



**Caution! Dangerous Merge Ahead:
M&A Must-knows for Stock Plans**

Laura Reis, CEP, Stock & Option Solutions, Inc.
David Thomas, Wilson Sonsini Goodrich & Rosati
Takis Makridis, Equity Methods



Webcast Materials

www.sos-team.com/PDFS/merge.pdf

Case-sensitive URL!

Agenda

Legal Considerations
Administrative Considerations
Equity Accounting for M & A



3

M&A Process



4

LEGAL CONSIDERATIONS

Legal: Types of M&As

Asset Deals
Stock Deals
Mergers
Tender Offers



Legal: Types of M&As

Asset Deals

- Acquires all (or portion of) target assets & may assume liabilities
- Board and shareholder approval required if sale of all or substantially all of target assets

Stock Deals

- Acquires target stock & assumes assets and liabilities
- Board approval required; shareholder approval implicit

7

Legal: Types of M&As

Mergers

- One company is merged into another company (survivor company)
- Assets and liabilities held by survivor company
- Cash or stock consideration
- Different types: direct, forward triangular, reverse triangular
- Board and shareholder approval required of non-survivor company

Tender Offer

- Buyer makes offer directly to target shareholders (hostile or friendly) cash or stock consideration
- 90% of shares must be tendered

8

Legal: Treatment of Equity Awards

Cashout

Acceleration

Assumption / Conversion

- Target awards converted to buyer awards via exchange ratio
- Decreases target share reserve

Substitution

- Cancellation of original awards
- New awards granted from buyer plan
- Decreases buyer share reserves

Combination of the above

Vested vs. Unvested Awards

- Can have different treatment



9

Legal: Due Diligence

Target's past compliance

- Important because: becomes risk/liability of buyer
- Does risk outweigh value?

Equity plans, award agreements, employment agreements, and individual agreements control

Equity Plans and Award Agreements to consider

- Stock Options
- Restricted Stock
- Restricted Stock Units (RSU)
- Stock Appreciation Rights (SAR)
- Stock-settled SAR
- Performance Shares
- ESPPs



10

Legal: Due Diligence

Countries and headcounts

- Determine if non-US counsel should be retained
- Additional lead time required for many jurisdictions
- Which countries run afoul when companies collide (thresholds, etc.)

Equity types in other countries

- Section 102 options in Israel

Tax Issues

- Section 409A discounted options
- Tax-preferred plans
- Withholding & reporting practices
- Mobile employees

11

Legal: Due Diligence

What to Do With Due Diligence Information

- Determine what alternatives are available for treatment of equity compensation
- Determine materiality/relevance
- Accrue for (potential) liability
- Push for additional reps & warranties
- Fix incorrect reps & warranties
- Incorporate in integration plan

12

Legal: Securities Considerations

SEC Filing and Disclosure Requirements

- S-8 filing for options assumed

Section 16 Short-Swing Profit Rules

- Officers & directors dispose of target shares and acquire buyer shares
- Advanced approval of target and buyer boards required to avoid short-swing profit disgorgement



Potential Tender Offer

- Necessary if terms of awards are modified

13

Legal: Tax Considerations

Depends on Treatment of Equity Awards

- Cashout: ordinary income treatment
- Acceleration of vesting: ordinary income (unless a Section 83(b) election previously filed)

ISO Treatment

- Assumption/Conversion cannot provide more favorable benefit
- Share-by-share comparison required
- Modification, extension or renewal could threaten ISO status and trigger Section 409A

14

Legal: Tax Considerations

Section 280G

- Potential parachute payment upon cash-out or acceleration of vesting
- Loss of tax deduction & excise tax
- Shareholder vote cures (private co. only)

15

Legal: International Considerations

Country-specific Considerations

- Cash-out or conversion/adjustment
 - May lose tax-qualified status or exemption (e.g., Canada, France, Italy, U.K.) or
 - Trigger financial services licensing requirements (e.g., Australia)
- Acceleration
 - May trigger EU prospectus requirement if 100 or more employees in Germany vest on same day or
 - Hong Kong securities issue if acceleration occurs within 6 months of grant date
- Keeping substituted awards (e.g., Denmark & Spain)

Data Privacy

- Include waiver on participation form & in disclosure

16

Legal: Other Considerations

Terminations/Severance

- Release for equity awards
- Administer different exercisability periods
- Enforceability of non-compete provisions



