Carving Up the Pie: Using Change in Control Carve-Out Plans to Incentivize Startup Employees

by Marshall Mort, Taylor Cashwell, and Shawn Lampron, Fenwick & West LLP, with Practical Law Employee Benefits & Executive Compensation

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A Practice Note providing an overview of carve-out plans and how startup companies can use these plans to retain and incentivize employees whose equity compensation has significantly decreased in value. This Note discusses issues that startup companies should consider when implementing a carve-out plan, including business, tax, and stockholder fairness considerations.

Startup companies often use equity compensation to attract, retain, and incentivize employees. Equity compensation benefits both:

- The company, which relies on equity compensation when it does not have the cash necessary to attract and retain talented employees with market rate salaries and benefits.
- The employees, who typically join the startup hoping its stock price increases significantly and the employees will share in that growth through their equity incentives.

A startup company may find it difficult to attract talented employees or retain its most important employees if the startup company has:

- A steady or declining enterprise value (which may cause the equity held by employees to be "underwater", meaning it has little or no economic value).
- Heavy liquidation preferences (which typically ensure all or nearly all of the proceeds from an exit event will go to investors holding preferred stock, with little or nothing left over for the company's founders and employees holding common stock or stock options).

If either of these circumstances exists, employees who joined the startup to participate in long-term growth may decide to seek employment elsewhere, at either:

- A public company with liquid equity incentives (for example, restricted stock units or an employee stock purchase plan).
- Another startup with a growing valuation whose equity incentives are more attractive.

To counter this attrition and recruit strong talent that may be needed for a startup to successfully position itself for a sale, the startup may need to offer its current and prospective employees other opportunities for meaningful value on a merger or other exit event. Some solutions include:

- Creating retention bonus plans to reward continued employment through specified dates and structuring the plan payments to accelerate on an exit event.

- Issuing full-value equity awards that retain value even with falling stock prices (unlike stock options, which have no value if the stock price falls below the exercise price).
- Adopting a carve out plan.

The most common solution is to adopt a carve-out plan.

Carve-out plans are aptly named because they "carve out" value from a company's stockholders and transfer that value to certain employees. This is done by promising these employees a payment on a sale of the company. This promise of payment is treated as a company debt, which means that carve-out plan payments are paid to employees before payments to preferred or common stockholders. Carve-out plan payments are typically made in the same form as the merger consideration (that is, cash or stock, or a combination of the two). The amount may be specified as:

- A fixed dollar amount.
- An allocated percentage share of a carve-out pool (see Pool Size).
- A distributive share of future appreciation in enterprise value.

Key Initial Considerations

Employees are typically most interested in whether they are participants and what their individual allocations are, but the most contentious decisions in designing the carve-out plan are often determining:

- When to award interests in the plan.
- Which employees will be participants.
- The plan's total size.
- Which stockholders will forgo exit proceeds to which they would otherwise be entitled to fund the plan.

When to Make Plan Awards

A threshold question for a startup company that has decided to adopt a carve-out plan is whether the company should:

- Award carve-out plan entitlements in advance of a sale.
- Take a "wait and see" approach.

Some companies may prefer the latter approach, adopting a plan but waiting until a sale is negotiated before making definitive awards or allocations, because this preserves flexibility and enables the company to reward those employees contributing the most to achieving the exit event. However, this approach does not do as much to facilitate recruitment or prevent employees from departing, which are key reasons to adopt a carve-out plan.

Employees typically insist on a definite award amount or settled percentage share if they are to remain committed to the company. As a result, it is generally expected that a company adopting a carve-out plan also makes immediate allocations to achieve the retention goals the plan is designed to achieve, although some companies wait until after a deal is on the table to do so.

Participating Employees

Another initial consideration for a startup company adopting a carve-out plan is which employees should participate in the plan. Most startup companies limit participation to management or other top employees who are essential to retain through the exit event, but some companies provide for more broad-based employee participation. The carve-out plan itself, as approved by the board, typically includes eligible classes of participants (for example, full-time employees). The board or its delegate then designates individual participants after the plan is adopted.

