of any excess parachute payments. These provisions, enacted in 1984, were designed to deter employers from providing excessive parachute benefits to executives, presumably contrary to the interests of shareholders.

An “excess parachute payment” results when the payments received by an employee that are contingent on a change of control exceed an amount based on the employee’s prior earnings from the employer. First, the employee’s “base amount” is determined: this is the average of the employee’s annual taxable compensation (i.e., W-2 amount) paid by the employer for the five years (or shorter period of employment) before the year of the change of control; this includes, for example, profits recognized from the exercise of non-qualified stock options, but does not include deferred compensation. Second, the excess parachute payment is the amount by which the payments made that are contingent on the change of control exceed the greater of (a) three times the employee’s base amount (which is called “the golden parachute safe harbor”) or (b) payments that constitute “reasonable compensation” for services rendered before or after the change of control. These payments include not only cash payments, such as severance pay and bonuses triggered by the change of control, but also such benefits as

accelerated vesting of stock and deferred compensation interests; the economic value of such accelerated interests is added into the parachute calculation.

Golden parachute agreements typically deal with these tax issues in one of three ways: (1) “grossing up” the payment so the employee receives the full value of the package net of the excise tax; (2) capping the parachute payment at \$1 less than the safe harbor amount; or (3) reducing the parachute payment to the safe harbor if doing so would put the executive in a better position than doing nothing. The first approach is most generous to the executive but may be perceived as expensive for the company, though the amount might be small relative to the amount of the underlying transaction. The second approach restricts the value of the package to the employee, sometimes effectively nullifying the value of such enhancements as accelerated vesting of stock interests and deferred compensation. The third approach balances these interests somewhat. The approach of doing nothing – that is, letting the chips fall where they may under the Code – makes no sense for the employer or the employee.

Given the current mobility of executives and competition for talent, the use of change of control arrangements will undoubtedly continue, and perhaps increase, as companies seek to hold onto key employees during times of change.

For more information on change of control arrangements and related topics, I recommend the book [Executive Compensation](#) by Sirkin and Cagney (Law Journal Seminars-Press), especially its chapter 9, “Change of Control Arrangements,” by Adam Chinn of Wachtell Lipton, which was a source for this article.