17

 Stock & Option Solutions

ADMINISTRATIVE CONSIDERATIONS

 Stock & Option Solutions

Admin: Key Items in Merger Agreement

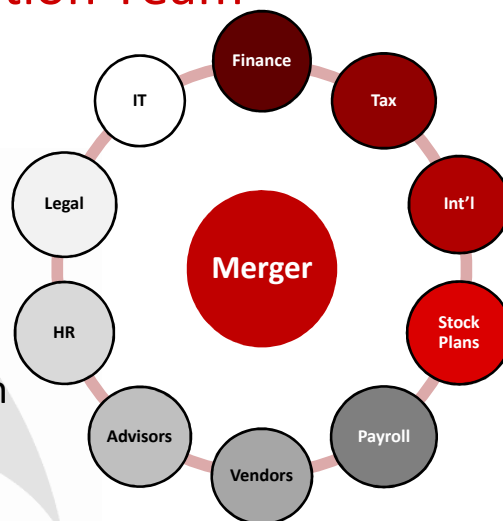
- Transaction type
- Conversion calculation
- Accelerations
- ESPP impact
- Non-US participant impact



19

Admin: Integration Team

- Get involved
- Meet the players
- Deadlines
- Project plan
- Integration details
- Communication plan



20

Employee Communication Plan

Item	Method	Timing	Content Notes
Announcement	Email	Event Date	impact on stock plans / outstanding grants / shares being held Details on in-person meetings/webcast
Announcement	Internet	Event Date	Same text as e-mail, must go up at same time.
Announcement	In-person Meetings	1-day Post Event Date	impact on stock plans / outstanding grants / shares being held
Announcement	Webcast	1-day Post Event Date	impact on stock plans / outstanding grants / shares being held
Pre-close	In-person Meetings	End of week of announcement	
Pre-close	Phone Support	Ongoing	
Post-close Communication	Email / Hardcopy	Within 1 week of close date	Pre & Post Grant Summaries – showing effect of transaction on equity grants

21

Admin: Participant Communications

Avoid a Failure to Communicate!
Communicate, Communicate, Communicate!

Timing:

- What is happening?
- When it will happen?
- How will I know it has happened?

Instruments

- Options
- Awards
- ESPP
- Cash Payouts
- Conversion Ratio
- Provide examples



22

Admin: Participant Communications

Historical Account Impact

- Closed
- Consolidated
- Maintained for historic grants only

New Provider?

- New accounts
- Broker differences
 - Set up requirements
 - Timing
 - Fees

New procedures

- Exercises
- Trading windows
- Insider policies & procedures

23

Admin: Participant Communications

Special Attention:

- Mobile employees
- International employees
- Terminating employees
- Executives

24

Data Integration

Timing

- Parallel
 - Additional effort / resources required
 - Less risk?
- Immediate integration
 - Rip the band off?
- Also depends on approach of other systems/depts



Approach

- Historical vs. outstanding
 - Depends on access to data / system considerations
- Remember FAS 123(R) & APIC Pool

25

Data Integration

Reconciliation

- Time-consuming but critical
- Compare pre- and post-event data
- Understand each and every difference
 - System differences
 - Grant differences
 - Accounting changes

Who

- Outsource vs. internal resources

26

Speed Bumps

Account / Participant Data

- Duplicate Employee IDs
 - Assign new ID – Use buyer's system
- Duplicate Participant Records
 - Same person worked at both companies?
- Different use of similar fields

Tax data

- Tax fields
- Current supplemental tax
- Update from PR or system?



27

Speed Bumps

Changes to post termination exercise (“grace”) periods

- Prior to and during integration

Accelerations

- ISO – NQ

Database differences

- Software / system
- Same software / different version

Cash Outs

- Disposition (disqualifying?) for ISO/ESPP

Update processes/procedures for SOX



28

Other “Directions”

Obtain Plan Documents ASAP

- Grant types allowed
- Exercise types allowed,
- S-8 registration of shares
- Termination and retirement
- Change in Control (CIC)