At many companies, the chief executive officer (CEO) decides who should participate in the plan because the CEO is usually in the best position to determine which employees are most essential to a successful exit event. In the case of a CEO delegation, the board would still specify the CEO's level of participation in the plan. Once the participants have been determined, each participant typically signs a short participation agreement.

Pool Size

If a company decides to establish a carve-out pool, then because payments under a carve-out plan are treated as debt and therefore must be paid before any distributions to stockholders, a startup company must strike a delicate balance between:

- Setting a pool size that is large enough to incentivize the entire group of key current and prospective employees.
- Fulfilling the company's fiduciary duties to maximize stockholder value.

A common starting point when negotiating total carve-out plan size among tech startups is 5% to 15% of the net merger proceeds, but this number may increase or decrease depending on other terms of the plan, including:

- Which stockholders are funding it (meaning the common stockholders, the preferred stockholders, or some mix of both).
- How net merger proceeds is defined (specifically, whether it includes or excludes escrowed amounts, earn-outs, or specific payments and liabilities, like transaction expenses, and whether it includes proceeds to pay off convertible debt), with a more expansive definition often resulting in a larger carve-out plan pool size.
- The number of plan participants, with a higher number of participants typically resulting in a larger pool size.

In a minority of cases, the company requires a minimum transaction size for the carve-out plan payments to be triggered or adopts a sliding scale for the pool size (therefore rewarding a larger exit by providing a larger bonus pool).

Funding Stockholders

The question of which stockholders should fund the carve-out pool was at the core of a Delaware case. In *In re Trados Inc. Shareholder Litigation* (73 A.3d 17 (Del. Ch. 2013)), a startup company adopted a carve-out plan because the company did not expect that its employees would ever realize value in their common stock and other equity incentives. The carve-out plan at issue sat at the top of the distribution waterfall like a debt, so its cost was most heavily borne by the common stockholders at the bottom of the waterfall (for more information on waterfall provisions, which describe the priority for allocation of company income on a sale or other event, see Practice Note, Structuring Waterfall Provisions). On a sale, the carve-out plan participants were paid and the preferred stockholders recouped some of their liquidation preference, but the common stockholders received nothing in consideration of their common stock holdings. The common stockholders sued, alleging the company's board of directors breached its fiduciary duties to the stockholders when it adopted the carve-out plan.

The Delaware Chancery Court dismissed the stockholders' claim, noting that the liquidation preferences were so high that the common stock was likely to be worthless even without the carve-out plan. However, the case's significance to a company looking to adopt a carve-out plan is that the court declined to use the deferential business judgment rule to evaluate the board's adoption of the carve-out plan. Instead, the Court applied the "entire fairness" standard, which is one of the strictest standards applied to board conduct under Delaware corporate law (for more on the standard of review applied to board actions in corporate transactions, see Practice Note, Fiduciary Duties in M&A Transactions). In a footnote, the court noted the following:

> "This case does not present the question of what is a fair allocation of the cost of the [carve-out plan]. The boundaries are clear: 100% could come from proceeds that otherwise go to the preferred stock (a scenario raising no fairness issues), or 100% could come from proceeds that otherwise go to the common stock (a scenario raising serious fairness issues). A range of intermediate allocations are possible and could be justified depending on the facts."

Therefore, courts may apply a higher standard to the adoption of carve-out plans than to other corporate actions in determining whether the directors breached their fiduciary duties. To reduce the risk of an expensive stockholder suit, companies should:

- Be mindful of divergent interests between preferred and common stockholders.
- Ensure that the cost of the plan is not disproportionately borne by the common stockholders.
- Use sound board processes to approve any carve-out plan (such as use of an independent committee and careful documentation of board considerations with respect to the interests of common stockholders).

