MEMO TO THE PARTNER

CHANGE IN CONTROL PROVISION FOR A NON-QUALIFIED EMPLOYEE STOCK OPTION AGREEMENT

Ashley Fawver*

TO:	Law Office Partner
FROM:	Associate
RE:	A Change in Control Provision for a Non-Qualified Employee Stock Option Agreement Between Sultra, Inc. and Rosalyn Lovebird

I. INTRODUCTION

As requested, I have drafted a change in control provision to be included in the Non-Qualified Employee Stock Option Agreement ("Option Agreement") between Sultra, Inc. ("Sultra"), a Delaware corporation, and Rosalyn Lovebird ("Rosalyn") to be exercised at the fair market value of Sultra's stock on the date of signing.

In the Rider attached to this memorandum, I have drafted the requested change in control provision and included a glossary of relevant defined terms from the Option Agreement. The remaining terms and provisions of the Option Agreement, including an anti-dilution clause preserving the value of the stock option if the underlying stock were affected by a capital structure change, have been drafted by other associates at our firm.

The remainder of this memorandum sets forth the transactional context in which the parties will sign the Option Agreement; the key substantive issues I encountered in drafting the attached change in control

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provision; and the analysis of the specific drafting choices I made to address each of those issues.

II. TRANSACTIONAL CONTEXT

Our client, Sultra, is a private, closely held cosmetics corporation incorporated in the State of Delaware with assets totaling $36 million. Currently, Sultra has one issued and outstanding class of common stock, which has been distributed pro rata to the five members of Sultra's board of directors (the "Board"). Furthermore, Sultra's Certificate of Incorporation authorizes the issuances of 30,000,000 shares of common stock, of which 10,000,000 shares are currently outstanding. The Certificate of Incorporation, however, does not currently authorize the issuance of preferred stock. Additionally, Sultra has chosen Delaware as the law governing the stock option and Option Agreement.

Three years ago, Sultra hired Rosalyn, a resident of Delaware, to serve as its Creative Director for its new cosmetic brand, Urban Vice, which launched two years ago. Urban Vice's launch was extremely successful, bringing in $24 million in net revenue with a net income of $2.4 million in the previous year. Sultra attributes its success to Rosalyn's services as its Creative Director. For this reason, Sultra would like to continue to retain Rosalyn's services as its Creative Director for the foreseeable future.

In accordance with its goal, Sultra is prepared to issue an Option Agreement under its Non-Qualified Employee Compensation Plan (the "Plan"). Additionally, the Plan provides authority for the Board to specify in "any Award Agreement, such action it deems appropriate to provide in the event of a Change in Control."[1] Thus, Sultra wants our firm to write the Option Agreement to issue the stock options to Rosalyn under the Option Agreement pursuant to the Plan.

The Option Agreement will give Rosalyn the right to buy 5,000 shares of stock at a fixed price which will be set at the fair market value on the date Rosalyn signs this Option Agreement. The stock options will vest over the span of five years. Each year, a pro rata amount will vest

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[1] Sultra, Inc., Non-Qualified Employee Compensation Plan (Form ##) (Month Day, 2017) (labeling Section 4 Change in Control) (fictional document).

subject to Rosalyn attaining a specified performance objective. Furthermore, Sultra hopes the Option Agreement aligns Rosalyn's interest with the Board's interest, thus maximizing shareholder wealth.

Rosalyn, also aware that her services bring value to the corporation, wants to benefit from the value her services brings to the corporation. However, due to Urban Vice's success, Rosalyn is concerned that a larger cosmetics corporation may acquire Sultra in the next two-to-five years before her stock options fully vest. Sultra has confirmed that Rosalyn's concern is valid. However, to negate any effect a merger would have on the value of Rosalyn's Option Agreement, Sultra agreed to insert a change in control provision in the Option Agreement, subjecting the vesting schedule of the Option Agreement to the change in control provision.

A stock option is "a right issued to an individual to buy shares of stock" from a given issuer "at a fixed . . . price (subject to adjustments) over a stated period of time."[2] A change in control provision is a version of an anti-destruction clause that protects the value of the security by providing benefits that may include severance payments, accelerated vesting, or cash-out payments of equity awards.[3] Accordingly, the change in control provision will protect the value of Rosalyn's stock option in the event of a change in control.