Employees acquired

- Where are they
- Legal and registration considerations in each location



29

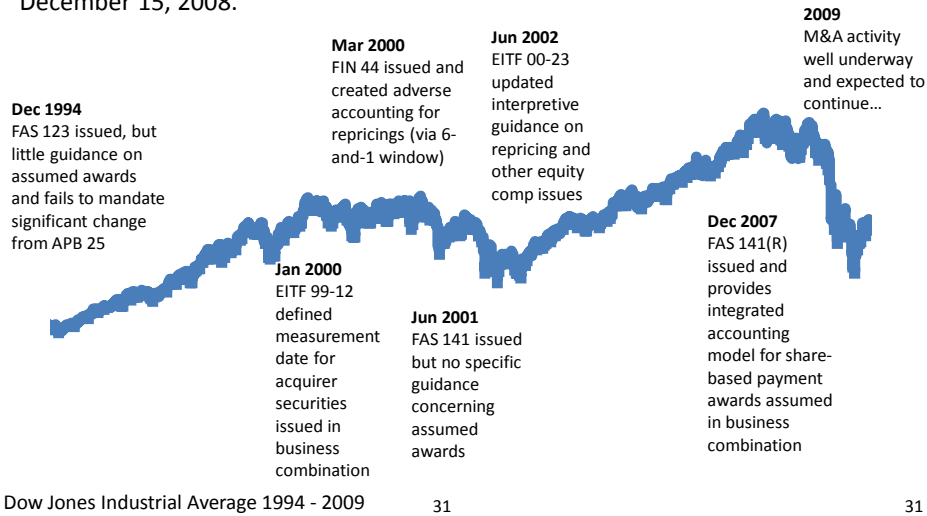
Focus on FAS 141(R)

ACCOUNTING CONSIDERATIONS



Authoritative Guidance

FAS 141(R) now governs accounting treatment for all deals in which acquisition date is on or after the beginning of the first annual reporting period after December 15, 2008.



FAS 141(R): Key Concepts and Terms

- Acquiree / Target and Acquirer / Buyer
- Replacement awards = consideration for:
 - Pre-combination services
 - Allocated to purchase price
 - Post-combination services
 - Recognized as compensation cost by acquirer over remaining service period, if any
- Is acquirer obligated to issue replacement awards?
- Two-step process for allocating fair value to pre-combination & post-combination services
- Total service period vs. original service period

Concept: Purpose of Replacement Awards

Need to ask: “What are these awards for?”

- Pre-combination services already rendered
 - Allocated to purchase price (consideration transferred)
- Compensation for expected post-combination services
 - Recognized in post-combination financial statements of acquirer
- Awards will often be split between pre- and post-combination services

33

Total service period vs Original service period

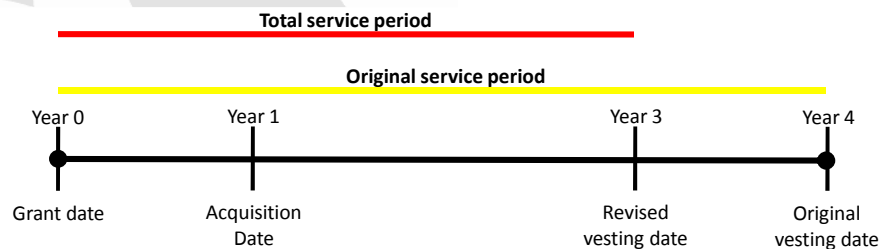
Total service period

- Vesting on acquiree’s awards pre-acquisition
- Plus: vesting required by acquirer post-acquisition.

Original service period

- Original vesting period on award issued by acquiree.

For example, assume acquirer shortens vesting by one year:



34

Two-Step Fair Value Allocation

1. Calculate fair value attributable to pre-combination services as:

$$\text{Total fair value of acquiree awards} \times \frac{\text{Vesting years on original vesting period completed pre exchange}}{\text{MAX \{ total service period, original service period \}}}$$

2. Calculate fair value attributable to post-combination services as:

$$\text{Total fair value of acquirer replacement awards} - \text{Fair value attributable to pre-combination services}$$

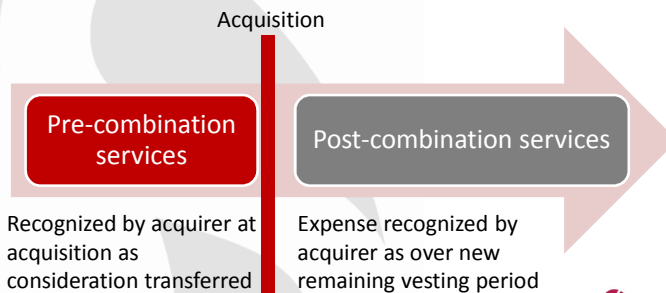
Treatment of Fair Value Allocation

Attributed to pre-combination services:

- Included in consideration transferred in business combination (purchase price)

Attributed to post-combination services:

- Recognized over service period of replacement award



Acquiree award fair value vs. Acquirer award fair value

Fair values often the same but can differ

Why a difference?

