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Using Purchase Price as Retention Tool

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Using Purchase Price as Retention Tool

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Buyers in a merger and acquisition transaction oftentimes intend to rely on their target company's management to remain and assist them with running the purchased business. Particularly in industries where human capital is the primary or perhaps only capital, such as technology or services companies, the art of retention—or motivating the existing management to remain with the business—can be the difference between a successful or disappointing acquisition.

Many buyers build retention incentives into the purchase price itself to avoid or supplement the necessity of additional retention payments. This article offers an overview of common strategies for doing so.

Each of the below strategies comes with its own tax treatment, which has an almost outcome determinative effect on the viability of the strategy. By tying the receipt of purchase price to remaining employed, the purchase price payments start looking more like compensation income rather than capital gains. That change in treatment can more than double the tax costs to the recipient in some jurisdictions.

This article explores both the economic incentives of such strategies together with the susceptibility of purchase price payments being "re-characterized" as compensation income. Note that for any of these strategies to achieve capital gains treatment, the payouts generally must be proportionate to the individual's share ownership in the company. For purposes of this article, "management shareholder" will refer to the individual participating in the retention incentive arrangement.

This article primarily focuses on the U.S. tax law consequences of the various retention strategies. The summary is only intended to reflect principles of general applicability and is not intended to provide any tax advice. Tax counsel should be consulted with respect to the tax considerations and consequences of any holdback arrangement.

Holdback of Purchase Price

Economics

Perhaps the most straightforward method for achieving purchase price retention is to simply withhold a portion of the purchase price otherwise payable to the management shareholder at closing, and instead pay it over time based on a vesting schedule tied to continued employment with the buyer post-closing, typically ranging from 24 to 48 months. This strategy has the benefit of being the easiest to understand and philosophically the closest to the time-based vesting that is prevalent in typical equity incentive plans.

One significant downside to this treatment for U.S. public companies is that U.S. generally accepted accounting principles (GAAP) will generally require such payments to be categorized as compensation, with the compensation expense recognized over the vesting period, even if the tax treatment described below is capital gains. As a result, if the heldback amount is significant, the buyer may have an optical decrease in GAAP earnings and earnings per share (EPS), which is somewhat counterintuitive given that the amounts would otherwise have been paid as purchase price, and so the buyer is not actually paying additional amounts.

One point of flexibility is that the heldback amount may generally be paid in a different form than the original purchase price. For instance, even if all other shareholders are receiving cash, the buyer can opt to pay the heldback amount in buyer shares. The payment in buyer shares can incentivize the management shareholder to grow the overall value of the buyer. Also, the payment in shares may mitigate the above accounting treatment, because some buyers can opt to treat it as stock-based compensation and reflect it accordingly in their non-GAAP numbers.

Third, it also allows buyers to conserve cash, while still cashing out the non-management shareholders, albeit at the cost of additional dilution. Finally, if more than 40% of the consideration consists of buyer shares and various other requirements are satisfied the transaction may qualify as a "reorganization," in which case target shareholders may be eligible to defer a portion of their U.S. tax liability. In certain cases, heldback buyer shares may count favorably toward the 40% threshold.

Paying with buyer shares does come with some downsides. First, expect to spend significant time negotiating the pricing of the shares, particularly for public company buyers. If the shares are priced at the closing price, the management shareholder is bearing the risk of price fluctuations over the multi-year vesting period. If the shares are priced at the time of vesting, the buyer is bearing such risk, and in fact may need to impose pricing floors to avoid situations where the buyer's share price unexpectedly drops so low as to trigger constraints like the shareholder approval requirements under U.S. stock exchange rules.

Second, the buyer will need to work through both the securities laws restrictions on issuing such shares to the management shareholders and on allowing them to subsequently resell such shares. If the buyer is asked to provide registration rights, that can create additional time and expense, particularly as the shares will vest over multiple tranches over time.

Another dimension that will need to get negotiated, whether cash or stock is used, is whether the management shareholder will benefit from a payout upon a termination by the company without "cause" or a resignation for "good reason." Management shareholders will often argue that because the heldback amount was originally due to them as part of the purchase price, they should receive it if buyer involuntarily terminates their employment—i.e. a termination "without cause"—or significantly and adversely changes their conditions of employment—i.e. thus giving them "good reason" to resign. Buyers will counter that such definitions may be too narrow to cover the full spectrum of underperformance that could cause the payment of substantial heldback amounts to be unmerited.