The Board has the authority to issue a stock option to Rosalyn. Under the General Corporation Law of the State of Delaware, "every corporation may create and issue . . . rights or options entitling the holders" to purchase from the corporation shares of its stock.[4] The Board may adopt a resolution providing for the creation and issuance of stock options.[5] The resolution must contain the "terms upon which, including the time . . . at or within which, and the consideration . . . for which any such shares may be acquired from the corporation upon the exercise of

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[2] JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURING AND REORGANIZATIONS 255 (Aspen Publishers ed., 2d ed. 1995).

[3] *See* Brian Cumberland et. al., *Despite Strong Winds, Golden Parachutes Still Holding Steady*, ALVAREZ & MARSAL (2018), https://www.alvarexandmarsal.com/insights/despite-strong-winds-golden-parachutes-still-holding-steady.

[4] DEL. CODE ANN. tit. 8, § 157(a) (West 2018).

[5] *Id.* at (b).

any such . . . option."[6] Sultra approved and adopted the Plan by a resolution in January 2017. The Plan authorizes the issuance of 1,000,000 non-qualified stock options and the Option Agreement. As of this date, no stock options have been issued. Thus, pursuant to the Plan, the Board has the authority to issue Rosalyn stock options.

Furthermore, this change in control provision is structured to avoid the adverse tax consequences of 409A of the Internal Revenue Code of 1986, as amended (the "Code").[7] Section 409A regulates deferred compensation arrangements that fall within its scope.[8] Deferred compensation that fails to adhere to Section 409A must be included in gross income as soon as soon as the employee obtains a legally binding right to the compensation and is immediately taxable.[9] Section 409A also subjects the employee to a 20% penalty for failing to adhere to its requirements.[10] Should Rosalyn run afoul of Section 409A, the Code would force Rosalyn to include the stock options in her income and she would be subjected to a 20% penalty.[11] Thus, Rosalyn's Option Agreement is structured to avoid Section 409A's adverse tax consequences.

Though issuers must register stock options pursuant to Section 5 of the Securities Act of 1933, as amended (the "1933 Act"),[12] Sultra is using the exemption provided in Rule 701 under the 1933 Act to avoid registration. State registration is not required.[13]

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[6] *Id.*

[7] I.R.C. § 409A (2014).

[8] *Id.*

[9] I.R.C. § 409A(a)(1)(A) (2014).

[10] I.R.C. § 409A(a)(1)(B) (2014).

[11] I.R.C. § 409A(b)(5) (2014).

[12] Securities Act of 1933 § 5, 15 U.S.C. § 77e (2000).

[13] DEL. CODE ANN. tit. 6, § 73-207(a)(11) (2018).

III. MAJOR SUBSTANTIVE ISSUES

Acceleration plays a significant role in this change in control provision. Accordingly, two major substantive issues with respect to a change in control provision involve the acceleration (or lack of acceleration) of vesting for unvested stock options. The final substantive issue will relate to the definition of a critical term.[14]

The first substantive issue the change in control provision addresses is how to provide for the accelerated vesting of unvested stock options to avoid the tax penalties under Section 409A of the Code while simultaneously granting both Rosalyn and Sultra's objectives. Pursuant to both Rosalyn and Sultra's objectives, the change in control provision protects Rosalyn's unvested stock options from cancelation during a change in control while simultaneously providing Sultra with the flexibility needed in dealing with the stock options to negotiate with a potential acquirer. This is because significant costs are associated with protecting the value of Rosalyn's stock options during a change in control. The cost may come in the form of an acquirer cashing vested stock options out.[15] In other circumstances, to avoid huge cash expenditures or to retain key employees, cost may come in the form of an acquirer agreeing to assume the target's stock options or substitute the target's stock options with its own.[16] However, an acquirer may want to avoid assuming the target's stock options because the options "may present integration issues."[17] Since stock options could potentially represent significant cost to an acquirer, the most optimal approach for Sultra would be to leave the question of how to deal with the stock options open until negotiations between Sultra and an acquirer actually occur. However, this approach

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[14] *See* Earthlink, Inc., 2011 Incentive Stock Option Agreement (Ex. 10.1, Form 10-Q) (Aug. 23, 2012) (labeling Section 2(b)(iii) Change in Control); Realogy Holding Corp., Non-Plan Inducement Stock Option Award Notice of Grant & Non Plan Inducement Stock Option Agreement (Ex. 10.2, Form 8-K) (Oct. 23, 2017) (labeling Section 5.1 Change in Control).