Employment Conditions

After the size and funding decisions, management teams and investors often debate whether the carve-out plans should pay only those who are still employed through a sale event (this is sometimes referred to as a "present to win" concept) or a different approach that does not penalize those who are involuntarily terminated. Different approaches are favored by:

- Stockholders, who fund the plan and therefore are inclined to reward only those who actually continued providing services to the company through a successful sale event.
- Members of management, who typically worry that employees may not be motivated by a carve-out plan that:
  - requires the employees to remain employed for an unspecified period of time to receive a payout; and
  - causes the employees to lose their award even if they are involuntarily terminated.
- Employees, who may:
  - worry about being terminated on the eve of a transaction and then forfeiting a carve-out plan payment; and

- wonder why the carve-out bonus should be forfeited upon a termination, whereas vested options may be retained and exercised.

Companies take a variety of approaches on this issue. One common approach is to mandate continued employment through the sale event, except that an award remains eligible for payment if the participant is terminated without cause or, less typically, resigns for good reason. This protection is often limited to a termination that occurs relatively close in time to the sale event, at which point an employee has likely done significant work in preparing the company for the sale. For example, a startup company may allow for payment of a carve-out plan award to an employee who experiences a qualifying termination within a six-month period before a sale event, because an employee who is terminated shortly before a sale likely contributed more to that sale than an employee who is terminated earlier. Some startup companies either:

- Provide this protection to some, but not all, plan participants (for example, only to executives).
- Allow for payment to all participants on a termination without cause, but only to some plan participants on a resignation for good reason.
- Allow for payment to all participants on terminations without cause or resignations for good reason, but vary the definitions of cause and good reason based on individual circumstances and positions (for sample definitions of cause and good reason, see Standard Document, Executive Employment Agreement: Section 5.1(b) and Section 5.1(c)).

Another, less common approach is to impose vesting conditions on a participant's allocated carve-out award. For example, an award may vest incrementally over a two-year period and on a change in control, pay only the vested portion. Some startups, in negotiations with potential buyers, may provide for the unvested carve-out entitlements to be assumed in the transaction and paid post-closing contingent on continued employment, allowing the buyer to obtain some retentive benefit under the plan.

Regardless of which approach is used, a startup company must decide what to do with the portion of the pool that is unallocated as of the closing of the sale event, either because it was:

- Never awarded.
- Forfeited by a participant because:
  - the award never vested; or
  - the participant's employment was terminated.

A plurality of plans allow the board (or plan administrator) to award these unallocated amounts at the sale event, which rewards those participants who actually contributed the most to the exit. Other plans are structured to return any unallocated amounts to stockholders or, less commonly, to automatically reallocate unallocated amounts among existing participants. This last approach, colloquially referred to as a "last man standing" clause, tends to be complicated and confusing for participants, and theoretically could cause a windfall to otherwise undeserving participants who happen to remain employed through the closing but do not contribute significantly to the success of the sale.

Contingent Payments

In most acquisitions of private companies, some portion of the merger proceeds is escrowed for a specified period of time. This portion of the proceeds typically either, or both:

- Is available to satisfy indemnification claims by the buyer for the target company's potential breaches of warranties or covenants.
- Represents contingent merger consideration payable on the achievement of specified metrics or goals (often called "earn-outs").

Because the key employees are often in the best position to craft and tailor the warranties made to the buyer about the business and are often key drivers to the success of any earn-out, investors and buyers typically seek to have the carve-out payments subjected to the same escrow and earn-out contingencies as those that apply to stockholders generally.

Bonus Cutbacks

Carve-out plans are often adopted as an employee retention tool when a startup company's common shares do not have enough value to continue to retain existing employees holding those shares (or options to purchase those shares). Because the carve-out plan is treated as a debt of the company, plan awards are paid before payments to preferred stockholders. In cases where the company rebounds, stockholders may view a carve-out plan as giving a windfall to employees if:

- The common shares regain value, so the employees' equity provides employees with the originally intended value.
- The carve-out plan payments are made anyway, so the employees receive a "bonus" under the carve-out plan in addition to their now increased equity value.