Thought should also be given to whether the heldback amount should also be available to buyer for indemnity purposes. Such dual use is obviously appealing for buyers, particularly as it is normally hard to claw back already-paid purchase price from sellers. However, in addition to being predictably controversial, buyers should also consider that recovering from the heldback amount disproportionately affects the management shareholders relative to the non-management shareholders, and also can dilute the original retention purpose of the holdback.

A variation on a theme of the purchase price holdback is the management rollover, which is often used in private equity buyouts. In a management rollover, the buyer allows or requires management shareholders to take a portion of their cash deal proceeds and reinvest them as equity in the post-acquisition company, at the same valuation as the buyer used in its purchase of the target company. The terms of the rollover are extremely customizable, in terms of the type of security and types of rights received, and are beyond the scope of this article. The key distinction from the holdback strategy described above is that, properly structured, a management rollover may be tax deferred, regardless of how much of the deal proceeds are being rolled over.

Tax

From a tax perspective, the goal of a purchase price holdback arrangement is to provide management shareholders with both a deferral of tax until the time that future payment of the purchase price consideration is received and taxation at capital gains rates. On the first point, holdback arrangements are often structured to delay tax recognition until future payment is received based on applicable tax law—i.e. in the U.S., parties will often rely on the "installment method sale" of tax reporting for this purpose, as opposed to recognizing tax at the closing of a transaction before payment has been made. Section 453, U.S. Internal Revenue Code of 1986, as amended (Code).

If the heldback amounts are required to be taxed at the closing of the transaction, then the parties will typically ensure that a sufficient portion of non-heldback purchase price consideration is paid to the management shareholders at closing in order to satisfy their tax obligations at closing. The second point as to whether the tax should be characterized as capital gains or compensation income is more complex and varies depending on the tax law of the relevant jurisdiction.

Generally, the heldback amount may be treated as purchase price consideration, and therefore, taxed at capital gains rates, unless it is determined that the payments are being made to the management shareholder in connection with the performance of services—in which case, they should be treated as compensation income (which is broadly defined in the Code in various contexts without necessarily distinguishing the form of compensation provided) and taxed at ordinary income rates with the payor being entitled to a tax deduction for such compensation.

This determination of whether the heldback amount more closely resembles purchase price consideration or compensation income ultimately depends on the facts and circumstances of the particular transaction, with no single factor being determinative. Certain rulings from the IRS and case law shed light on certain factors and other issues to consider in making this determination, but there is limited guidance directly on point.

In the case of *Lane Processing Trust v. United States*, 25 F.3d 662 (8th Cir. 1994), the court found that sales proceeds distributed to employees pursuant to a court-approved bankruptcy plan constituted "remuneration for employment" for tax withholding purposes, noting that the "payments made to each employee were based on factors traditionally used to determine employee compensation, specifically, the value of the services performed by the employee, the length of the employee's employment, and the employee's prior wages." The court also noted that "the distributions were conditioned not only on prior service, but also on continuing employment at the time of the sale."

In an analogous case, *R.J. Reynolds Tobacco Co. v. United States*, the court held that a corporation could not deduct as compensation certain distributions made to employee-stockholders (i.e. dividends) pursuant to the corporation's bylaw distribution plan under which distributions were paid in proportion to their stockholdings in the corporation and not in relation to the value of services rendered by the employee-stockholders. *R.J. Reynolds Tobacco Co. v. United States,* 149 F. Supp. 889, 894 (Ct.Cl.), *cert. denied,* 355 U.S. 893 (1957).

The court found that "the payments to employees were because of their investment in stock and not purely for services." In making its determination, the court noted certain factors, including that "the payments were always in exact proportion to the common stock owned by the employee and were in addition to fixed compensation, regardless of the duties and responsibilities of the employee" and "salaries and hourly wages paid to plaintiff's employees on the levels below directors, officers, and junior officers, and other key employees, were at the going rate in the community."

In Revenue Ruling 2007-49, the IRS addressed the scenario of a merger pursuant to which fully vested stock of the target corporation held by an individual is exchanged (whether pursuant to a tax-free reorganization or a taxable exchange) for unvested stock of an acquirer corporation that is scheduled to vest over three years, subject to that individual's continued employment through the vesting date, while the other stockholders of the target corporation receive the same purchase price consideration, but without the vesting restrictions.

