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Business Law Update

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Business Perspectives

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In this edition of Thompson Hine's *Business Law Update*, we include the first installment of a two-part article featuring a guest co-author, in which we take a deeper look at a particular topic, namely: how to organize an M&A growth program for success and efficiency. My co-author, Bill Schult, is a leading financial executive with extensive M&A experience. In this two-part series Bill and I discuss a variety of techniques, tools and best practices in a variety of disciplines, designed to control costs, minimize business disruption, and enhance the chances of a successful transaction and business integration process.

This topic aligns well with Thompson Hine's focus on innovative approaches to delivering legal services. For example, in our firm's M&A practice we have adopted a mandatory policy requiring detailed fee and cost budgets for all new M&A matters. We collect performance data from these budgets and use that information to refine and improve budgeting on future matters. In this way we strive continuously to improve the efficiency and predictability of our work on our clients' important M&A matters.

I hope you enjoy this Fall 2018 edition of our *Business Law Update*.

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For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or David R. Valz, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

Mergers & Acquisitions

Organizing and Implementing an M&A Growth Strategy for Success: Optimizing for Predictability, Efficiency and Transparency

By William M. Schult, CPA* and Frank D. Chaiken, Esq.

To be successful in growth through M&A, companies, whether public, private or private equity-backed, need to consistently deploy a focused strategy and process-based approach. In this first article of a two-part series, we discuss some of the considerations, techniques and approaches that are critical to executing successful acquisitions.

Dedicated Team

The senior management team sets the tone and tempo for any acquisition program. From the CEO to senior division leaders, the needs of the business lines have to drive the strategy. The CFO and finance team also play a critical role in defining the financial objectives and understanding the potential contribution of a prospective acquired business, especially the impact on the balance sheet, earnings and overall business profile. This may include a dedicated internal M&A or corporate development team and in-house legal team.

The company's outside advisers, including banking, legal, accounting, engineering and other disciplines, play a critical role as "force multipliers" in augmenting the company's internal teams. Any successful acquisition program must integrate these internal and external resources into an efficient, seamless team. Outside advisers to acquirers in particular should place a premium on predictability, efficiency and transparency.

Clear Strategy and Focused Target Criteria

When it comes to acquisitions, it is better for a business to be active and strategic, rather than passive and opportunistic. The goal should be to be considered the "acquirer of choice" in the company's space (or segment or industry). A company should not sit back and wait for sellers, search firms, business brokers and investment banks to reach out and bring them deals. On the contrary, successful acquirers continuously build relationships with all of these parties and others to identify targets that make strategic sense.

Strategic objectives for growth acquisitions will vary from company to company, but all fall into several recognizable categories, such as geographic market expansion, new product lines, new customers, talent and technology acquisition, logistics and other cost consolidation opportunities. There may be others, of course. What is important is that a company establish an acquisition strategy (with a list of names or at least a definition of the type of target) that will lead to growth. In many businesses, particularly in mature markets, it is very difficult to grow organically, so acquisitions become a critical way (and are sometimes the only way) to grow.

Once a company has decided to employ acquisitions as a way to grow, it must establish clear goals and answer important questions, such as: What types and sizes of businesses do we want to buy? What are we willing to pay for these businesses? Identifying and defining the right targets is the most important part of building an acquisition or growth strategy. The growth strategy should consider whether the company and the targets can or should be able to help each other with new or more robust applications and/or technologies, relationships with key customers, building out high-performing or high-potential management teams, and so on. When all of the criteria have been established, the company may already be able to identify (by name) the targets it would like to acquire, or at least a list of the types of targets it would like to acquire.

Once a list has been produced, it is important to prioritize the targets and communicate this information to search firms, business brokers and investment banks, and other referral sources as appropriate, often depending on size and valuation. Sometimes the acquisition of Company B becomes more important if Company A declines to even discuss being acquired.

A potential acquirer needs to have the courage to say “no” if a target presents itself that does not meet the strategic criteria. Even if it is a “good deal,” such an acquisition may distract management from its main targets and objectives. Of course, the opportunity to purchase a non-strategic business at an attractive valuation may well suggest a reassessment and change of strategy.

Selling a business is often a very personal decision, especially when the founder is the potential seller. The timing must be right and sometimes it can take years of relationship building before a seller will decide to move forward. An acquirer must nurture relationships and be willing to give the seller time to decide to do a deal, but must also be willing to move down the list to talk to a lower priority target. Successful acquirers build and nurture these relationships in various ways, such as by creating a positive public image for the acquirer and its leadership and participating in industry trade groups, organizations and other networking forums.

