Startup Company Carve-Out Plans: Mechanics, Tax Obstacles, and Optimization

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Agenda

1:00	Introduction
1:05	Background on carve-out plans for privately held corporation
1:15	Business considerations on the mechanics of carve-out plans
1:35	Delaware case law on carve-out plans
1:40	Section 280G considerations
1:50	Section 409A considerations
2:00	Practical Law explanation of related resources
2:02	Q&A session
2:10	Conclusion

Carve-Out Plans

What is a Carve-out Plan?

A carve-out plan “carves out” value that would otherwise be paid to shareholders upon a sale of the company and allocates that value to executives and other key employees

What is the Purpose of a Carve-out Plan?

- A carve-out plan is a bonus plan designed to incentivize executives and other key employees in the event of a change in control transaction (CIC) where the equity held by the key employees is substantially underwater (i.e., of little or no economic value).
- Generally, a carve-out plan is used to provide incentives to retain key employees through a CIC by paying a bonus in connection with a CIC.

What is the Purpose of a Carve-out Plan?

A carve out plan is often adopted when the Company's preferred preferences are often so high that the common is unlikely to receive value in an exit transaction.

Example:

- A company's investors have invested $30M and have a 2x liquidation preference, meaning that they are entitled to the first $60M in net value (after debts are satisfied) in an exit.
- This company is currently valued at $20M, so it is unlikely that they will achieve an exit at $60M before they expect to run out of cash in a few months of time.
- The company's employees, who hold options and common shares, begin to lose faith in the company and attrition rises. The company needs to stave off this attrition since it will be hard to attract new hires.
- The company offers employees a carve out plan to encourage select key service providers to remain in their seats through a merger. This will be a "debt" so will sit at the top of the waterfall, in advance of the preferred liquidation preferences.

What is the Purpose of a Carve-out Plan?

Survey of Carve Out Plans

- We have surveyed about 40 carve out plans, mostly in the high-tech space, since 2011 onward. Most of the carve out plans were of California companies.
- This data is historically difficult to obtain since carve out plans are often adopted by private companies and not disclosed to the market or public as a whole. As such, the sample size may be skewed and reliance should be appropriately discounted.
- The survey looked at plans adopted before a merger was in process (i.e., before the adoption of a term sheet).

How Does a Carve-out Plan Work?

- Typically, a carve-out plan designates either a percentage of the aggregate consideration payable by the acquiror in the CIC or another fixed amount (the "Pool") to be paid to key employees in connection with the CIC. Payment is a "debt" and thus paid before preferred shareholders.
- Plan can take one of three forms:
  - Carve-out plan reserves a percentage of the "net proceeds" in the transaction, so each carve-out participant effectively gets a portion of that percentage;
  - Fixed dollar amount;
  - Phantom stock; each carve-out participant has the right to payout as if holding 1 or more actual shares of stock (i.e., a notional shareholder).
- Payment can be structured to pay on the CIC or at a future date.

Key Structure Considerations

Key Structure Considerations

- Pool size & calculation
- Form of payments
- Participants
- Allocation method & forfeitures
- Reduction of bonus payments
- Timing & conditions on payments
- Amendment & termination

Structure – Pool Size & Calculation

- Pool size varies greatly from deal to deal.
  - Pools of approximately 10% of the aggregate CIC consideration are common; rarely see pools under 5% or over 15%
  - The more participants, the larger the pool
- Pool may be straight % of the aggregate CIC consideration
- Pool may be a sliding formula (e.g., Pool % moves up as the aggregate CIC consideration increases). For example:
  - Pool is 10% if aggregate CIC consideration is more than $X but less or equal to $Y, but Pool is 12.5% if aggregate CIC consideration is greater than $Y but less than or equal to $Z
- Pool may be a fixed dollar amount (more common when implemented in connection with CIC term sheet).

