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GLOBAL PUBLIC COMPANY ACADEMY

IPOs and SPACs: Key Executive Compensation Similarities, Differences, and General Considerations

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Presenters

Timothy Durbin

Associate | Philadelphia

Ryan Montgomery

Associate | Boston

Patrick Rehfield

Partner | Washington, DC

Presentation Outline

1. Going Public Process

- General Planning
- Engaging Consultants and Advisors
- Due Diligence

2. De-SPAC vs. IPO

- Background on de-SPACs
- General Differences
- Other Considerations

3. Executive Compensation

- Long-Term Incentive Compensation
- Short-Term Incentive Compensation
- Severance/Employment Agreements
- Employee Stock Purchase Plans

4. Key SPAC Considerations

- Change in Control Treatment/280G
- Equity Awards/S-8 Timing
- Equity Plan Approval Process

5. Additional Considerations

- Section 162(m)
- ISS Considerations
- Compensation-Related Filing Obligations for Public Companies

1. Brief Going Public Process Overview

General Planning

- Assess current compensation program—what do you have in place today?
- Analyze peers/market
- Analyze key personnel, retention, hires
- Conduct a general competitive assessment

Engaging Compensation-Specific Consultants and Advisors

- In addition to the standard consultants and advisors for a go-public transaction (lawyers, bankers, accounting firm, etc.), compensation-specific advisors should be engaged to assist with the following:
  - Identifying which currently public companies would serve as good "peer companies"
  - Benchmarking current pay practices against peer companies
  - Advising on any proposed adjustments to compensation arrangements to conform to practices of peer companies

  → **Compensation Consultant**

  - For de-SPACs, conduct an analysis of any potential "parachute payments" that become payable (***discussed in more detail later***)

  → **Legal Counsel or Outside Accountant**

Timing

- IPOs
  - Generally a longer time frame—may have months/years to prepare
- SPACs
  - SPAC has a 2-year period to find a target and merge
  - Shorter time frame; similar to a traditional transaction

Due Diligence Process

- Underwriters (and, in the case of a de-SPAC transaction, the SPAC's counsel) must all conduct a "due diligence" review of the issuer's business
- From a compensation perspective, this review includes:
  - Discussions with management throughout the process
  - Documentary due diligence (via a "data room")
  - Analysis of pre-IPO stock issuances, which will include review of all previously made equity grants
  - Review to ensure no "cheap stock" issues
- The checklist to the right provides a non-exhaustive list of items likely to be critical documents in the diligence process

DD Checklist

- ✓ Current equity plan
- ✓ Any individual award agreements for outstanding grants
- ✓ Board resolutions approving grants, and for certain appreciation awards (options/SARs/profits interests) any valuation relied on for setting exercise price,
- ✓ Current or proposed employment agreements
- ✓ Severance arrangements
- ✓ 83(b) elections

2. Traditional IPO vs De-SPAC Transaction

Background: What is a SPAC and How Does it Work?

- A **S**pecial **P**urpose **A**cquisition **C**ompany is a blank check company formed for the purpose of effecting a business combination with one or more businesses (such as a merger or share exchange)
- SPACs are formed to raise capital in an IPO with the purpose of using the proceeds from the IPO to acquire an unspecified business after the IPO
- Formation
  - Most SPACs are formed by a private equity fund, financial institution or group of investors whose investment vehicle is known as the ***Sponsor***

SPAC Background (cont.)

- Initial IPO / Capital Structure
  - In its IPO, the SPAC typically issues equity that is structured to include one share of common stock and a warrant to purchase common stock
  - Simultaneously with the IPO, the Sponsor acquires additional units, shares, or warrants in a private placement
- de-SPAC Transaction
  - Following the IPO, the SPAC will seek an opportunity to acquire an operating business (the "***Target***"). This is known as a "***de-SPAC***" or the "***Business Combination***"
  - It allows a private company to become a US public company outside of the typical IPO process

Advantages of SPACs over Traditional IPOs

- Speed of execution
  - Going public through a SPAC is typically faster than through an underwritten IPO
  - In some transactions, the Target becomes public less than two months after signing the de-SPAC merger agreement
  - In a best case scenario, a traditional IPO takes at least four months (often longer)
- Access to additional funds beyond the amount the SPAC raised in its IPO
  - De-SPAC transactions can include a private investment in public equity (PIPE)
  - The PIPE signs when the de-SPAC merger agreement is signed, and funds when the de-SPAC merger closes
- Deal is not public until signed
  - Traditional IPOs are made public when the company files its registration statement with the SEC
  - If the IPO falls through, e.g. because of market conditions, the company's disclosure remains public knowledge
  - In a de-SPAC, if negotiations break down between the Target and the SPAC before signing, the potential de-SPAC transaction is not made public