If the recipient's employment were terminated any time before the vesting date, then the acquirer corporation would have the right to repurchase the stock at the lesser of the fair market value at the time of the acquisition or the fair market value at the time of termination. The IRS found that this exchange constitutes a transfer of property subject to Code Section 83, which provides rules for the taxation of property transferred in connection with the performance of services..

Under Code Section 83(a), the transferred property is generally not taxable until the property becomes vested, in which case, the excess of the fair market value of the property at the time of vesting over the amount paid, if any, for the property is taxable as compensation income. Alternatively, a recipient may make an election under Code Section 83(b) to be taxed on the difference between the fair market value of the property at the time of transfer, as determined without regard to any lapse of the substantial risk of forfeiture, and the amount paid, if any, by filing a Section 83(b) election with the IRS within 30 days of the date of transfer.

In Revenue Ruling 2007-49, it was contemplated that the recipient would make a Section 83(b) election with respect to the substantially unvested stock of the acquirer corporation received in the merger. By making a Section 83(b) election, the recipient should not recognize any compensation income upon receipt of the acquirer stock—assuming that the fair market value of the acquirer stock is equal in value to the fair market value of the target corporation stock in the exchange—no compensation income should be recognized when the stock becomes vested, and any subsequent appreciation in value of the acquirer stock should be taxed at capital gains rates upon disposition of the acquirer stock.

For these reasons, when unvested stock of an acquirer corporation is issued to a management shareholder in exchange for fully vested stock of the target corporation, the management shareholder may consider making a Section 83(b) election.

A common feature of holdback arrangements is that the management shareholder must remain employed through certain post-closing dates as a condition to the receipt of payment. Although this feature is supportive of treating the holdback as compensation income, tying the right to receive payment to continued employment is essential for retention purposes. The parties may provide for payment upon certain terminations of employment—i.e. a termination by the company without "cause" or a resignation for "good reason"—which could increase the likelihood of payout, on one hand, but could resemble a compensatory severance benefit, on the other hand.

In addition to those factors described above, certain other factors should be considered in determining whether the holdback may be characterized as purchase price or compensation income. Below is a list of prevalent factors that may be viewed as supportive of purchase price treatment.

- The total payments made to all selling shareholders represent a reasonable value of the price paid to acquire the target company
- The value of the withheld portion reflects and does not exceed the proportionate value of the consideration that actually becomes payable to other selling shareholders holding shares of the same type
- The payment period for the heldback amount is reasonable.
- The management shareholder is separately entitled to reasonable compensation for the performance of post-closing services with the buyer or its affiliates, such as pursuant to a separate offer letter or employment agreement that is unrelated to the holdback arrangement
- The amount of the holdback payable to the management shareholders does not vary based on the location of employment, length of employment, job classification, or other factors traditionally used to determine employee compensation
- The definitive agreement underlying the sale of the target company and related ancillary documents are appropriately drafted to reflect the intended tax treatment of the holdback as purchase price consideration.

Ultimately the tax characterization of the holdback arrangement should be discussed with legal counsel to assess the risk and ensure that the tax reporting, documentation, and implementation of the arrangement reflects the agreed-upon treatment by the parties. The foregoing discussion assumes that the source of consideration subject to the holdback consists of proceeds payable in respect of target company stock held by the management shareholder. If other sources will be included, such as proceeds payable with respect to the cash-out of equity awards, it is important to consider any potential tax implications from those sources.

In addition, from a U.S. tax perspective, if the holdback arrangement is determined to provide for compensation income, then the holdback payments may be subject to the "golden parachute" provisions of Code Section 280G, which generally impose a 20% excise tax on certain disqualified individuals—including officers, highly compensated individuals, and 1% stockholders—for excess parachute payments made to them that are contingent upon a change in control of a corporation, and a loss of tax deduction by the corporation, unless a statutory exception applies. In addition, the holdback payments may be subject to the deferred compensation rules of Code Section 409A, in which case, the payments would need to be structured to be exempt from, or compliant with, Code Section 409A.