Proper Sequencing of Tasks to Control Costs

Identification of a suitable and willing target is the necessary first step in the deal process. Then the real work and fun begin. Most likely the parties will have discussed some general deal parameters, including basic facts about the business and rough numbers suggesting that a mutually beneficial transaction is possible.

The parties then usually exchange a confidentiality or non-disclosure agreement to allow the freer exchange of information, which enables the buyer to sharpen its pencils and develop a more definitive view of the “fit” as well as potential valuation. This is a critical juncture in the life cycle of the deal, at which point the parties will discuss the valuation and determine if there is a mutual desire to proceed.

Companies often ask whether it is necessary, or important, to enter into a formal letter of intent or indication of interest letter at this stage. While such documents usually are not binding on the parties, they are a good way to document the negotiation process, and are a means for each party to set some basic deal parameters and hold the other accountable to some extent as they each start to invest more substantial resources in the project.

Another important function of such a document is to establish a time line and milestones along the way which will assist parties in keeping the process on track. At this point both sides begin to face increasing demands on their time. The parties may use this document to iron out in advance some of the significant deal points, as a way of increasing their confidence that ultimately they can complete the transaction. Someone, usually from the buyer’s side (corporate development, counsel, investment banker, if any) will establish a detailed project task schedule and a directory of contact information for those who will be involved in the project.

Both buyer and seller are well-advised to limit and sequence the level of their activities at this point, as there is still a lot to learn on both sides and the risk that things may not proceed remains relatively high. As in other areas of life, the basic rule of “first things first” will apply.

The seller usually wants to keep the circle of those who know about the potential transaction very limited to avoid disruption among its staff, customers and others. Some activities, such as disclosure of information about customers, sources of supply and key personnel, often will come only near the very end of the process, just before the signing of a definitive agreement or even the closing of a transaction.

The buyer similarly wants to sequence and prioritize its activities, focusing first on those that are most likely to uncover material obstacles, risks or valuation issues that would suggest cutting off the process before incurring undue costs and expenses. Validation of the target company’s financial statements, earnings performance and valuation will take first priority, as discussed below. Close behind that come confirmation of the strategic fit, balance sheet assets and liabilities, customers, supply chain, technology, leadership, and other critical business and value drivers. It is a best practice for the project time line to define the hurdles to be cleared before each new work stream begins. There may be exceptions to this rule where the overall time line is short, or there is potential competition for the target. Internal discipline in this regard helps increase the cost-efficiency of the buyer's overall acquisition program.

Target Valuation and Deal Structure

The valuation of a target business is probably the most important single item to be negotiated and agreed in any M&A project. This forms the basis for the parties' price negotiations. A valuation as of the closing date also is required for tax and financial statement reporting purposes, and to establish the opening balance sheet of the company upon closing.

There are different ways to value a business to be acquired. Valuation professionals will often value businesses a number of ways, including discounted cash flows, comparable recent transactions in the market, appraisals of assets and others. These various methods may be used either before or after the closing the transaction. In this article, we will focus on a very common approach used in the price negotiation phase of a private company or middle-market acquisitions: multiples of EBITDA.

EBITDA is an acronym for "earnings before interest, taxes, depreciation and amortization." It is a way to roughly estimate how much cash a business is generating from its core activities. It excludes depreciation and amortization because these are non-cash charges to the income statement. It also excludes interest and taxes. Interest is a function of the capital structure, i.e., the amount of debt vs. the amount of equity in a company, as part of the capital deployed in support of the business; it is not directly related to the cash flow from core activities. Taxes are excluded, not because they are irrelevant or unimportant, but because different tax rates in different jurisdictions impact the bottom line and, as in the case of interest, are not related to the core activities of the business.

EBITDA varies from company to company, and even industry to industry. A primary objective of financial due diligence is to substantiate EBITDA being reported by the target company in question. Individual companies' financial statements may include "add-backs" to account for certain one-time, non-recurring or other cash payments to EBITDA. Such add-backs may even be defined in the company's financing agreements with its lenders for purposes of their financial covenants. Sometimes buyers and sellers will disagree on whether a certain add-back truly is a one-time or non-recurring item. It is in the seller's interest to add back as much as possible to increase EBITDA, if the price is based on a multiple of EBITDA.