[15] Ilona Babenko, Fangfang Du & Yuri Tserlukevich, *Will I Get Paid? Employee Stock Options and Mergers and Acquisitions* 8 (European Corp. Governance Inst., Working Paper No. 486, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2749045.

[16] *Id.* at 9.

[17] *Id.* at 8.

leaves Rosalyn exposed to the danger that Sultra may cancel her unvested options. To resolve this issue, I have drafted the provision to provide for an accelerated vesting of the unvested stock options in the event that Sultra or the successor company does not provide for the assumption or substitution of Rosalyn's stock options.

The second substantive issue the change in control provision addresses is avoidance of the adverse tax consequences of Section 409A of the Internal Revenue Code. Again, the intent is to avoid adverse tax consequences while simultaneously granting both Sultra and Rosalyn's objectives. Sultra's primary objective is to incentivize Rosalyn, its most valuable employee, to remain the Creative Director should a friendly acquisition occur. Rosalyn's main concern is that an acquiring company will fail to provide compensation or benefits that were as favorable as those provided to her immediately before the change in control.[18] To resolve this issue, I drafted a provision that protects both parties' interests and fits within the exemption Section 409A(a)(2)(i) of the Code, as described below.

The third substantive issue the change in control provision addresses is a definition critical to the preceding acceleration of vesting clauses, referred to here as "Good Reason." This definition is critical for two reasons. The first is the fact that the definition of "Good Reason" has to conform to the safe harbor definition of "Good Reason" specified in Treasury Regulation 1.409A-1(n)(2)(ii) in order to qualify for the separation of service exemption listed in Section 409A(a)(2)(i). Failing to adhere to the definitional safe harbor would subject Rosalyn to adverse tax consequences. The second reason this definition is critical is because Rosalyn wants to ensure that an acquirer provides compensation and benefits that are as favorable as those provided by Sultra right before the change in control. For these reasons, I based my definition of "Good Reason" on the safe harbors for "Good Reason" provided in Treasury Regulation 1.409A-1(n)(2)(ii).

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[18] *See* Adam D. Chinn, et al., *Post-Merger Employment Changes Insufficient to Trigger "Chute" Benefits*, 7NO. 2 M & A LAW. 25 (2003).

IV. ANALYSIS OF MAJOR DRAFTING DECISIONS

To resolve the first issue on how to protect the value of Rosalyn's unvested stock options while simultaneously providing Sultra with the flexibility needed in dealing with the stock options to negotiate with potential acquirers, I chose to use a single-trigger acceleration clause.[19] To avoid the adverse tax consequences of Section 409A of the Internal Revenue Code, I made the trigger for accelerated vesting Sultra's or the successor corporation's failure to assume or substitute Rosalyn's stock option award under the "change of control" exemption listed in Section 409A(a)(2)(v).

This trigger also gives the acquirer the choice to assume or substitute Rosalyn's stock option award to avoid acceleration. Consequently, triggering (or not triggering) this award is entirely in the hands of Sultra and the acquiring corporation at the time of the negotiations. Accordingly, this single-trigger acceleration clause provides Sultra the flexibility it desired for negotiations and provides Rosalyn the protection she desired from having her stock options canceled.

To resolve the second issue, I chose to use a double-trigger provision for acceleration. Should an acquirer desire to retain Rosalyn's service as a Creative Director (which it most certainly will), the acquirer has the option to assume or substitute Rosalyn's stock options pursuant to the first sentence in the change in control provision. Once an acquirer assumes or substitutes the stock option award, I designed the double-trigger provision to provide for accelerated vesting of Rosalyn's stock options only if two events occur. Namely, accelerated vesting of Rosalyn's stock options only occurs if there is a change in control and Rosalyn has terminated her employment for Good Reason or Sultra or the successor

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[19] The use of a double trigger in equity awards "has continued to grow increasingly popular, while single trigger has gradually become less prevalent." For the purposes of the study I examined, the use of both a single and double trigger in an equity award, as I have used in Rosalyn's Option Agreement, was included in the double trigger category. *See 2017/2018 Executive Change in Control Report: Analysis of Executive Change in Control Arrangements of the Top 200 Companies*, ALVAREZ & MARSAL (Nov. 15, 2017), https://www.alvarezandmarsal.com/sites/default/files/article/pdf/50890_tax_executive_change_in_control_report_13_interactive.pdf.

company has terminated her employment for any reason other than Cause, death, or disability.