Other Considerations

- Parties Involved (Buyer, Seller, Management, Underwriter)
  - IPO—No Buyer (SPAC) but have to go through underwriting process
    - Longer process, as noted earlier, but not as many cooks in the kitchen
  - SPAC—Have both buyer/seller in de-SPAC and additional interested party/shareholders
    - More likely to have separate management counsel
    - Passive vs. non-passive SPAC/Counsel
- Approval Timing Differs for SPAC and IPO
  - Public vs. Private Company Shareholder Approval

3. Executive Compensation Elements of Going Public

Compensation Design Overview

- As the Target company begins to consider becoming a public company, it should review its compensation arrangements with a view to its eventual status as a public company
- The checklist to the right is a non-exhaustive list of specific considerations when going public, and these points are discussed in more detail in the slides that follow

Comp. Design Checklist

- ✓ Implement a public-company style long-term incentive plan/omnibus equity incentive plan
- ✓ Consider whether short term/transaction incentives are necessary to incentivize performance leading up to offering
- ✓ Consider how short-term incentives will be provided once the Target is public
- ✓ Identify of individuals expected to be potential named executive officers (***NEOs***)
- ✓ Determine whether NEOs and other senior executives should enter into new employment agreements or amended employment agreements or be enrolled in a new severance plan
- ✓ Consider the appropriate mix of different elements

Long-Term Incentive Compensation

- In the process of becoming public, companies tend to adopt a public company-style omnibus equity incentive plan
- Under the rules of major listing exchanges, equity grants must be approved by stockholders or be made under an approved plan
- Adopting a plan pre-IPO eliminates the need for later public company shareholder approval and the complexities of the shareholder approval process, including shareholder advisory firms (Institutional Shareholder Services (ISS) and Glass Lewis)

Equity Plan Design Considerations

Equity Plan Design Considerations Checklist

✓ Consider appropriate timing for adoption
✓ Determine appropriate size of authorized pool / potential dilutive impact to other shareholders
✓ Determine whether to include an evergreen
✓ Determine whether to include individual plan limits
    ✓ Director limits (common)
    ✓ Other recipient award limits (less common)
✓ Form of grants for IPO and go-forward awards (*discussed on next slide*)
✓ Benchmarking Analysis
✓ ISS Considerations (*special SPAC considerations discussed below*)

Equity Award Grants

Timing of Grants

- Typical to see initial tranche of grants to senior executives timed to the completion of the IPO
- Following IPO, typical to switch to annual grants consistent with public company peer companies and compensation design advised by compensation consultant

Form of Awards

- For both initial and annual grants, consider whether full value or appreciation awards are preferable
- For initial tranche of awards, common to grant stock options, restricted stock units (**RSUs**), and restricted shares
- For annual grants, more common to grant RSUs and performance-based RSUs (**PSUs**), based on advice from compensation consultant, benchmarking, and considerations around shareholder advisory firms

Transaction Compensation

- Consider whether any **transaction awards** are appropriate:
  - If any in-house members of the team are expected to take on additional work related to the transaction and going public, consider whether they should be entitled to additional compensation.
  - While not common, consider whether it would be advantageous to set up a retention program for employees during first several key months following an IPO or to reward employees when a lock-up may apply and limit liquidity of shares. Consider whether the retention program should pay out at the time of the transaction or after a specified period of time following IPO (e.g., six or 12 months). We note that this is fairly rare.
  - Did the company expect to implement an equity plan and never formalize the arrangements or were employees expecting greater value increase in respect of their equity awards prior to a sale? If so, should employees be "made whole" by new transaction awards?

Go-forward Short-term Incentive Compensation

- Leverage benchmarking by compensation consultant to determine **appropriate annual and other short-term cash incentives** for executives and other employees once the company is public
- Currently, there appears to be a developing trend toward a standalone annual cash bonus plan applicable to all executives, which is either based on individual target amounts or based on a pool that is funded, with individuals having a percentage share of the pool
- Determine the best metrics for cash incentives (share price, EBITDA, revenue, departmental objectives, sales or other operational goals, qualitative business goals (e.g., ESG), and personal objectives)

Short-term Incentives Design Considerations

Short-Term Incentives Design Considerations Checklist

✓ Documentary considerations—do you want a formal plan?
✓ SEC disclosure considerations—
    ✓ if you have a formal plan, you likely have no future disclosure if actions are consistent with plan terms
    ✓ terms that relate to NEOs must be disclosed in annual filings
✓ 162(m) considerations—more flexibility
✓ Market considerations—shift from fixed compensation to performance-based compensation (ISS)