Buyers want to know and understand the drivers of EBITDA, usually over the last few years, so that they can make a judgement as to whether it can be sustained or improved going forward. Experienced buyers, sellers and advisers understand how the other side will view and analyze EBITDA, so this area understandably receives a lot of focus from all sides.

Determining, and hopefully agreeing, on EBITDA for a given year or over a number of years is a first step in coming to agreement on price. The next and equally important question is what multiple to apply. For example, a business with $3 million in EBITDA may be sold for $15 million (five times EBITDA), $24 million (eight times EBITDA) or some other number. So, how is the multiple established? A number of factors go into this determination, including the industry, the size and scale of the business, the level of capital expenditures required, earnings growth rate performance over time, and many others.

Let's say businesses in a certain industry are traded at multiples in the range of five to eight times EBITDA, based on market examples. Larger businesses are more likely to be valued at the higher end of that range, because buyers are willing to pay for scale. A business requiring higher capital expenditures is likely to command a multiple at the lower end of the range, because less of the cash flow will be available to the new owners. A business that has performed well over 10 years is likely to receive a higher multiple than a business that has performed well over two years. Sellers and buyers will both consider the multiples paid in similar, recent deals, if that information is publicly available.

Many other factors impact a valuation of a business. The buyer may foresee "synergies" from owning the business that are not available to the seller, such as lower costs resulting from economies of scale, incremental sales and profit opportunities resulting from the integration of the target company into the buyer's existing business, and tax savings resulting from the structure of the transaction. Savvy sellers and their advisers will be aware of these synergies, and may negotiate to try and share in the benefits.

The purchase price is just one component of the agreement between the buyer and the seller. Even if a purchase price has been agreed upon, there are many other points that must be considered. Is the buyer purchasing the equity shares of the seller, or rather its assets and liabilities? Is all of the purchase price payable at closing, or will it be paid over time in instalments, or upon achievement of defined business targets post-closing (referred to as an earnout)? How much of the purchase price will be set aside and held by an escrow agent in case there are valid reasons for a buyer to "claw back" some of the purchase price? Is any of the purchase price contingent upon the seller remaining with the business for some time or upon the achievement of satisfactory financial results in the year(s) after closing? Will the purchase price be paid entirely in cash or will the buyer offer shares in its company to the seller as partial payment? Will the owner or management of the target business continue to be employed or consult with the business after the closing?

The answers to many of these questions may change as a result of the information the parties develop through the due diligence process. But, as noted elsewhere, both sides will invest tremendous time and expense in the transaction process. So, the more such details can be ironed out in the very early stages of the acquisition process, the better.

Stay tuned for Part II of this article in the next edition of *Business Law Update*, in which we'll cover the deal process from due diligence, negotiations and closing to the integration of the acquired business into the fold.

Frank Chaiken leads the firm's highly regarded Corporate Transactions & Securities practice, which comprises more than 100 professionals who represent clients of all sizes across virtually every industry. If you have questions or would like to share your thoughts, please contact Frank at 513.352.6550 or Frank.Chaiken@ThompsonHine.com.

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The Odd Couple: Understanding the Relationship Between Indemnification and Representation and Warranty Insurance

By William M. Henry and Jim Brown

The increasing prevalence of representation and warranty (R&W) insurance in M&A transactions in the last 10, and especially five, years is well understood. What is less well understood is how its application works in the context of the M&A transactions in which it is used as it relates to the buyer's access to the remedy of indemnification against the seller (target company). As such, this article offers a brief description of the interplay between a representation and warranty policy on the one hand, and the use of a basket and a cap on the other (as well as a few other special considerations).

R&W insurance is, in its most common form, obtained by the buyer in an M&A transaction as a means of seeking recourse against the policy, instead of the seller, in the event of a breach by the seller of the seller's representations and warranties in the transaction's main purchase agreement. For instance, if the seller breaches the financial statements representation in the purchase agreement, in a no-R&W insurance transaction (we'll call this "ordinary" for purposes of further discussion in this article), the buyer would seek indemnification recourse against the seller, while in an R&W insurance transaction, the buyer would seek indemnification recourse primarily against the policy, not the seller.