Structure – Pool Size & Calculation

- Definition of aggregate CIC consideration from which the Pool is determined is important.
- Typical definition is the total consideration payable to Company shareholders (i.e., the “Net Proceeds”) (true about 80% of the time).
- The definition of Net Proceeds can include or exclude specific payments or liabilities, such as:
  - Transaction expenses (common to exclude, ~80%);
  - Assuming that no payment is made under the carve-out plan itself (common to assume, ~90%) (i.e., the Net Proceeds definition assumes there is no carve-out plan);
  - Other liabilities generally (i.e., vacation accrual or bonus accrual; uncommon to exclude these).

Structure – Pool Size & Calculation

- Definition of aggregate CIC consideration from which the Pool can also include earn-outs or the escrow value (~95%).
- If included, the portion of the Pool attributable to the earn-out or escrow would be payable to participants if and when paid to shareholders, subject to conditions.
  - Recommendation – since including earn-outs and escrow can add complexity, consider structuring the plan to give the board discretion to determine whether to include earn-outs or escrow at the time of the CIC.
  - Warning – there are 409A implications if earn-out or escrow payments are included.

Structure – Form of Payments

- Carve-out plans can pay in cash or acquiror stock to reflect the structure of the CIC (most are drafted to accommodate both types of payments).
  - If paid in acquiror stock, must consider securities law compliance.
    - Will the acquiror stock need to be registered somehow if the acquiror is public?
    - What exemption will apply if the acquiror is a private company?
  - If the merger consideration is a mix of stock/cash and is paid in an earn-out, 409A implications may arise if payment is not on the same “terms and conditions” as to stockholders generally.
    - Is the “form” of the earn-out carve-out plan considerations part of the “terms and conditions”?
- Some plans may require cash (to the extent there is cash in the transaction) at closing, but that any deferred amount to cash/stock at same mix as to stockholders.
- Payment under a carve-out plan is a taxable event.

Structure - Participants

- Who?
  - Can be broad-based, but typically limited to management or top employees who are key to retain through a CIC.
  - Plan (as approved by the board) will include eligible classes participants (e.g., full-time employees)
- How?
  - Board (or its delegate, often CEO) designates each participant and allocation
  - Participants should sign a short participation agreement.
  - Less often, plans may reserve the right for a post-closing independent committee to administer the plan to avoid administration by the buyer's board.
- When to designate participants and allocations?
- May be notified at time plan is adopted (serves retention purpose).
- May be notified later, and close in time to CIC (less retentive value, but increased flexibility in divvying up Pool).

Structure – Allocation Method

- Payment Value – allocation of payment value is highly flexible (e.g., may be linked to duration of service, rank, title, percentage of base pay).
  - Award based on a percentage of the Pool
    - Ex: “A” gets 5% of the Pool, “B” gets 3% of the pool, etc.
    - Problem: run out of percentages, as approaching 100% awarded. No room for new additions.
  - Award based on units
    - Ex: Pool has 1,000 units, “A” gets 100, “B” gets 50, “C” gets 300, etc.
    - Problem: easy to increase number of units and dilute prior holders, without increasing overall carve-out dollar size.
  - Awards may be subject to vesting
    - Can impose vesting and provide that only vested awards at an exit will get paid

Structure – Present to Win?

Continued employment through CIC?

- If a participant leaves the Company prior to the CIC, typically forfeits his allocation (~70% require continued employment at closing).
  - Exception to forfeiture on a qualifying termination (e.g., without cause (~60%), for good reason (~10%), for death/disability (~15%).
  - ~30% do not require continued employment at closing. Some may allow an earlier termination without cause within a short window (e.g. 30 days, or 3 months) pre-closing to not cause forfeiture.
- Plan should dictate what happens to forfeited amount.
  - Returns to the Pool and **may** be re-allocated among remaining participants at the discretion of the board or plan administrator (~80%); OR
  - Automatically reallocated among remaining participants on a pro-rata basis (a "last-man standing" clause) (~20%)
    - Warning: in theory, all participants could leave and the sole remaining participant would automatically be allocated the full Pool.