Severance Protections/Employment Agreements

- Based on pre-IPO review of current arrangements, and benchmarking from compensation consultants, consider whether:
  - new employment agreements should be entered into
  - current employment agreements should be amended to be consistent with public company practice
  - a new severance plan should be adopted
- Current trend appears to lean toward simple/streamlined employment agreements or offer letters and a severance plan, with enhanced severance multiples following a change in control

Employee Stock Purchase Plans ("ESPPs")

- An employee stock purchase plan ("**ESPP**") is a broad-based employee benefit plan that enables employees to purchase shares of company stock on a tax-favored basis
- An ESPP allows employees to purchase stock at periodic intervals through after-tax payroll deductions accumulated under the ESPP at a purchase price not less than 85% of the lower of:
  - (i) the market price of company stock at the beginning of the purchase period or
  - (ii) the market price on the purchase date (i.e., the last day of the purchase period)
- An ESPP must be shareholder approved to remain tax qualified
- Timing and rollout of ESPP – whether simultaneous or staggered

ESPP Design Considerations

ESPP Design Considerations Checklist
✓ What is the appropriate size of authorized pool of shares / potential dilutive impact to other shareholders? ✓ Is an evergreen appropriate? ✓ Are non-US employees expected to participate? (foreign jurisdictions come with special considerations) ✓ Should the plan take maximum advantage of the statutory discount or utilize a different formulation? ✓ ISS considerations—potentially lessened

Section 409A – Specified Employee Rule

- **Section 409A** provides for specific and onerous requirements for deferred compensation (including rules for deferral elections, distributions, and funding mechanisms)
- Deferred compensation is broadly defined under Section 409A as:
  - Any arrangement under which the service provider has a legally binding right in one year to compensation that will be paid in a later year
  - Any such arrangement not otherwise within an exception from Section 409A is subject to Section 409A
- For public companies, Section 409A imposes an additional rule where if deferred compensation is paid to **a specified employee** of a publicly traded company on account of separation from service, the commencement of the payment must be **delayed for six months**, except in the event of death

Section 409A (cont.) – Specified Employee Rule

- The Section 409A regulations set forth the requirements for determining which employees are considered specified employees for the purpose of the **six-month delay**
- A **specified employee** is any employee who:
  - owns more than 5% of their employer's stock
  - owns more than 1% of their employer's stock and receives annual compensation greater than $150,000, and/or
  - is among the 50 most highly compensated officers of their employer and earns annual compensation greater than the indexed threshold of $200,000 (for 2022)
- In general, the list of specified employees is **determined on an annual basis** on the public company's "specified employee identification date" (December 31, by default), and that designation takes effect on the next "specified employee effective date" (April 1, by default) and continues for 12 months (i.e., until March 31 of the following year, by default)

4. Key SPAC Compensation Considerations

Potential Change in Control Triggers

- De-SPAC transactions tend to involve a public shell merging with, or otherwise acquiring, the Target. Depending on its structure, it is likely that the transaction will trigger the **change in control provisions** under the Company's equity compensation plan and other executive compensation arrangements
- The Target should work with legal advisors to determine whether:
  - any unvested awards are subject to automatic vesting and whether such awards will be automatically cashed out in the transaction
  - any transaction bonuses become payable
  - any severance protections become enhanced as a result of the transaction
  - any retention awards become payable
  - any employee benefit plans cannot be amended following the transaction, require funding, or have other CIC triggers built into the applicable plan documents
  - any promises to pay excise taxes

CIC Triggers (cont.) - Section 280G

- To the extent that any awards are subject to accelerated vesting, or any payments or benefits otherwise become vested or payable:
  - consider whether **the loss of the intended retentive value** of the vesting schedule or retention awards should be replaced with new awards
  - work with legal advisors—and potentially an outside accountant—to determine whether any of the potential payments are "excess parachute payments" for the purposes of **Section 280G**
- In a typical IPO, Section 280G does not apply because the IPO does not constitute a "change in control of the corporation" for 280G purposes, whereas, for a SPAC transaction, the acquisition transaction likely meets the statutory definition
- Private Company 280G exception does not apply to SPAC. Only one corporation can undergo a change in control for 280G purposes

Section 280G (cont.)