In an ordinary M&A transaction, there is usually only one basket—basically a deductible that protects the seller against de minimis claims. An R&W insurance transaction introduces further complexity by adding a separate, second basket: the "retention," which is a higher amount (usually two times the basket) that further limits the responsibility of the insurer to pay out on a typical R&W policy, by being essentially a second, higher deductible that must be met before the insurer will pay on a claim. The retention is the responsibility of the policy holder, meaning it is then up to the buyer and seller in a transaction to negotiate between the two of them who will be responsible for the retention. Note, importantly, that the basket "overlaps" with the retention: so, if the basket is satisfied, then the amounts satisfying the basket also count toward satisfying the retention. Often, an escrow/holdback will be used to account for the amount by which the retention exceeds the basket (so if the basket is $300,000 and the retention is $500,000, a $200,000 escrow might be used to account for the difference, as further illustrated below).

Likewise, in an ordinary M&A transaction, there is usually a cap—often around 10 percent for general representations and warranties, with a higher cap (or no cap!) for "fundamentals" or other key representations. In an R&W insurance transaction, there is much greater latitude for the parties to stipulate what the caps might be—which is great—but, practically, there is usually a hard cap (the policy "limit"), no matter whether the representations are general or fundamental. Note here that there are effectively two caps: the seller will expect that its liability is capped at the retention, while the insurer will only care about the overall policy limit. Correspondingly, the survival period for claims under representations and warranties policies can be lengthier, but will almost always (as must be actuarially true) have a defined time limit (often six years).

Here's how the deductible and the retention might work in a standard ("market") transaction nowadays (understanding that the math may change as the market shifts and R&W policies become cheaper over time). Let's suppose a $50 million transaction, with a basket of $250,000 and a retention of $500,000. Policy limits can vary, but let's also assume a 10 percent ($5 million) policy limit. Now let's assume that the seller breached a representation, and map it out through three common scenarios:

- Scenario 1: $300,000 loss asserted. Here, the basket "eats up" $250,000 of that loss—so the buyer bears the cost. However, only $50,000 of the remaining $250,000 retention has been satisfied, so the buyer would look to the seller directly for indemnification (and the buyer would be wise to have had an escrow of $250,000 for the purpose).

- Scenario 2: $1.7 million loss asserted. Here, the basket has been satisfied, as has the retention, and in fact, losses exceed the retention by $1.2 million, which is the amount that the buyer would look to recover from the insurer.
- Scenario 3: $6.2 million loss asserted. Here, again, both the basket and the retention have been satisfied, but losses exceed the retention by $5.7 million, which exceeds the $5 million policy limit. As such, the buyer can recover only $5 million from the R&W policy. Two points here: first, the policy limit is, as with an escrow, an aggregate limit—so the buyer would not be able to make any further claims under the policy, no matter the origin. Second, the buyer can try, but is not likely to, prevail in purchase agreement negotiations against the seller if it asks the seller to "cover" any excess over the policy—here, $700,000—because while economically the request makes intuitive sense, such exposure defeats much of the purpose of an R&W policy in limiting the seller's overall exposure.

Before concluding, we do want to identify a few variations we've seen in our transactions. The first is the rise of the "no-recourse" deal in which the seller refuses to assume any indemnification obligations—that is, where there is no indemnification available from the seller in favor of the buyer, and instead, the buyer looks only to the representation and warranty policy (effectively, the basket equals the retention). This type of transaction is more likely to exist in auction contexts, as in most instances, the buyer likes knowing that the seller has some, even if modest, "skin" in the indemnification game. The second is how to mitigate against "known" liabilities—of no surprise, R&W insurance will not pick up the costs of existing issues (and usually includes "anti-sandbagging" language to this effect)—such as environmental exposures uncovered in diligence or pending lawsuits. In those scenarios, a buyer would do well to seek a line-item indemnity and an associated special escrow to recover directly from the seller for these items.

The R&W insurance market is increasing and steadfastly evolving, which may date this article quickly. The themes as it evolves, though, are timeless. The beauty of R&W insurance is that it facilitates the buyer and seller customizing the baskets, caps and survival periods in both the purchase agreement and the R&W policy, in each case, to address and allocate unknown risk. The interplay between the purchase agreement and the R&W policy is vital in that regard. Indeed, though one may think that obtaining an R&W policy is a panacea for the lengthy discussions around indemnity, understanding the baskets, retentions, caps and related remedies is essential to a thoughtful negotiation for all parties.