Employees and investors holding preferred stock are likely to argue that employees should receive carve-out plan payments in addition to their increased equity value given that the employees helped the company rebound. However, common stockholders may argue that the increased value of the common shares underlying carve-out plan participants' equity awards provides the necessary retentive and incentive effect, so that it is no longer necessary or appropriate for the company to shift stockholder value to the workforce with the carve-out plan. For this reason, startup companies commonly include a provision in carve-out plans reducing any plan payments by the value the participant receives for the participant's equity in the sale event (a "cutback").

If a startup company elects to include a cutback provision in its carve-out plan, the company should also consider whether and how the cutback should apply to the following circumstances:

- **Preferred shares held by a participant.** A cutback may be appropriate for the value of a participant's common shares, but may not be appropriate for the value of the preferred shares purchased by a participant alongside other investors, on the theory that a participant stands more as an investor rather than a service provider with respect to the participant's preferred shares. Much more often than not, startup companies apply any cutback only to a participant's common stock holdings and common stock underlying equity compensation awards and not to any preferred shares held by a participant.

- **Unvested equity awards**. Most plans with cutback provisions provide that any cutback should only apply to value paid out at closing and not to potential future value (for example, if an acquirer assumes unvested awards, some plans do not apply the value of those unvested awards to cutback a present payment under the carve-out plan). However, some startup companies and their shareholders may favor factoring unvested equity into a cutback because it:
  - shrinks the size of the carve-out plan;
  - returns value to stockholders; and
  - increases the retentive purpose of assumed equity awards (therefore making the company more attractive to potential buyers).
- **Revesting equity**. In some cases where equity awards held by founders and key employees are predominantly vested, a buyer may require that a portion of the merger proceeds be subjected to vesting (or "revesting") based on the employees' continued employment post-closing. Startup companies can address this risk by providing that the cutback does not apply to reduce a participant's carve-out payment for any portion of the participant's equity that is subjected to new vesting conditions. Key employees may resist a plan provision that reduces their carve-out payment at closing by the value of revested merger proceeds that may ultimately never vest or be paid. It is relatively rare to see plans address this point specifically.

Amendment Provisions

Startup companies adopting carve-out plans must manage the tension between wanting:

- Flexibility to adjust carve-out plan allocations up through the closing date.
- The carve-out plan to serve as a retention tool when employees' equity holdings are not providing the intended retentive value to the company.

A startup with a decreasing enterprise value or common shares burdened by heavy liquidation preferences may face a dwindling workforce with many departing employees. A carve-out plan may not provide the retentive or incentive value necessary to keep the workforce moving toward a successful exit event if either:

- The participants are not told their allocations at the time the plan is adopted.
- The plan is a flexible policy instead of a binding contractual right.

For this reason, many companies immediately grant awards under their carve-out plans and include plan provisions requiring the company to obtain a participant's consent before making any adverse changes to that participant's award (excluding the risk that additional grants under the carve-out plan may dilute the bonus amounts due to existing participants).

A popular alternative to this consent requirement is to allow the plan administrator to amend plan terms if the holders of a majority of then-allocated awards approve the amendment. This eliminates the risk of a single holdout participant seeking additional consideration for giving the participant's consent to amend.

Another, less common, alternative is to enable the board to amend the plan in its discretion, while clarifying that a special committee should make any determinations relating to any post-closing plan terms or administration. This clarification should reduce participants' concerns about the board of the surviving company, which will be controlled by the buyer, making determinations regarding carve-out payments.

Startup companies should consider their individual circumstances when deciding which approach to follow.

Tax Considerations

Payments under a carve-out plan are deemed wages for tax purposes and are subject to ordinary income tax withholding, including federal income tax at marginal rates and Federal Insurance Contributions Act (FICA) taxes (see Practice Note, Payroll (FICA) Taxes). Just like a cash bonus, withholding is applied to reduce the net amount deliverable under an award.