- Section 280G of the Code applies to compensatory payments that are "contingent on a change in control"* paid to a "disqualified individual"* to the extent they exceed the threshold applicable to the individual*
- Consequences:
  - 20% excise tax for the individual on the portion that is an "excess parachute payment"*
  - Loss of tax deduction to the employer

*"Contingent" on a "change in control"
- Payment would not have been made absent the CIC
- Any arrangement entered into within one year prior to a CIC is presumed to be contingent on the CIC
- Payment made as a result of an event that occurs within one year following a CIC is presumed to be contingent on the CIC

*"Disqualified Individual" means any individual who is:
- an officer (no more than 50 employees, or, if less, the greater of 3 employees or 10% of the employees)
- more than 1% shareholder or
- a "highly compensated employee" (highest-paid 1%, not to exceed 250 employees)

*The threshold applicable to a disqualified individual is three times such individual's "base amount", which is generally such individual's average annual W-2 compensation for the most recent five calendar years.

If the threshold is exceeded, all amounts in excess of one times the disqualified individual's "base amount" are "excess parachute payments

Equity Plan Approval Process

- Listing exchanges require that equity awards be granted pursuant to an equity plan that has been approved by shareholders of the issuer
- In typical IPOs, an equity plan is approved by shareholders prior to the IPO
- Given the transaction steps involved in a de-SPAC transaction, consider the appropriate timing for shareholder approval
- ISS considerations

Equity Awards – S-8 Timing

- Public companies typically register the shares underlying their equity plans (and any other compensation plan providing for shares or share-based derivatives) on a Form S-8
- Under the rules applicable to SPACs, the combined public company will not be eligible to use Form S-8 for the registration of compensatory securities offerings until at least 60 calendar days after the effectiveness of the de-SPAC
- This delay does not present issues for new grants of unvested options (which generally do not require a registration statement until the option becomes exercisable), but it presents issues for grants of RSUs, PSUs, and restricted stock as well as for ESPPs

Equity Awards – S-8 Timing (cont.)

- The delay in restriction of equity awards may cause a perceived loss of value
  - employees that receive grants following the 60-day delay may lose value associated with early run-up in post-IPO share price
- Workarounds include:
  - utilizing options as IPO grants (note: to ensure that any such options are not subject to Section 409A, the grant date needs to be at least the day before the IPO and not contingent on the IPO)
  - for other awards, using a target value based on closing price and increases number of shares to reflect increases in value and providing any lost value in delay

5. Additional Considerations

Section 162(m)

- Section 162(m) of the Code imposes a limitation on the deductions available to a public company, and no deduction can be taken on compensation in excess of **$1 million** to any covered person
- Previously, this deduction cap would not apply to a recently public company; however, the IPO safe harbor was repealed by the Tax Cuts and Jobs Act
- Currently, companies should be prepared to comply with Section 162(m) from day 1 following a de-SPAC or traditional IPO

Shareholder Advisory Firm Considerations

- Shareholder advisory firms (e.g., ISS and Glass Lewis) have continued to play a large role in compensation designs and decision-making
- Depending on the ultimate ownership percentages of a SPAC Target once public, shareholder advisory firms may hold less sway within the Target's shareholder base
- Where applicable, we have seen companies in this situation provide enhanced equity plans for executives, when advised by a compensation consultant, including:
  - Larger initial authorized pool for equity plans
  - "Evergreen" provisions (annual share increases to authorized pool of shares for plans
  - Protections disfavored by shareholder advisory firms (e.g., single-trigger acceleration, share recycling, etc.)

Post-IPO Compensation Reporting Obligations

- Annual proxy statement/annual report
  - Require detailed disclosure of executive compensation
  - Certain aspects of executive compensation disclosure lessened for emerging growth companies
  - “Say-on-pay” and “say-on-frequency” voting
  - CEO “pay ratio” disclosure

- Forms 8-K, 10-Q, and 10-K
  - Required to file compensation plans covering, and individual agreements with, executive officers

Reporting Obligations (cont.)

- Form S-8
  - Shorter form registration statement for shares underlying equity plan, employee stock purchase plan, and any 401(k) style plan with employer securities
- Section 16
  - Executive officers, directors and 10% stockholders must file Forms 3, 4, and 5 with respect to beneficial ownership of common stock (Section 16(a))
  - Initial Forms 3 due on date of IPO pricing
  - Section 16(b) short-swing profit liability
  - Late filings must be disclosed in annual proxy statement

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at **www.morganlewis.com/topics/coronavirus-covid-19**

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to **subscribe** using the purple "Stay Up to Date" button.

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Biography

TIMOTHY J. DURBIN
ASSOCIATE
Philadelphia
+1.215.963.5203
timothy.durbin@morganlewis.com

Timothy advises public and private companies on a wide variety of executive compensation and employee benefits matters, both in ensuring compliance in the ordinary course of business and when engaging in corporate transactions, including M&A, spinoffs, initial public offerings, joint ventures, and restructurings. He regularly assists private equity clients with the negotiation of equity and cash-based compensation packages for executives of portfolio companies and advises public companies on compensation-related public disclosure rules, including drafting and reviewing their public filings.