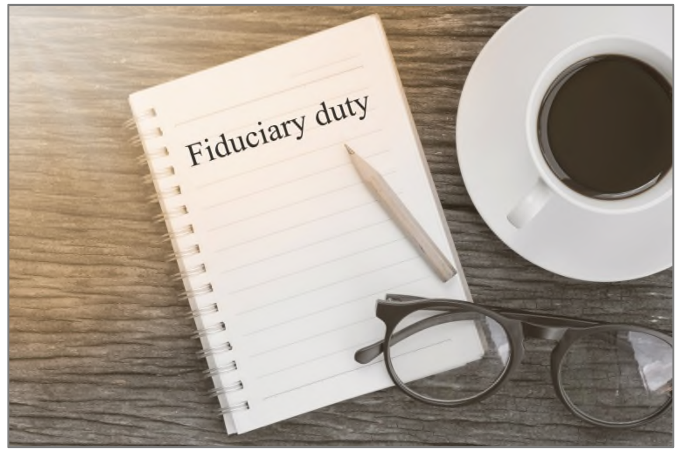
Please contact Will Henry or Jim Brown for more information.

Employee Benefits

So Your Company Has Asked You to Serve as a Fiduciary for an ERISA Plan …

By Brian J. Lamb

It is quite common for businesses to ask officers or employees to serve in a fiduciary capacity in connection with a company-sponsored retirement plan, such as a 401(k) plan or a traditional defined benefit plan. Perhaps your own company thinks you would be a good fit to serve on a plan fiduciary committee, because you have expertise in human resources, benefits, investments or administration. You should be honored to be entrusted with such a great responsibility. The word fiduciary is derived from the Latin word for “trust.” But you should also be on high alert, for serving as a fiduciary of an ERISA plan is a serious undertaking. Indeed, in recent legal disputes, federal courts have critiqued (and in some cases, lambasted) individual ERISA fiduciaries for failing to take their roles sufficiently seriously. So, how should you approach your role as an ERISA fiduciary?



1. Read the Plan Documents. ERISA requires that every employee benefit plan be established and maintained according to a written plan document. This plan document serves as the touchstone for most of the responsibilities of the plan’s fiduciaries. In one recent ERISA lawsuit, a member of the fiduciary committee admitted under oath: “I don’t review the plan documents. That’s what I have staff for.” The judge was not impressed, and criticized the committee member for a lack of familiarity with basic concepts relating to the plan.

2. Don’t Be a Clock-Watcher. It is important to show up for meetings on time and stay for the entire meeting. Plaintiffs’ lawyers often review committee meeting minutes with a fine-tooth comb, searching for signs of poor attendance, from which they will infer lack of care and diligence. In a recent case, a plaintiff’s lawyer painted a picture of a disengaged committee, telling the court: “It’s one of those committees where they meet at 4:30 in the afternoon on a Friday and everyone’s checking their watches.” While attendance is important, your mere “presence” is not enough. A federal judge recently criticized a member of a fiduciary committee for viewing “paper movement” as her primary function on the fiduciary committee. Another committee member tried to explain her inattentiveness to fiduciary matters by testifying, “I have a big job,” implying she was too busy to be a good fiduciary. The judge publicly criticized the individual as displaying “a lack of true appreciation for the significance of her role as a fiduciary.”

3. Mind Your Duties of Loyalty and Prudence. The duty of loyalty requires fiduciaries to act “solely in the interest of the participants and beneficiaries” and “for the exclusive purpose of providing benefits to participants and their beneficiaries; and defraying reasonable expenses of administering the plan.” The duty of prudence requires a fiduciary to act “with the care, skill, prudence, and diligence under the circumstances that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

4. Consult Qualified Experts. Hiring qualified subject matter experts is essential for those who do not possess the requisite expertise themselves. The outcome of a recent ERISA trial hinged largely on the court’s assessment of the credibility and qualifications of the experts retained by the fiduciary committee to help advise on them plan matters. Strong experts led to a defense verdict.

5. Pressure Test the Experts’ Advice. Simply hiring qualified experts is not enough. While fiduciaries may rely on experts, they may not unthinkingly defer to the experts’ opinions. A fiduciary must be skeptical and ask questions. A federal judge recently complimented a member of a fiduciary committee who "questioned the expert's recommendations all the time." As the court put it: "good old-fashioned kicking of the tires of the expert's work is required," further explaining that fiduciaries must meaningfully probe the expert's advice before making informed but independent decisions.

6. Conduct Periodic Requests for Proposals (RFPs). Once you find experts you like (a lot) and can rely on (but not too much), you must consider replacing them every few years. (!) While conducting periodic RFPs can be disruptive and burdensome, it is beyond dispute that the RFP process can also result in lower fees, better service and a good night's sleep for the members of the fiduciary committee, knowing that they have canvassed the market for the right mix of quality and cost, all for the benefit of the plan.