Structure – Reduction of Bonus

- The carve-out plan may provide for reducing the bonus amount for payments the participant receives in respect of equity.
  - Reduce carve-out bonus for payments at closing in respect of common shares / options / restricted stock units (RSUs) (~60%);
  - Reduce carve-out bonus for payments at closing in respect of preferred shares (~10%);
  - Reduce carve-out bonus for payments post-closing in respect of unvested equity at close (uncommon: ~5% of all plans, or ~10% of plans that reduce for equity holdings generally).
    - Warning: This may result in a low payout in the case of revesting of consideration (e.g., a holdback) or where the participants may never fulfill the post-closing vesting conditions on unvested merger consideration.
- The carve-out plan may reduce the bonus amount for payments otherwise received in the transaction by any participant (e.g., severance or other CIC bonuses). This is uncommon (~10%).

Structure – Payment Timing & Conditions

- Typically, carve-out plans pay upon or within a set number of days following the closing of the CIC (e.g., 60 days). Payments almost always run through a payroll provider.
- Less commonly (~15% of plans that require continued employment at closing), the payments may be subject to post-closing vesting requirements based on continued employment with the acquiror
  - Pro – provides retentive value to acquiror; assists in smooth transition.
  - Con – carve-out plan is a means to provide CIC-related payments to certain employees. Incentivizing employees after closing should be the acquiror’s responsibility and cost.
  - If post-CIC service requirement is included, almost always add termination protection for terminations without cause and good reason resignations.

Structure – Payment Timing & Conditions

- A company can impose conditions on payment:
  - CIC closing (required)
  - Participant remains employed on the CIC (~70%)
  - Participant satisfies post-CIC vesting or service requirement (15% of plans that require continued employment at closing)
  - Participant must sign a release of claims in favor of the company (75%, and recommended)
  - Participant must be in compliance with employment agreement or other company agreement (e.g., restrictive covenants)
  - Participant agrees to be subject to “drag along”

Structure – Amendment & Termination

- Two typical alternatives to amend or terminate:
  - Board may amend or terminate plan **only with approval** from a majority of the allocated Pool (~25%) or, as to adverse changes to any award, with the participant's consent (~40%)
    - Limits flexibility to make changes
  - Board may amend or terminate plan at any time **in its discretion** (~25%)
    - Awards are essentially illusory; limits retentive value
  - Plan sunset:
    - Because of the typical approval requirement for amendments and terminations, some plans include an automatic sunset/termination to allow the company to amend or terminate
    - Typically range 2-5 years; rarely in excess of 10
  - Other terminations:
    - IPO; next financings; CIC in excess of $X

Legal & Tax Considerations

Key Legal & Tax Considerations

- In Re Trados
- Corporate Approvals
- Ordinary Income Tax
- 280G
- 409A

Legal & Tax – In Re Trados

- A carve-out plan may create a risk of shareholder litigation for breach of fiduciary duty or waste of corporate assets
- Plan approval by a disinterested committee of the board could reduce this litigation risk, and obtaining shareholder approval could further reduce the risk
- If the proceeds will be carved-out from the consideration otherwise payable to preferred holders of company stock, preferred stockholder approval is generally required.

Legal & Tax – In Re Trados

- August 2013 – Delaware Court of Chancery applied the entire fairness test when considering whether directors breached fiduciary duties to common shareholders who received no consideration in a CIC
- Sale of Trados, Inc., a private VC-based DE corporation
  - Common shareholders received no consideration
  - Senior management received payments via carve-out plan
  - Preferred shareholders received some gain, but less than entire liquidation preference
- Common shareholder sued for appraisal of shares and breach of fiduciary duties
- Court found (1) directors failed to implement a fair process, but (2) the common had no economic value prior to the merger. No economic liability.
- Take-away: be mindful of divergent interests and use steps to show fairness (e.g., special committees, sound board processes).