The double-trigger provides incentive for Rosalyn to remain employed as the Creative Director in a company after a change in control by risking the loss of her unvested stock options. The way in which the double-trigger provision is drafted also avoids adverse tax consequences by using the exemption located in Section 409A(2)(i) of the Code that allows for accelerated vesting on a separation of service.[20]

To resolve the third issue in drafting the definition for "Good Reason," I reviewed the safe harbor listed in Treasury Regulation 1.409A-1(n)(2)(ii) and several precedent documents.[21] The precedent documents I reviewed contained definitions for "Good Reason" that mirrored the safe harbor listed in the Treasury Regulation 1.409A-1. For this reason, I chose to base my definition on Treasury Regulation 1.409A-1(n)(2)(ii).

V. MINOR DRAFTING CHOICES

I also made the following minor drafting choices to provide for a flow and ease in reading:

I chose to include only four of the conditions listed in the safe harbor definition for "Good Reason." While the safe harbor definition for "Good Reason" listed more conditions, precedent transaction documents only listed the four conditions I included in the draft. The four conditions included actions that are taken unilaterally by the employer that represent material negative changes in Rosalyn's employment.

Additionally, I chose to include the definition of "Good Reason" in the change in control provision instead of defining the term in a defined terms section. The provisions I reviewed followed this format, including the definition of "Good Reason" in the change in control provision. I

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[20] Michael J. Canan, et al., *Qualified Retirement Plans, Nonqualified Plans in M & A's-IRC § 409A Deferred Compensation Rules*, 2 QUAL. RET. PLANS § 24.55 (2017) (explaining that a double-trigger consisting of a change in control and termination can satisfy the definition of separation of service).

[21] *See* Treas. Reg. § 1.409A-1(n)(2)(ii) (2007); Realogy Holding Corp., Amended and Restated 2012 Long-Term Incentive Plan, (Ex. 10.1 Form 8-K) (May 5, 2016) (labeling Section 2.26 Good Reason); ADT Inc. 2018 Omnibus Incentive Plan Nonqualified Option Award Agreement (Exhibit 10.34, Form S-1) (Jan. 1, 2018) (labeling Section 3(e) Change in Control).

chose to follow precedent document examples because the change in control provision was already a short provision which allowed for ease in reading. The ease in reading was not impaired by including the definition for "Good Reason" within the provision. In addition, if I had moved the definition of "Good Reason" to a defined terms section, that would make the reader look up an additional definition when the reader was already required to look up two other definitions.

RIDER A

Section 4: Change in Control:

a. In the event no provision is made for the assumption of or substitution for this Award by the Company or its successor in connection with a Change in Control, then, prior to the Change in Control, the Award shall vest in full, to the extent not vested previously, provided the Participant has remained continuously employed by the Company from the Date of Grant until the Change in Control.

b. If provision is made for the assumption of or substitution for the Award by the Company or its successor in connection with the Change in Control, then, if the Participant's employment is terminated by the Participant for Good Reason or by the Company (or any Affiliate or successor) for any reason other than Cause, death or disability, at or within twenty-four months after the Change in Control, the Award shall vest in full, to the extent not vested previously, contemporaneously with the termination of the Participant's employment with the Company or any Affiliate.

  i. "Good Reason" means the Participant's voluntary termination of employment with the Company or a successor other than on death or disability and is based on one or more of the following:

    1. The assignment to the Participant of duties materially inconsistent with the Participant's position and status with the Company as they existed immediately prior to the Change in Control, or a substantial diminution in the Participant's title, offices or authority, or in the nature of the Participant's other responsibilities, as they existed immediately prior to the Change in Control, except in connection with the Participant's termination of employment by the Company or any Affiliate for Cause or on account of the Participant's death or disability or by the Participant other than for Good Reason; or