7. Understand that Process Matters. Decisions that you make in a fiduciary capacity might be scrutinized or criticized by others after the fact. You might even end up in court facing a legal challenge to your conduct. Litigation frequently follows the money, and there is a lot of money held by retirement plans in the United States. You will not be judged by a "hindsight" standard; rather, you will be judged by whether you engaged in a prudent process that was free of conflicts and that gave due consideration to the pros and cons of various alternatives, as a prudent person would.

8. Beware of the Defaults of Others. ERISA contains a particularly harsh scheme of "co-fiduciary liability," which can make a fiduciary 100 percent liable for the wrongful acts or omissions of *other* fiduciaries. If you are concerned that another fiduciary might be failing to fulfill his or her duties, you must not look the other way. You have an affirmative duty to attempt to remedy the situation – or face potential liability as if you had committed the wrongful act yourself.

9. Ask About Fiduciary Insurance. Most director and officer (D&O) liability policies do not cover risks arising from an officer or director's service as an ERISA fiduciary, even if it is in some sense related to their job. Therefore, most employers purchase separate riders or policies specifically designed to cover "fiduciary liability." You should ask your employer if fiduciary insurance, in addition to D&O insurance, exists before you agree to serve. Consult an insurance broker if you have any questions.

10. Use a Safety Net. Make sure you are getting good legal advice about items 1-9 … and the dozens of other aspects of being a fiduciary that are not covered in this brief article.

Please contact Brian Lamb with any questions.

Startups

Primer on Equity Incentive Plans and Types of Awards

By Kaoru Christopher Suzuki

Startup companies use equity incentive awards as extra compensation with potentially incredible upside for their executives and key employees. The characteristics of equity incentive awards, including tax treatment, voting rights, vesting and statutory requirements, vary greatly. This primer serves as a brief overview of the most common types of equity incentive awards that are used by companies, and applicable statutory and regulatory requirements.

Importance of Equity Incentive Plans

Competitive hiring of talented employees by startups always includes equity compensation. Equity compensation should be (and sometimes is *required* to be) granted pursuant to an **equity incentive plan** or a **stock option plan**. An equity incentive plan details the number of shares of equity and types of equity awards that can be granted, the proper recipients of the awards, and the administration of the plan.

Properly drafted equity incentive plans and related forms of award agreements are essential to all startups. For starters, an improper equity award can result in a violation of Section 409A of the Internal Revenue Code (IRC), which could lead to increased tax obligations and penalties. Improper equity awards can also result in violations of federal and/or state securities laws and regulations. Note that no changes to Section 409A have been made under the 2018 tax bill passed by Congress.

For limited liability companies (LLCs) and partnerships, a profits interest is the preferred equity award because of its tax characteristics and relative simplicity compared to options granted by LLCs or partnerships. A profits interest plan (or profits interest provision in the operating agreement or partnership agreement) and related forms of profits interest award agreements can ensure proper tax treatment by properly structuring the profits interests, treating the recipients as members or partners in the LLC or partnership, and ensuring that these grants are properly authorized, administered and accounted for in the recipient's capital accounts.

The equity incentive plan and the shares of equity reserved under the plan must be approved by the corporation's board of directors or LLC's board of managers. If the startup is a corporation and is granting incentive stock options, the plan must also be approved by shareholders.

Stock Options

A stock option is a type of equity compensation that provides the employee with the right to buy stock at a specified exercise price at the end of a specified vesting period.

The exercise price is typically the fair market value of a share of stock at the time the option is granted (and in this regard, compliance with IRC Section 409A is required). Options are exercisable for a specified period after the option vests, typically five to 10 years. As discussed in more detail below, stock options are classified for tax purposes either as non-qualified stock options or incentive stock options. The tax treatment of a stock option depends on its classification.

Incentive Stock Options

Incentive stock options, or ISOs, are options that qualify as "statutory stock options" under the IRC. ISOs are not subject to ordinary income taxes at grant or exercise. Instead, only the profit made on any sale of the underlying shares is taxed at prevailing long-term capital-gains rates. Under certain circumstances, the holder of an ISO may also be subject to alternative minimum tax in the year the ISO is exercised. Only corporations are eligible to grant ISOs.