Legal & Tax – Corporate Approvals

- Plan adoption
  - Board must approve plan
    - If any board members are participating, should be approved by independent members
  - Stockholder approval is recommended to reduce litigation risk
    - Preferred shareholders should approve the plan if it will pay in preference to them
  - Following plan approval, full board (or a designated committee) may approve the participants and allocations
- Amendment to charter
  - An amendment to the charter may be necessary to clarify the preference of the plan payments over the company's capital stock
  - If so, both board and shareholder approval is required

Legal & Tax – Taxable Income

- Cash payments and stock payments will be taxable as ordinary income upon receipt, subject to treatment as wages (withholding and payroll taxes apply).
  - *This is true even for participants who are former employees
- If the CIC considerations includes stock of a private company, then the taxable amounts are illiquid, but the value is still taxable at the CIC (unless subject to additional vesting).
  - Taxation will occur as the aquiror shares vest, unless a valid 83(b) election is made
  - If the shares are liquid and publicly traded, holders may prefer to be taxed as ordinary wage income as they vest

Legal & Tax – 280G and Carve-Out Plans

- Payments under a carve-out plan are CIC payments subject to Section 280G's golden parachute tax on CIC payments to "disqualified individuals"
- If a disqualified individual receives CIC benefits in excess of 3x his or her average compensation for the past five full years ("base amount"), then he or she is subject to an additional 20% excise tax on all amounts that exceed 1x his or her base amount. The payor loses a corresponding compensation tax deduction.
- The shareholders of a private company undergoing a CIC can approve the payments such that the excise tax will not apply and the deduction will be preserved.
  - 75% approval by disinterested shareholders
  - Requires full disclosure of all payments to disqualified individuals to be given to shareholders
    - May need to disclose last man standing concept in the plan and any contingent payments to carve out holders post closing
  - Disqualified individuals must waive their right to receive payments before solicitation of the vote

Legal & Tax – 409A

- Warning – carve-out plans may implicate Section 409A, which assesses additional taxes above ordinary income (20% federally) on nonqualified deferred compensation.
  - If an arrangement is 409A non-compliant, income is recognized once the right is vested, even if the amounts aren't yet paid
- Nonqualified deferred compensation is a plan that represents a legally binding right during a taxable year to compensation that is or may be payable in a later taxable year to a service provider
  - Some exceptions (e.g., short-term deferral)
  - If not exempt, then payment must be triggered by one of six permitted events (fixed date, separation from service, change in control disability, death, unforeseeable emergency)

Legal & Tax – 409A

- A carve-out plan can be drafted to be exempt from 409A or compliant with 409A

Exempt	Compliant
Require employment through the closing date	No employment requirement, but payout on a 409A-compliant CIC definition • Sale of majority of vote / value of equity • Change in effective control • Sale of substantially all of the assets
Maintain that the change in control is itself substantially uncertain and thus a substantial risk of forfeiture	

- Exempt arrangements can be more flexibly changed
- With few exceptions, it is generally not permitted to change the timing of compliant arrangements

Legal & Tax – 409A: Further Deferral?

- Escrow/Earn-Out ("Transaction Based Compensation")
  - Must pay on the same schedule and under the same conditions as generally applicable to shareholders, but the earn-out period is capped at 5 years post-closing.
  - Only for 409A compliant change in ownership or sale of substantially all assets
  - Exception is for sale of "stock of the service recipient," so often in reference to enterprise value (such as carve-out plan referring to "Net Proceeds")
- New vesting conditions
  - Permitted to add substantial risk of forfeiture to an amount otherwise vesting on a change in control

Related Practical Law Resources

- [Practice Note, Choosing the Right Type of Equity Compensation for Startup Company Employees]
- [Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview]
- [Practice Note, Section 409A Issues in a Change in Control]
- [Practice Note, Private Corporations and Code Section 280G]

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Q&A Session

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Marshall Mort focuses his practice on compensation and employee benefits matters. Marshall particularly enjoys developing creative solutions that support attractive compensation plans. Working with both private and public companies, Marshall excels in navigating complex tax, securities, and accounting issues within the equity and executive compensation environment. This includes maximizing tax efficiency, and advice that further supports HR policies to promote retention and mitigate risk. Marshall writes and speaks on equity compensation and benefits issues, and has served as an adjunct lecturer at Santa Clara University-Leavey School of Business.


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Taylor Cashwell focuses his practice on a broad variety of corporate matters to support clients in the high technology and life sciences industries. While attending law school, Taylor was a concurrent member of the Hastings Law Journal and Hastings Women's Law Journal. He served on the executive board of OutLaw and externed as Law Clerk for the National Center for Lesbian Rights, where he later served as Fenwick & West Public Interest Fellow.


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