- Longer vesting period?
- New award terms?
- Non-value-for-value exchange?

Probably not due to underlying share price difference

Important to apply accepted valuation techniques

Two-Step Fair Value Allocation

1. Calculate fair value attributable to pre-combination services as:

$$\text{Total fair value of acquiree awards} \times \frac{\text{Vesting years on original vesting period completed pre exchange}}{\text{MAX (total service period, original service period)}}$$

2. Calculate fair value attributable to post-combination services as:

$$\text{Total fair value of acquirer replacement awards} - \text{Fair value attributable to pre-combination services}$$

36

Some Examples...

Assume:

- Replacement awards issued: 1,000
- Acquirer obligated to issue repl. awards

Orig. Vesting Period	Add'l Vesting Req'd Post Acquisition	Service Rendered Pre Acquisition	Total Service Period	Acquiree FV Acquirer FV	Pre-Combination Allocation	Post-Combination Allocation
4 years	0 years	2 years	2 years	Acquiree: \$15 Acquirer: \$15	\$7,500 = \$15 × 1,000 × (2 ÷ 4)	\$7,500 = \$15 × 1,000 - \$7,500
4 years	3 year	2 years	5 years	Acquiree: \$15 Acquirer: \$15	\$6,000 = \$15 × 1,000 × (2 ÷ 5)	\$9,000 = \$15 × 1,000 - \$6,000
4 years	1 year	2 years	3 years	Acquiree: \$15 Acquirer: \$15	\$7,500 = \$15 × 1,000 × (2 ÷ 4)	\$7,500 = \$15 × 1,000 - \$7,500
4 years	1 year	2 years	5 years	Acquiree: \$15 Acquirer: \$20	\$6,000 = \$15 × 1,000 × (2 ÷ 5)	\$14,000 = \$20 × 1,000 - \$6,000
4 years	1 year	4 years	5 years	Acquiree: \$15 Acquirer: \$15	\$12,000 = \$15 × 1,000 × (4 ÷ 5)	\$3,000 = \$15 × 1,000 - \$12,000
4 years	2 years	1 year	4 years	Acquiree: \$15 Acquirer: \$15	\$3,750 = \$15 × 1,000 × (1 ÷ 4)	\$11,250 = \$15 × 1,000 - \$3,750

Accepted Valuation Techniques

Expected Term

- Research shows standard estimation methods (when applied to deep in-the-money or underwater awards) generally yield large measurement errors (> 100%)
- Best practice is to use a lattice model
- Does not preclude ongoing use of Black-Scholes for vanilla grants issued at the money

Volatility

- Must pertain to acquirer
- Should consider effect of business combination on acquirer volatility

39

Forfeiture Rates

Both consideration transferred (pre-combination services) and post-combination compensation cost should be adjusted for expected forfeitures.

- Changes and true-ups to that estimate are accounted for only in the post-combination financial statements.
- Fair value allocated to consideration transferred never adjusted.

Example:

- 1,000 awards
- 2-year remaining svc period
- 2% actual forfeiture percent; for simplicity, assume true-up only performed once at vest
- \$20 fair value
- 50-50 allocation to pre- and post-combination services
- 10% forfeiture rate

	At acquisition	Year 1	Year 2	Vest @ End Year 2
Consideration Transferred	\$8,100 $(50\% \times 1,000 \times \$20) \times (1-10\%)^2$	\$0	\$0	
Post-combination Financial Stmts.	\$0	\$4,050 $(50\% \times (1,000 \times \$20) \times (1-10\%)^2) \div 2$	\$4,050 $(50\% \times (1,000 \times \$20) \times (1-10\%)^2) \div 2$	\$3,400 Value earned - Value recognized $[1,000 \times \$20 \times (1 - 2\%)] - \$8,100 - \$4,050 - 4,050$

Attribution Methods

Allocation of fair value between pre- and post-combination services should be based on existing attribution method of acquirer.

- Actual expense recognized by acquiree (based on attribution method) pre acquisition irrelevant.