    2. A material reduction by the Company or an Affiliate in the Participant's base salary as in effect immediately

prior to the Change in Control or as the Participant's base salary may be increased from time to time, without the Participant's written consent; or

3. A material reduction by the Company or an Affiliate in the target cash bonus payable to the Participant under any incentive compensation plan(s), as it (or they) may be modified from time to time, as in effect immediately prior to the Change in Control, or a failure by the Company or an Affiliate to continue the Participant as a participant in such incentive compensation plan(s) on a basis that is not materially less than the Participant's participation immediately prior to the Change in Control or to pay the Participant the amounts that Participant would be entitled to receive in accordance with such plan(s); or

4. The Company or an Affiliate requiring the Participant to be based more than fifty miles from the location where Participant is based immediately prior to the Change in Control, except for travel on the Company's or Affiliate's business that is required or necessary to performance of the Participant's job and substantially consistent with the Participant's business travel obligations prior to the Change in Control.

GLOSSARY

1. “Award” means the employee stock options granted pursuant to this agreement.
2. "Cause" means (i) the Participant's willful and repeated failure to comply with the lawful directives of the Board, the Board of Directors of any Affiliate or any supervisory personnel of the Participant; (ii) any criminal act or act of dishonesty or willful misconduct by the Participant that has a material adverse effect on the property, operations, business or reputation of the Company or any Affiliate; (iii) the material breach by the Participant of the terms of any confidentiality, non-competition, non-solicitation or other agreement that the Participant has with the Company or any Affiliate or (iv) acts by the Participant of willful malfeasance or gross negligence in a matter of material importance to the Company or any Affiliate
3. “Change in Control” means the occurrence of an event set forth in any one of the following paragraphs:
    a. the acquisition (other than from the Company), by any person (as such term is defined in Section 13(c) or 14(d) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act")) of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of more than fifty percent (50%) of the combined voting power of the Company's then outstanding voting securities; or
    b. the individuals who, as of the date hereof, are members of the Board, cease for any reason to constitute at least a majority of the Board, unless the election, or nomination for election by the Company's shareholders, of any new director was approved by a vote of at least a majority of the Board, and such new director shall be considered as a member of the Incumbent Board;
    c. there is consummated a merger or consolidation of the Company or any direct or indirect subsidiary of the Company with any other corporation or other entity, if

i. the shareholders of the Company, immediately before such merger or consolidation, do not, as a result of such merger or consolidation, own, directly or indirectly, more than fifty percent (50%) of the combined voting power of the then outstanding voting securities of the entity resulting from such merger or consolidation in substantially the same proportion as their ownership of the combined voting power of the voting securities of the Company outstanding immediately before such merger or consolidation or

ii. immediately following the merger or consolidation, the individuals who comprised the Board immediately prior thereto do not constitute at least a majority of the board of directors of the entity resulting from such merger or consolidation (or, if the entity resulting from such merger or consolidation is then a subsidiary, the ultimate parent thereof); or

d. A complete liquidation or dissolution of the Company or the closing of an agreement for the sale or other disposition of all or substantially all of the assets of the Company.

e. Notwithstanding the foregoing, a Change in Control shall not be deemed to occur solely because more than fifty percent (50%) of the combined voting power of the Company's then outstanding securities is acquired by (1) a trustee or other fiduciary holding securities under one or more employee benefit plans maintained by the Company or any of its subsidiaries or (2) any corporation which, immediately prior to such acquisition, is owned directly or indirectly by the shareholders of the Company in the same proportion as their ownership of shares in the Company immediately prior to such acquisition.

f. In addition, for each Award that constitutes deferred compensation under Section 409A of the Code, solely to

the extent required to avoid the imposition of additional taxes and penalties under Section 409A of the Code, a Change in Control shall be deemed to have occurred under the Plan with respect to such Award only if a change in the ownership or effective control of the Company or a change in ownership of a substantial portion of the assets of the Company shall also be deemed to have occurred under Section 409A of the Code. Consistent with the terms of this Section 2.9, the Administrator shall have full and final authority to determine conclusively whether a Change in Control of the Company has occurred pursuant to the above definition, the date of the occurrence of such Change in Control and any incidental matters relating thereto.

4. "Participant" means the employee of the Company or an Affiliate that is selected to receive an Award pursuant to this agreement.