Separate Retention Pool

A retention pool is an allocation of a portion of the purchase price specifically to fund employee retention. They come in many flavors, such as cash bonus programs, deal success bonuses, and equity incentive programs. Retention bonuses can be paid at closing, post-closing on a vesting schedule, or with performance metrics. The key commonality is that buyer is, in planning its total acquisition budget, taking count of how much will be needed to retain employees, and reducing the purchase price to shareholders accordingly.

On the positive side, retention pools offer the greatest flexibility to target retention dollars at high-value employees, since their allocation does not have to be tied to the employees' prior share ownership in the target. On the negative side, retention bonuses payable in cash are unavoidably treated as compensation income, while any retention bonuses payable in the form of equity incentives will be subject to the tax rules governing the treatment of equity compensation in the applicable jurisdiction. Most of the negotiating points associated with negotiating retention pools are very similar to those for negotiating purchase price holdbacks, and so we will not repeat them.

Instead, we cover retention pools here for one important cautionary point: unlike purchase price holdbacks, a retention pool unavoidably pits the target's shareholders against the target's employees, when the entire package is presented as part of the deal negotiations. Since the overall buyer "budget" is fixed, a dollar being allocated to the retention pool is one less dollar that target shareholders will receive.

Thus, the target's board is often suspicious that management is negotiating with mixed motives, when an offer with a retention pool is presented. Further, under U.S. fiduciary principles, management's duties are to maximize shareholder value, so the presence of a retention pool and negotiating for a larger one can put the management team at risk of a fiduciary duty breach claim by a disgruntled shareholder. As such, buyers seeking to impose retention pools should ensure, first, that such a concept is reflected in its initial offer, to avoid any appearance that management suggested the idea in order to divert funds into such a pool, and second, tread carefully in any conversation where an increase to the pool is at the expense of a decrease to the purchase price.

Performance-Based Earnouts

An earnout is an additional amount of purchase price that is payable upon the achievement of pre-specified criteria, such as revenue or growth in earnings before interest, tax, depreciation, and amortization (EBITDA), product milestones, or other performance goals. Management shareholders may be reluctant to agree to earn-outs because achievement of the metrics to determine their payout is primarily beyond their control, as opposed to a holdback arrangement tied to continued employment. Much has been written about earnouts generally, including as to the fact that they are the most heavily litigated provisions in M&A, and such commentary is beyond the scope of this article. Rather, the focus of this section is solely on their usage in an employee retention context.

Earnouts are primarily useful, from an employee retention perspective, if using a simple purchase price holdback is risky from a tax perspective. For instance, if the entire company is owned only by the management shareholders, in the U.S. it may be more difficult to make the case for capital gains treatment for a purchase price holdback. As such, particularly for small, closely held targets, an appropriately crafted earn-out can be an alternative to incentivize management to stay, in order to assist in the meeting of the earn-out. And in certain jurisdictions, adding a performance condition to an employment-vesting condition may increase the probability that the holdback will be respected as capital gains.

The first consideration is how to craft the earn-out performance conditions. The conditions need to have a Goldilocks quality to them. They cannot be so easy to meet that the management shareholders do not feel the need to actually work to achieve them, or a tax authority may argue that it was illusory. They cannot be so hard to meet that the management shareholders get discouraged and leave, or otherwise argue that they are imposing an unreasonable hurdle relative to the original objective of simple retention. Further, tracking the earn-out itself can be a hassle if the acquired business is not meant to be run as a standalone business line, or if additional financial reporting is necessary, particularly given the always-present specter of litigation if the metrics are not met.

One significant downside is that performance-based conditions do tend to induce a degree of inflexibility into the management shareholder's role at a buyer. Particularly in talent-driven acquisitions, buyer may want the management shareholder to fully integrate into the company, and perhaps even move roles or assume greater responsibility within the company. Having that individual always be thinking of their earn-out conditions means that buyer may need to be flexible in amending such conditions or waiving them, in each case, always with an eye towards whether doing so increases tax re-characterization risk.

Another significant downside is that, in the U.S., for the earnout to be respected for capital gains treatment, it must apply to everyone equally, in proportion to their share ownership. This creates two problems. The first is that buyers must convince non-management shareholders to accept the risk of the earn-out as well. Hence this approach has limited utility for larger companies with significant outside investors. The second, and reverse, problem is that there is a free-rider effect created among the employees. Each individual will be paid the earn-out amount so long as the conditions are met, whether or not they are still employed with buyer, unless there is a separate retention condition. So if the intended group of covered employees is large, they may not feel the incentive to remain, so long as they believe that either others will stay, or that the performance conditions will get met anyways.