ISOs must satisfy the requirements of IRC Section 422, including, among other things, the requirement that the ISO be issued pursuant to a qualifying, stockholder-approved equity incentive plan, and that the underlying shares be held until the later of one year from the date of exercise or two years from the date of grant of the option.

Non-Qualified Stock Options

Non-qualified stock options, or NQSOs, are options that do not qualify as "statutory stock options" under the IRC.

There is typically no tax at the time of grant of an NQSO, so long as it has no readily ascertainable fair market value at the time of grant. Unlike ISOs, when the NQSO is exercised, there is ordinary income in an amount equal to the spread (the excess of the fair market value of the total equity received on exercise over the aggregate exercise price). The company is entitled to a federal income tax deduction corresponding to the amount of ordinary income recognized on exercise by the recipient of the NQSO.

In addition, when the shares acquired after exercise of the NQSO are sold, long-term or short-term capital gain or loss is recognized, depending on how long the shares were held prior to the sale.

Profits Interests

Partnerships, or LLCs that are taxed as partnerships, are able to grant profits interests, which are equity interests in a partnership or LLC that give the owner the right to receive a percentage of future profits (but not existing capital) from the LLC or partnership. Only entities that are taxed as a partnership can grant profits interests; therefore, corporations are not eligible to grant profits interests.

Profits interests function like stock options and are granted to a member or partner in exchange for a contribution of services. Note that a recipient of a profits interest cannot simultaneously be treated as an employee of the partnership. Therefore, if an employee is granted a partnership interest, the employee must become a new member or partner in the LLC or partnership.

Profits interests must also be structured appropriately to receive tax-free treatment. There are currently four requirements to grant tax-free profits interests:

1. The profits interest must not entitle the recipient to any share of the current capital in the LLC or partnership, meaning that if the LLC or partnership liquidated immediately after the profits interest is granted, the owner of the profits interest would receive nothing;
2. The profits interest must not relate to a "substantially certain and predictable stream of income";
3. The profits interest must not be transferred, sold or disposed of within two years of receipt of the interest; and
4. The partnership must not be a "publicly traded partnership."

In addition, profits interests must be held for at least three years to be taxed as capital gains.

Restricted Stock (Capital Interest)

Restricted stock is stock granted to employees that is subject to certain restrictions (i.e., vesting, repurchase rights, forfeiture obligations, etc.). On the grant date, the employee becomes the owner of record of the shares and has voting, dividend and other stockholder rights. However, the shares are non-transferrable and subject to forfeiture until the restricted stock vests (meaning until the restrictions lapse). If the vesting conditions are not satisfied, the shares are forfeited.

The shares, which are fully issued at the time of the grant, ordinarily have no purchase or exercise price and provide immediate value to the recipient. Restricted stock is generally treated as taxable ordinary income because it is compensation for services performed. Ordinary income is subject to U.S. federal income tax at marginal rates and Federal Insurance Contributions Act (FICA) taxes. Consequently, restricted stock is normally granted only at or near the formation of the company, a point in time when the value of the equity is low.

Restricted stock is considered a transfer of restricted property at the time the grant is made, which means that holders can elect to be taxed on the entirety of the award on the grant date under IRC Section 83(b) (generally a tax-advantaged election for the holder, although not without risk due to the risk of forfeiture of the shares). Such an IRC Section 83(b) election must be filed with the IRS within 30 days of the grant date. If an IRC Section 83(b) election is not made, the holder is taxed when the shares vest.

Corporations may issue restricted stock. The analog for LLCs is an award of membership interests in the form of capital interests.

Equity compensation is a critical tool for startups in the competition to hire (and retain) top talent. Equally important is understanding the various equity incentive award models and choosing the one that best aligns with an organization's structure and objectives.

If you have any questions, please contact Kaoru Suzuki.

2018 Labor & Employment and Professional Conduct Seminar

Wednesday, December 5 – Cincinnati

Clients and friends of the firm are invited to attend the all-day L&E seminar (including the professional conduct session) or just the professional conduct session, as desired.

Labor & Employment and Professional Conduct Seminar

- Labor & Employment Year In Review
- Paid Family & Sick Leave
- Medical Marijuana
- Employment Policies
- Immigration
- #MeToo Developments
- Employee Benefits Update

8:00 a.m. – 8:25 a.m. *Registration*
8:25 a.m. – 4:45 p.m. *Program*

Continental breakfast and lunch provided

7.5 hours of CLE credit has been requested in Indiana, Kentucky and Ohio, including 5 hours for the Labor & Employment portion and 2.5 hours of professional conduct credit for the afternoon session.

