I. INTRODUCTION

In a corporate transaction such as a stock sale, merger or asset sale, employee benefit plans and executive compensation arrangements can be the source of major liabilities and are often subject to extensive negotiation between the buyer and the seller. Both the buyer and the seller are looking to avoid or minimize their own liability with respect to employee benefit plans. In addition, the buyer and the seller may have other specific goals concerning employee benefits and compensation arrangements. For example, the seller may be protective of the employees and wish to ensure certain post-acquisition protections for them. The buyer may intend to integrate its newly acquired employees into its own benefit and compensation structure or may plan (and desire to minimize costs of) strategic reductions in force or other restructurings.

Employee benefit plans typically at issue include plans that provide medical, surgical, pension, profit-sharing or hospital care benefits, or benefits for sickness, accident, disability, death, unemployment, vacation or training. Compensation arrangements include plans and agreements that provide for bonuses, deferred compensation, incentive compensation, severance, stock purchases, stock options, stock appreciation rights or other stock-based incentives. In a stock sale or a merger, the buyer assumes the seller's employee benefit plan liabilities and other obligations by operation of law. In contrast, in an asset sale, the buyer generally does not assume any plan liabilities, unless the buyer affirmatively agrees to do so. Stock sales of subsidiaries may present a hybrid situation—similar to a stock sale with respect to plans at the subsidiary level and to an asset sale with respect to plans at the parent (seller) level.

Employee benefit plans and compensation arrangements are subject to extensive regulation that must be taken into account in analyzing the available alternatives of how the plans will be treated in a transaction. Employee benefit plans sponsored by public companies that hold employer securities are subject to regulatory requirements under the Securities Act of 1933, as amended (the "Securities Act") and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Those plans that are tax-qualified plans are subject to extensive regulation under the Internal Revenue Code of 1986, as amended (the "Code") and under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

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1 This general rule may not apply where successor liability may be imposed upon the buyer by law. Successor liability may be based on statute (for example, an obligation of a purchaser of assets to provide health continuation benefits in some circumstances, as discussed below) or common law. Factors that may give rise to common law successor liability include whether "(1) the successor had notice of the claim before the acquisition; and (2) there was 'substantial continuity in the operation of the business before and after the sale." Chicago Truck Drivers, Helpers & Warehouse Workers (Indep.) Pension Fund v. Tasemkin, Inc., 59 F.3d 48, 49 (7th Cir. 1995) (citation omitted); accord Brend v. Sames Corp., No. 00C4677, 2002 U.S. Dist. LEXIS 12648, at *12 (N.D. Ill. July 9, 2002).
The following discussion analyzes employee benefit related issues in the context of a stock sale (or merger) or an asset sale and methods of dealing with those issues. Generally, any benefit or compensation liabilities related to the transaction are quantified and factored into negotiation of the price of the transaction.

II. EMPLOYEE BENEFIT AND COMPENSATION PLANS IN ACQUISITION CONTEXT

A. Individual Employment or Change in Control Agreements

1. General.

Certain executives of the entity being acquired may be parties to employment or change in control agreements which provide them with generous cash severance and other benefits upon specified qualifying terminations of employment. Such qualifying terminations of employment generally include involuntary terminations other than for cause and constructive terminations (so-called "good reason" terminations). In addition, the agreements may permit the executive to terminate his employment voluntarily within a specified window period following the acquisition and collect severance. An agreement with a generous definition of "good reason" may, in practice, have a similar effect. Although severance provisions vary, a typical cash severance may be an amount equal to two or three times the sum of the executive's salary and target bonus as of the termination date. Agreements also typically provide for continuation of benefits for a specified period, as well as accelerated vesting in equity awards and additional credit under non-qualified pension and other plans.

2. Due Diligence.

The buyer should take special care in examining employment and change in control agreements to determine the impact of the cost of anticipated severance on the overall transaction and whether golden parachute penalties will be triggered, and if so, whether any actions may be taken to reduce or eliminate such benefits and/or the penalties (see Section II.A.3 below). The buyer should also analyze whether any employees it desires to retain have arrangements that give financial incentive for voluntary (or "good reason") termination after the acquisition, and if so, whether such agreements should be replaced or restructured prior to the closing.


a. Section 280G of the Code provides that no deduction is allowed to a corporation (whether private or public) for "excess parachute payment[s]," and Section 4999 imposes an excise tax on the recipient of any excess parachute payment. The golden parachute rules only apply to "disqualified individuals." A disqualified individual is any individual who, at any time during the twelve-month period prior to and ending on the date of the change in ownership, is an employee or independent contractor and is either an officer, a highly compensated

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payment equal to 20% of such amount. A "parachute payment" is any payment, including non-cash compensation such as the continuation of health insurance or the acceleration of otherwise unexercisable stock options, that is contingent on a change in ownership or control of the corporation. Note that the Section 280G restrictions apply only to corporations and not businesses organized in other forms (e.g., partnerships).

b. Excess parachute payments consist of the excess of parachute payments over an executive's "base amount." "Base amount" means the average taxable compensation received by the employee from the company during the five taxable years (or the entire period of employment if less) preceding the year in which the change in control occurs. The Code provides a "safe harbor" of 300% of the executive's base amount, i.e., the parachute rules do not apply if parachute payments do not equal or exceed that amount. Although the safe harbor is up to 300% of the base amount, the 20% excise tax is imposed on (and the nondeductibility applies to) the difference between the total payments and the base amount (i.e., not on the amount in excess of the safe harbor). For example, if an executive has a base amount of $500,000, a parachute payment of up to $1,499,999 will not be subject to the excise tax or the disallowance of deduction, but a parachute payment of $1,500,000 will be subject to those rules to the extent of $1,000,000. The extra dollar the executive receives results in an excise tax of $200,000 and the payor corporation cannot deduct $1,000,000 of the $1,500,000 paid.