Biography

RYAN R. MONTGOMERY
ASSOCIATE
Boston
+1.617.341.7819
ryan.montgomery@morganlewis.com

Ryan advises clients with respect to employee benefits and executive compensation. He drafts and assists with equity plans and compensation arrangements, deferred compensation plans, tax-qualified pension and profit-sharing plans, bonus plans, and employment agreements. Ryan has experience designing equity incentive programs in the United States and in over twenty other countries, and assists clients with the tax and securities aspects of global equity incentive programs.

Biography

PATRICK REHFIELD
PARTNER
Washington, D.C.
+1.202.739.5640
patrick.rehfield@morganlewis.com

Patrick focuses on matters related to executive compensation, payroll tax, and employee fringe benefits. He advises private and public companies on designing and implementing nonqualified retirement plans, equity compensation plans, and executive compensation arrangements. He also counsels publicly traded companies on reporting and compliance matters involving the SEC, with a focus on proxy and disclosure issues, executive compensation, and corporate governance. He advises public and private companies on employee benefit issues in mergers and acquisitions, including executive compensation matters for senior management.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore*
Tokyo
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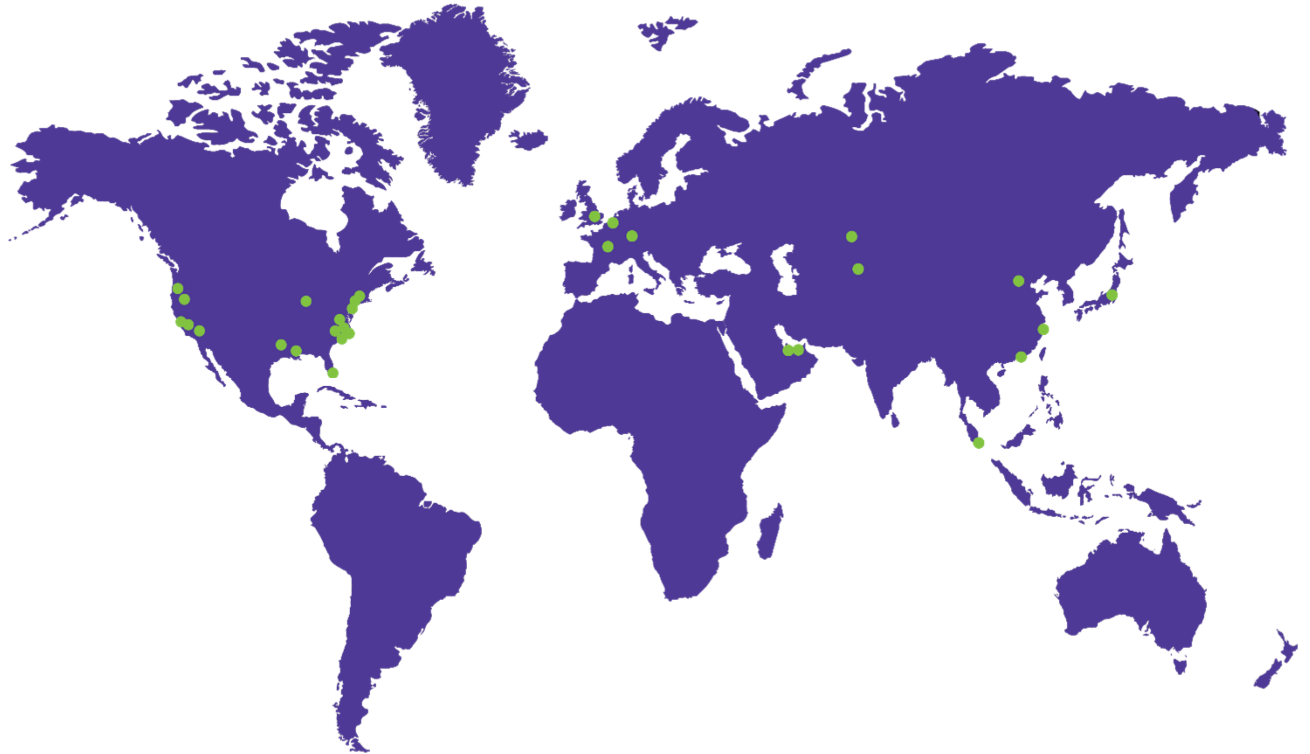

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