Carve-out plan payments are typically made in the same form as the consideration payable to stockholders generally. As a result, issues may arise when the merger consideration in the transaction is in the form of stock or a combination of stock and cash. The carve-out participants are taxed on the value of the vested stock issued under the plan, just as they are when they receive payments of cash. Therefore, the acquirer or target must typically provide enough cash to cover withholding taxes: for example, the stock payments can be settled net of shares with a value equal to the tax withholding, which would require the company to remit a cash amount to the taxing authorities and make a corresponding reduction to the number of shares deliverable to the participant. This may become an important transaction hurdle if neither company has the cash on hand to fund that withholding (for example, in an all-stock deal). This is a problem in a private acquisition of a private target, but can also be a problem if the acquirer is public because unless the stock issued to the carve-out participants is registered with the Securities and Exchange Commission, it cannot be sold on the public market to cover tax withholdings. An alternative to using the employer's cash to pay the withholding amount to the Internal Revenue Service (IRS) is to provide that the carve-out plan expires in the event that, or to the extent that, merger consideration is payable in stock, but this is uncommon as it likely undermines the retentive effect of the carve-out plan. Where the consideration is stock, it is most common for the acquirer to provide the cash needed to pay withholding taxes.

Section 409A

Section 409A and its related regulations govern the taxation of nonqualified deferred compensation and include rules about the form and timing of deferred compensation payments. Very broadly, deferred compensation arises under Section 409A when an employee has a legally binding right to a payment in one tax year, but the payment is or may be made in a later tax year.

Carve-out plan payments are typically a form of deferred compensation because participants have a legally binding, although contingent, right to a payment in one year but the payment may be made in a later year. To avoid severe penalties imposed on employees for violations of Section 409A, employers must structure deferred compensation payments, including carve-out plan payments, to either:

- Comply with Section 409A.
- Be exempt from Section 409A.

If the carve-out plan award is subject to a substantial risk of forfeiture, meaning it is conditioned on the occurrence of a condition related to the purpose of the compensation and there is a substantial risk that the payment event won't occur, then the carve-out plan award is not subject to taxation until it is substantially vested, or no longer subject to a substantial risk of forfeiture. If the award is designed to be paid out and in all cases actually pays out within 2 1/2 months following the end of the year in which it vests, then the award is not subject to Section 409A because it meets the short-term deferral exception. For example, an award that vests only if the participant remains employed at the closing of a sale and will in all cases be paid within 2 1/2 months after that closing date meets the short-term deferral exception and therefore is not subject to Section 409A.

If the carve-out plan award is not subject to a substantial risk of forfeiture, because for example, a transaction is pending and continued employment is not required through the closing date, then the award must meet the requirements of Section 409A. One of Section 409A's requirements is that deferred compensation must only be paid in connection with certain specified payment events. One allowed payment event is a change in control, as long as that the change in control definition under the plan meets the requirements of Section 409A. Very generally, a carve-out plan may allow payment if the company undergoes a change in:

- **Ownership of the company**. This generally occurs when a person or group acquires stock that, combined with existing stock ownership of that person or group, constitutes more than 50% of the total fair market value or voting power of the company. Where a person or group owns more than 50% of the total fair market value or voting power of the company and the same person or group acquires additional stock, the additional acquisition does not constitute a change in ownership of the company.
- **Effective control of the company**. This generally occurs on the date that, within a twelve-month period:
    - any person or group acquires stock having 30% or more of the company's total fair market value or voting power; or
    - a majority of the board of directors is replaced by directors who are not endorsed by a majority of the board of directors before the date of the appointment or election.
- **Ownership of a substantial portion of the assets of the company**. This generally occurs when any person or group acquires at least 40% of the total gross fair market value of the company's assets immediately before the acquisition.

A startup company should be aware that if it designs a plan with awards that are not subject to a substantial risk of forfeiture, the company then has less flexibility to amend the plan or replace it with a new benefit because any changes must comply with Section 409A. Companies should also note that if a plan provides for payment on a change in effective control of the company, it may be that plan payments could inadvertently be triggered upon certain large financings. Companies should take care to avoid drafting change in control triggers under carve-out plan that may result in an inadvertent payout requirement.