Example:

- 1,000 awards
- \$20 fair value
- 0% forfeiture rate
- 4-year graded vesting period
- Acquisition at end of year 2
- Vesting period not changed

	Year 1	Year 2	Cum. Remaining Xp. @ Acquisition	Year 3	Year 4
FIN 28 Attribution	\$10,417	\$5,417	\$4,167	\$2,917	\$1,250
Straight-line Attribution	\$5,000	\$5,000	\$10,000	\$5,000	\$5,000

Settlement by Acquiree

Suppose no replacement awards are issued because acquiree settles awards prior to business combination

For whose benefit?

- Analyze whether for the benefit of acquirer (compensation for expected post-combination services)
- If for benefit of acquirer, apply standard calculations to determine portion allocable to consideration transferred and post-combination financial statements.



Settlement by Acquirer

Now suppose no replacement awards are issued because the acquirer settles awards.

- For unvested awards, constitutes an acceleration.

Follow standard “two-step” approach, computing fair value allocation to:

- Pre-combination services (consideration transferred),
- Post-combination services.

Cash amount constitutes “replacement award” fair value.

43

 Stock & Option Solutions

Extension to Income Tax Accounting

Record a deferred tax asset (DTA) based on fair value included as consideration transferred for acquiree (purchase price allocation).

- Fair value attributable to pre-combination services *times* statutory tax rate, net of forfeiture rate applied.
- No adjustments to purchase price recorded at settlement.
- Fair value related to post-combination services will result in a DTA as fair value is recognized over vesting period.
- Standard FAS 123R calculations apply at settlement:
 - Credit/debit to additional paid-in-capital;
 - Increase/decrease to APIC Pool.
- Accounting for ISOs is unaffected.

44

 Stock & Option Solutions

Diluted EPS Calculations

Impacted by modification accounting

- Average Unamortized Expense During Period
 - Will reflect expense allocated to post-combination financial statements (including incremental cost computed)
- Tax Benefit Calculations
 - Should reference cumulative deferred tax asset recorded on entire award in post-combination financial statements
- Compute assumed proceeds and buyback shares based on adjusted calculations, then test for anti-dilution

45

Auto Change in Control Clauses


Automatic accelerated vesting due to a change in control clause results in allocation of entire acquisition date fair value to pre-combination services

Be careful: if such a clause was added in contemplation of business combination, may have post-combination expense

46

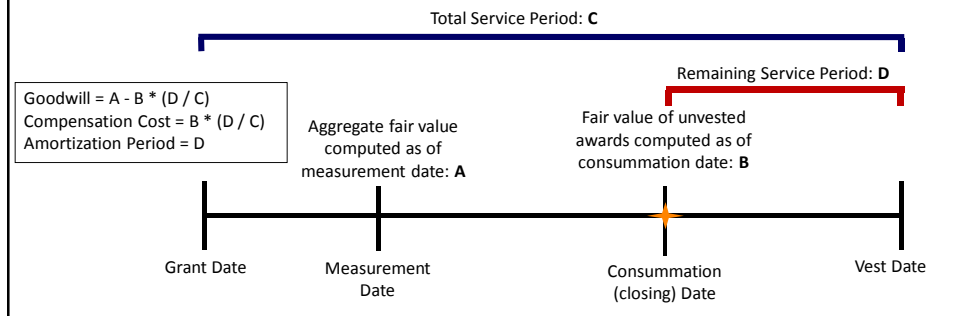
FAS 141 Overview

ACCOUNTING CONSIDERATIONS



A Different Two-Step Allocation

1. Compute aggregate fair value as of measurement (“announcement”) date.
2. Then, compute portion of assumed awards that are unvested and their fair value as of consummation date.
 - Subtract from aggregate announcement date value for purchase price allocation.
 - Expense over remaining vesting period of awards.



Example

- Vest start date: 1/1/2008
- Modified vest end date: 6/30/2010
- Announcement date fair value: \$5
- Original vest end date: 12/31/2010
- Granted amount: 100 shares
- Consummation date fair value: \$12

At Announcement:		
Aggregate compensation cost	\$500	= \$5 × 100 shares
At Consummation:		
Remaining service period	1.25 years	= (6/30/2010 – 3/31/2009) ÷ 365
Total service period	2.50 years	= (6/30/2010 – 1/1/2008) ÷ 365
Percent of service rendered	50%	= (1.25 years ÷ 2.50 years)
Aggregate compensation cost	\$1,200	= \$12 × 100 shares
Unrecognized compensation cost	\$600	= 50% × \$1,200
Final goodwill amount	-\$100	= \$500 - \$600

49

 Stock & Option Solutions

Extension to Income Tax Accounting

Per EITF 00-23, deferred tax asset not recorded in acquirer's financial statements related to the fair value attributable to goodwill (purchase price).