Tax

Like holdback arrangements, performance-based earnouts are designed to provide management shareholders with both a deferral of tax until the time that future payment of the purchase price consideration is received and taxation at capital gains rates, the key difference being that the earnout is contingent upon the achievement of company performance conditions that are unrelated to continued employment. Typically, earnout arrangements are structured to delay tax recognition until future payment is received based on applicable tax law. As noted above, in the U.S., parties will often rely on the “installment method sale” of tax reporting for this purpose. Whether the tax should be characterized as capital gains or compensation income will depend on the tax law of the relevant jurisdiction.

In the U.S., the tax characterization of the earnout is based on a facts and circumstance analysis that is similar to the analysis that applies in the context of a holdback arrangement. If the earnout is solely tied to company performance conditions without regard to any continued employment requirement, then there is a stronger basis for taking the position that the earnout is not payable in connection with the performance of services, and therefore, should not constitute compensation income, particularly if other non-management shareholders participate in the earnout on the same terms and conditions as the management shareholders.

Alternatively, adding a continued employment vesting requirement to an earnout for management shareholders only may be one factor that weighs in favor of treating the earnout as compensation income, understanding that other factors should be taken into account in the analysis.

Repurchase Rights or Clawbacks

Economics

A repurchase right, or a call option, is a contractual right for buyer to buy back its stock at a predetermined price. Such repurchase rights can be triggered upon the termination of the holder's employment for any reason and can have a repurchase price that may be based on fair market value or a nominal amount, such as a penny, or a variation thereof, depending on the reason for the termination. Payments are typically made in cash in a lump sum or in installments or in the form of a promissory note. So a repurchase right structure involves paying the purchase price consideration in the form of shares of buyer stock issued to the management shareholder at close, but then subjecting such shares to the repurchase right at cost for the vesting period post-closing.

A similar tactic may also be possible with cash payments rather than stock payments, and in effect operates as a claw back of previously paid cash proceeds, subject to applicable law as certain jurisdictions may have employment or other laws that limit the ability of companies to claw back previously paid amounts.

The repurchase rights structure is rarer in the US. Relative to the more common purchase price holdback structure, the repurchase rights structure has a few downsides. First, the shares have to be issued at closing, so there is no option to price the shares at the value at the time of vesting. Second, exercising the repurchase right requires affirmatively taking back an asset already in the management shareholder's possession, which, in a situation where the parties are parting ways, means that buyer may need to initiate, or at least threaten litigation and/or face the risk that the management shareholder has already spent the funds..

Tax

If a company repurchase right is available to repurchase stock at a nominal repurchase price upon a termination of the recipient's employment for any reason, the stock will generally be viewed as restricted stock—i.e. stock subject to a substantial risk of forfeiture that lapses over time. The tax consequences of restricted stock vary by jurisdiction and advice from local tax counsel should be sought to understand the tax issues related to the issuance, vesting and disposition of restricted stock in the relevant jurisdiction. For example, under U.S. tax law, a management shareholder may consider making a Section 83(b) election with respect to restricted stock.

A claw back will typically require repayment of cash proceeds received by the management shareholder as soon as practicable or within a specified period of time following the occurrence of a specified event. Tax complexities often arise depending on the tax rules of the applicable jurisdiction, particularly if the payment of proceeds occurs in one taxable year and repayment of proceeds, which were previously subject to taxation, follows in a subsequent taxable year.

Conclusion

The one unifying theme of the above discussion is that this is not an area of practice with a one-size-fits-all solution. Nearly every retention strategy described above is ultimately a “facts and circumstances” analysis, requiring close collaboration between the client's business team in assessing ultimate retention objectives and the outside counsel's tax, compensation and corporate teams in assessing tax and other legal issues.

Further, strategies that work in the U.S. may not work in non-U.S. jurisdictions. A summary of a multi-jurisdictional survey of tax issues to consider regarding the tax treatment of holdback arrangements in the U.S., as well as in Brazil, Canada, China, France, Germany, Israel, Italy, Japan, Russia, Singapore, South Korea, Spain, and the U.K., is available here. With careful planning, analysis, and understanding of the applicable laws of the relevant jurisdictions, the parties may work towards their goal of achieving retention in a tax-efficient manner.

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