Earn-Outs and Section 409A

Carve-out payments are often structured to be exempt from Section 409A (see Section 409A), but delaying carve-out payments in an earn-out may cause them to be subject to Section 409A and its strict rules regarding changes to payment timing.

A special rule under Section 409A contemplates carve-out plan payments that are delayed because they are held in escrow or payable only upon earn-out achievement. The rule allows for carve-out payments to be paid on an escrow or earn-out release, regardless of whether the recipient is employed at that time, as long as both:

- The escrow and earn-out are under the same schedule and terms and conditions as those that apply to payments to stockholders generally.
- The payments are completed no later than five years following the closing.

(Treas. Reg. § 1.409A-3(i)(5)(iv).)

Certain problems may arise when applying this rule in some sale events. For example in some transactions:

- Earn-outs may not be achieved within the five year limitation from the closing of the transaction.
- An earn-out may apply to:
  - only common stockholders and not preferred stockholders, or
  - only employee stockholders and not non-employee stockholders.

In these situations, some flexibility may exist if the earn-out is itself subject to a substantial risk of forfeiture under Section 409A, meaning it is conditioned on either:

- The performance of substantial future services.
- The occurrence of a condition related to the purpose of the compensation (for example, a performance condition).

(Treas. Reg. § 1.409A-1(d)(1).)

Special care should be taken in the drafting of these earn-out provisions to avoid potential tax liability under Section 409A because the risk of forfeiture being substantial is determined based on facts and circumstances. Some facts that may support a finding of a substantial risk of forfeiture could be that the earn-out:

- Is tied to an objective for which a company would tend to base its own bonus programs, such as the achievement of revenue or profits, which are reach goals.
- Has a deadline and the metrics are not substantially achieved as of the closing (for example, the successful rollout of a product within a specified period that is only in an idea-phase at the closing).
- Is conditioned on the achievement of substantially uncertain liquidity conditions (for example, an initial public offering (IPO)).
- Is tied to meaningful organizational goals relevant to the carve out participant's job (for example, growth in each department's employee size by double or triple in magnitude).

Under the Section 409A rules, there are some events that could never constitute a substantial risk of forfeiture for this purpose (for example, an agreement to refrain from competing).

For more information on Section 409A generally, see Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview. For more information on Section 409A issues in corporate transactions, see Practice Note, Section 409A Issues in a Change in Control.

Sections 280G and 4999

Carve-out plan awards often constitute golden parachute payments, subject to Sections 280G and 4999 of the Internal Revenue Code (Code). Section 280G (26 U.S.C. § 280G) prohibits a corporation from deducting certain parachute payments and Section 4999 (26 U.S.C. § 4999):

- Imposes a 20% excise tax (which is in addition to ordinary income tax) on the individual receiving certain parachute payments.
- Requires an employer to withhold the excise tax from the individual's compensation.

Very generally, parachute payments are:

- Compensation payments.
- Made to (or for the benefit of) disqualified individuals.
- Contingent on a change in control of a corporation.
- In excess of a specified amount.

If carve-out payments, when aggregated with other compensatory parachute payments, exceed the specified amount, then the disqualified individual is subject to Section 4999's tax penalties. However, carve-out payments (and other payments) made to a disqualified individual by a private corporation may be exempt from treatment as parachute payments if the private corporation meets the requirements of the shareholder approval exception, including:

- 75% of the disinterested stockholders of a private corporation must approve the potential parachute payments immediately before the change in control.
- The private corporation must provide adequate disclosure to the stockholders before the vote.
- The stockholder approval must determine the individual's right to receive the payment, which means that the disqualified individual must waive the excess payments if the stockholders fail to approve them.

If the stockholders approve the payments, then the penalties under Sections 280G and 4999 will not apply. A startup company granting carve-out awards should consider whether the awards are likely to trigger Sections 280G and 4999 and, if so, whether the company and its employees can avoid the penalties by meeting the requirements of the shareholder approval exception.

For more on Sections 280G and 4999 and the shareholder approval exception, see Practice Notes, Sections 280G and 4999: Golden Parachute Payments and Private Corporations and Section 280G.

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