(1) **Safe Harbor Cap**

Change in control agreements for lower-level executives often provide that, if the executive is to receive payments that would be subject to the excise tax imposed by Code Section 4999, the payments will be reduced to the 280G safe harbor. Typically, an executive can choose which payments will be cut back. Waiving the accelerated vesting of stock options that would otherwise become vested in a transaction is a common form of a cutback.

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individual or a shareholder who owns more than 1% of the total fair market value of the outstanding shares of all classes of the company's stock. Treas. Reg. § 1.280G-1, Q/A-15, Q/A-17. A "highly compensated individual" is anyone who is, or would be if the individual were an employee, within the highest paid 1% of the employees of the company (up to a maximum of 250), but who in any event has annualized compensation in excess of $95,000 for the twelve-month period preceding the change in control (subject to cost of living increases). Treas. Reg. § 1.280G-1, Q/A-19.

3 Code § 280G(b)(2).

4 Code § 280G(b)(3).

5 Code § 280G(b)(3)(ii).
A more executive-friendly variation on this "cutback" of payments is the 280G valley approach. Under the 280G valley, the executive’s payments are cut back as above unless, after comparing the value of the payments on an after-tax basis (including excise tax), the executive would be in a better after-tax position by receiving all payments (i.e., if he paid the excise tax). The cliff-like nature of the excise tax makes it possible for an executive to receive a greater after-tax benefit by reducing the amount of payments he receives because of the change in control.

(2) Gross-Up Payments

Gross-up payments are frequently used to protect an executive from the adverse effects of Code Sections 280G and 4999. A gross-up payment is simply a cash payment to reimburse an executive for any excise tax the executive would otherwise owe the Internal Revenue Service (the "IRS"). But, because the gross-up payment itself is treated as a payment contingent upon a change of control, it is also subject to the Code Section 4999 excise tax (as well as ordinary income tax). Therefore, a geometric calculation is required to arrive at the total gross-up, which may be a substantial part of the executive’s total payments, depending on the executive’s overall tax rate. Assuming a combined income tax rate of 45%, the gross-up payment on $1,000,000 of excess parachute payments would be approximately $570,000.

(3) Private Company Shareholder Approval

A private company can avoid being subject to the golden parachute rules if shareholder approval requirements with respect to the payments are met.6 "Shareholder approval" means a vote of persons who (on a date within six months before the change in control) owned more than 75% of the voting power of the private company, provided that there was adequate disclosure to all shareholders of all material facts concerning all payments which would have been parachute payments.7 Although this exemption is available, in practice it is difficult to rely on because the vote must determine the right of the disqualified individual to receive the parachute payments.8 Thus, someone who has existing entitlements that would entitle him to receive parachute payments must be willing to put them at risk in order to avail himself (and permit the employer to avail itself) of this exemption.

(4) Reasonable Compensation

Pursuant to Code Section 280G(b)(4), the parachute payments do not include any amounts that can be established as "reasonable compensation" for personal services to be rendered on or after the change in control date9 or any payments which are

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6 Code § 280G(b)(5).
7 Code § 280G(b)(5)(B); Treas. Reg. § 1.280G-1, Q/A-7.
8 Treas. Reg. §1.280G-1, Q/A-7.
9 Id. at §1.280G-1, Q/A-9.
made pursuant to an agreement entered into after the change in control.\textsuperscript{10} Facts and circumstances of the particular situation dictate whether payments constitute "reasonable compensation." Factors considered in such a determination include the nature of the services rendered or to be rendered, the individual's historic compensation for performing such services, and the compensation of individuals performing comparable services where the compensation is not contingent on a change in control.\textsuperscript{11} It should be noted that the final 280G regulations promulgated in 2003 (the "280G Regulations") have made it more difficult to restructure parachute payments than was the case under the 1989 proposed regulations.\textsuperscript{12} Strategies to reduce or eliminate the amount of the excise tax payable to executives are often designed to take advantage of the fact that a payment is not treated as a parachute payment if it is made pursuant to an agreement that was entered into after a change in control and there was no pre-change obligation to enter into the post-change agreement, and that payment for services to be rendered after a change in control are eligible for treatment as reasonable compensation for future services (which are exempt from 280G). For example, a new agreement would be entered into pursuant to which retention or consulting payments (or payments for a non-compete) would be made. This new agreement would replace a pre-existing change in control severance agreement.

However, the 280G Regulations restrict the availability of these tax strategies for transactions closing after 2003. Specifically, the 280G Regulations state (like the 2002 proposed 280G regulations\textsuperscript{13}) that if an individual has a right to receive a parachute payment under an agreement entered into prior to a change in control (a "pre-change agreement") and gives up that right in exchange for benefits under a post-change agreement, then the agreement will be considered to be post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement.\textsuperscript{14} Time will tell the effect of these new provisions on practice in this area, one in which practitioners have not traditionally been reluctant to take aggressive tax positions.

4. Dealing with Employment or Change in Control Agreements in Acquisitions.

a. Sale of Assets

\textsuperscript{10} Id., Q/A-23.

\textsuperscript{11} Id., Q/A-40.


\textsuperscript{14} Treas. Reg. §1-280G-1, Q/A-23.