- Record DTA as unearned compensation cost is recognized.

At settlement:

- Vested portion (allocated to purchase price): adjust purchase price for tax benefit up to award fair value, and any excess benefit above this amount is recorded to APIC.
- Unvested portion (unearned compensation): compare actual tax benefit to cumulative book DTA per standard policy.

50

 Stock & Option Solutions

Interesting Implications

ACCOUNTING CONSIDERATIONS

Interesting Implications

Issuance of vested awards for unvested awards (i.e., vesting acceleration) will not shield post-combination financial statements from expense.

- Departure in FAS 141(R) from FAS 141

Interesting Implications

Post-combination financial statements particularly sensitive to use of an imprecise forfeiture rate

- Upward (downward) biased rate will trigger a large upward (downward) expense adjustment in post-combination financial statements
- Because purchase price allocation never adjusted; all adjustments flow through post-combination financials
- Important to study forfeiture patterns carefully at both acquiree and acquirer, in addition to specific patterns related to population whose awards are being assumed

53

Interesting Implications

FAS 141(R) will not allow more expense to be included in consideration transferred than amount earned as of acquisition date

Expense allocated to post-combination services captures:

- Modifications that increase fair value
 - Consistent with FAS 141
- Modifications that reduce service period
 - New in FAS 141(R)

54

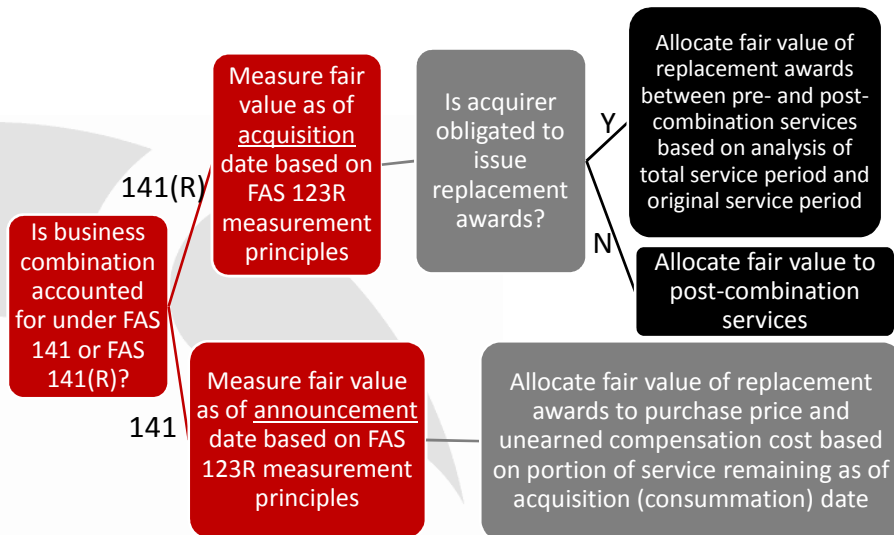
Interesting Implications

Under FAS 141, changes in stock price between announcement date and consummation date may significantly affect purchase price and unearned compensation cost figures

See prior example

55

Analysis Process Flow



56

Additional Resources & References

FASB Summary of Statement 141

- Revised 2007
- <http://www.fasb.org/summary/stsum141r.shtml>

PWC – Mergers & Acquisition Snapshot

- Feb 2009
- http://www.pwc.com/us/issues/business-combinations/assets/ma_snapshot_0409.pdf

Deal Lawyers – How the New Accounting Standards Will Impact M & A

- Jan-Feb 2009
- <http://www.sos-team.com/PDFS/DLnewsMAAccounting.pdf>

57

Contact Information



Laura Reis, CEP
Manager, Data Solutions
6399 San Ignacio Avenue, Suite 100
San Jose, CA 95119 USA
Bus: (408) 979-8700
E-mail: lreis@sos-team.com
www.sos-team.com



David Thomas
Senior Associate
650 Page Mill Road
Palo Alto, CA 94306 USA
Bus: (650) 849-3261
E-mail: dthomas@wsgr.com
www.wsgr.com



Takis Makridis
Director, Professional Services
14614 N Kierland Blvd Ste S-170
Scottsdale, AZ 85254-2747 USA
Bus: (480) 237-3107
E-mail: tmakridis@equitymethods.com
www.equitymethods.com

58