Professional Conduct Seminar

- Yes, That Really Happened: (Un)Professional Conduct; Women in the Law
- Mediators Behaving Badly
- Professionalism and Pro Bono in Ohio

1:45 – 2:15 p.m. *Registration*
2:15 – 4:45 p.m. *Program*

2.5 hours of professional conduct credit has been requested in Indiana, Kentucky and Ohio.

For more information, or to register, please visit ThompsonHine.com/Events.

Executive Compensation

SEC Addresses Exemption for Sales of Securities to Employees

By David A. Neuhardt

Many companies, both public and private, use various forms of equity in the company to provide incentives to their employees and as a means of supplementing cash compensation. Most forms of equity, including stock, stock options, restricted stock and restricted stock units, are securities for purposes of federal and state securities laws. Those laws require that the issuance and sale of securities be registered with the appropriate federal or state agencies, unless an exemption from registration is available.

The Securities and Exchange Commission (SEC) recently issued a pair of releases that indicate that it is re-thinking its regulatory regime for securities issued for compensatory purposes, with a view to updating and perhaps simplifying the requirements.

Rule 701

The SEC's Rule 701 provides an exemption from the registration requirements of the Securities Act of 1933 for the issuance and sale of securities under compensatory plans and contracts by companies that are not required to file reports with the SEC. Given the compensatory nature of these securities, Rule 701 generally only requires that a company relying on the rule provide to each investor a copy of the compensatory plan or contract under which the securities are being issued (together with any other information necessary to satisfy the antifraud provisions of the federal securities laws). However, if the aggregate sales price or amount of securities sold in reliance on Rule 701 exceeds $5 million (prior to the recent rule change) in any 12-month period, the issuer also is required to provide investors with detailed additional information about the compensatory plan or contract, the risks associated with the investment and specified financial statement statements as of a date within 180 days prior to the sale. Further, if that threshold is exceeded at any time during the 12-month period, the rule requires that the additional information be given to *all* investors, including those purchasing prior to the threshold being reached, a reasonable period of time before they invest. As a consequence, a failure to anticipate that the aggregate amount of securities to be offered in a 12-month period may exceed the threshold, and to provide the required information from the beginning of the offering, can result in the loss of the exemption for all sales in the offering.

Increased Threshold for Additional Information

In the first of its recent releases, the SEC increased the threshold under Rule 701 for providing the additional information to investors from $5 million to $10 million, thus helping to assure that many private companies relying on the Rule 701 exemption, which might otherwise have bumped up against the threshold, will never be required to provide the additional information. This rule change was mandated by the Economic Growth, Regulatory Relief and Consumer Protection Act.

Concept Release and Request for Comments

Although the change in the threshold for providing additional information should be welcomed by private companies with larger compensatory arrangements relying on the Rule 701 exemption, the SEC's second concept release was even more intriguing. In it, the SEC asked for comments on ways in which it could update the requirements of Rule 701.

Among the concepts that were raised by the SEC was expanding the scope of the individuals to whom securities may be sold under Rule 701, particularly for members of the so-called "gig economy" who typically are not employees, consultants or advisers and, therefore, are not currently covered by the rule. The release also asked about the appropriate amount and timing of the disclosure requirements under the rule, including financial statements, and how frequently the information should be updated. A number of questions were directed at how the exemption applies to restricted stock units, a form of compensatory security frequently used today, but not common at the time Rule 701 was adopted. Finally, the release asked commentators to consider the necessity of continuing the annual ceiling for Rule 701 transactions.

The SEC's concept release also requested comments regarding ways in which the SEC's venerable Form S-8, which is the abbreviated registration statement used by public companies to register securities issued to employees, consultants and advisers in compensatory arrangements, might be updated. Among the questions raised with respect to Form S-8 were the possibility of a single registration statement covering all of a public company's compensatory benefit plans and expansion of Rule 701 to public companies (which could limit, or eliminate, the need to register compensatory plans on Form S-8).

The many companies using equity to incent and compensate their employees and which, therefore, are forced on an ongoing basis to deal with the complexities of complying with Rule 701 or Form S-8, should keep an eye on how the registration/exemption rules may be modernized and made more efficient. We will continue to monitor the changes being contemplated and provide updates as more information becomes available.

Please contact Dave Neuhardt for more information.

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