VOLUME 5, ISSUE 4
MARCH 14, 2014

Meridian Client Update

Private Equity Firm Near to Closing Deal to Acquire Institutional Shareholder Services

On March 10, 2014, *The Wall Street Journal* reported that Insight Venture Partners, a New York private equity and venture capital firm, is likely to acquire Institutional Shareholder Services Inc. (ISS) from its parent company, MSCI Inc., a publicly traded company listed on the New York Stock Exchange.

Previously, in a client update dated November 12, 2013, we reported that MSCI had authorized the exploration of "strategic alternatives" regarding ISS. It now appears that an auction winner has been identified and the parties are imminent to closing the deal. *The Wall Street Journal* reported that the deal could be valued at $300 million, which would be considerably less than ISS has been sold for in the past.

Meridian Comment*. If the deal is consummated, ISS would be sold for the third time since 2007. It remains to be seen whether Insight's acquisition of ISS would avert or bolster concerns regarding conflicts of interest. Insight's acquisition of public companies would give it a vested interest in ISS's recommendations on such deals. Presumably, Insight and ISS would develop policies and procedures to address actual and perceived conflicts arising from Insight's ownership of ISS. However, having yet another parent company could lead to more changes in ISS methodologies and scoring systems.*

IRS Adopts Final Regulations on Section 83 Clarifying Definition of Substantial Risk of Forfeiture

On February 25, 2014, the Internal Revenue Service and the Treasury Department issued final regulations under Internal Revenue Code (Code) Section 83 clarifying the definition of "substantial risk of forfeiture."

The regulations do not constitute a narrowing of the requirements to establish a substantial risk of forfeiture but are consistent with the Service's historical interpretation and application of Section 83.

Overview of Section 83

Generally, Section 83(a) of the Code provides that property transferred to an employee in connection with the performance of services is subject to tax in the first taxable year in which the property ***is transferable*** or ***is not subject to a substantial risk of forfeiture***. The amount subject to tax is equal to the fair market value of the property (determined on the date the property becomes subject to tax) less the amount (if any) paid for such property.

Restricted stock is the most common form of property transferred to an employee that is subject to Section 83 of the Code. For example, assume on January 2014 a company grants to an employee 1,000 shares of stock subject to the employee completing three years of continuous service. At the time of grant, the 1,000 shares would not be subject to taxation since the shares are subject to a substantial risk of forfeiture (i.e., failure of the employee to complete the service requirement). However, at the completion of the three-year service requirement (i.e., January 2016), the shares would no longer be subject to a substantial risk of forfeiture and, therefore, would become subject to tax. The amount subject to tax would equal the fair market value of the shares on January 2016.

Final Regulations on Substantial Risk of Forfeiture

The final regulations clarify that a substantial risk of forfeiture exists only if rights in property that are transferred are conditioned, directly or indirectly upon the **future performance (or refraining from performance)** of substantial services or upon the occurrence of a condition **related to the purpose of the transfer (i.e., a performance condition)** if the possibility of forfeiture is substantial.

Transferred property is **not** subject to a substantial risk of forfeiture if at the time of transfer (i) the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced or (ii) upon the return of the property, the employer is required to pay the fair market value of the property to the employee. In addition, the following conditions, standing alone, do not create a substantial risk or forfeiture:

- The risk that the value of property will decline during a certain period.
- A nonlapse restriction.
- Restrictions that if violated, whether by transfer or attempted transfer of property, would result in forfeiture of some or all of the property, or liability by the employee for any damages, penalties, fees or other amount (except in the case of restrictions based on Section 16(b) of the Securities Exchange Act of 1934 (Exchange Act)). For example, restrictions imposed by lock-up agreements under an underwriting agreement or related to the insider trading rules under Rule 10b-5 of the Exchange Act **do not** constitute a substantial risk of forfeiture.

The regulations apply to property transferred on or after January 1, 2013.

Meridian comment. *The new regulations will not impact most public companies' current approach to designing restricted stock awards. As a general matter, these awards are subject to conditions that give rise to a substantial risk of forfeiture as defined under the final regulations (i.e., awards are subject to a substantial future service and/or a condition relating to the purpose of the transfer such as the achievement of a pre-determined financial metric).* ***However, the regulations make clear that an employer's contractual right to clawback vested shares under certain circumstances does not alone create a substantial risk of forfeiture. This would also be true with regard to statutorily required clawbacks under Sarbanes Oxley and Dodd-Frank.***

For a variety of reasons, public companies have been moving away from granting restricted stock in favor of granting restricted stock units and performance share units. It is important to note that the taxation of these types of grants is determined under Code Section 409A, not Code Section 83.

EEOC Lawsuit May Force Companies to Alter Severance Agreements

In February, the Equal Employment Opportunity Commission (EEOC) filed a lawsuit against CVS Caremark claiming that the health care provider's separation agreement unlawfully violated employees' rights to communicate with the EEOC and file discrimination charges.

The EEOC lawsuit focuses on CVS's standard separation agreement under which a terminated employee is provided certain severance benefits in exchange for the employee's general release of claims against CVS and agreement to comply with restrictive covenants. In this case, the EEOC had not received any discrimination-based complaints from employees or former employees. However, in its press release on the CVS case, the EEOC noted that the agency has the "ability to take action even where an employee might not have been able to reach out to the agency and file a charge. In this case, the EEOC alleges that numerous employees were subject to the overly broad release, and we are seeking to end these "unlawful practices"—as well as ensure the necessary safeguards to prevent further wrongdoing."

The CVS separation agreement includes a provision that advises an employee of his or her rights "*to participate in a proceeding with any appropriate federal, state or local government agency enforcing discrimination laws" and to cooperate "with any such agency in its investigation*."

In its complaint, the EEOC notes that the above provision is only set forth in (and modifies) a single covenant of the separation agreement (i.e., employee's covenant not to sue CVS) and that the provision is not included in other limitations and restrictions contained in separate paragraphs of the agreement.

These other limitations and restrictions include (i) general release of claims; (ii) prohibition on the making of disparaging comments regarding CVS or any of its officers, directors or employees; (iii) prohibition on the disclosure of confidential information; (iv) requirement to promptly notify CVS's general counsel by telephone and in writing of any inquiry received by the employee relating to any civil, criminal or administrative investigation involving CVS and to cooperate with CVS in connection with any such proceeding. Additionally, an employee must reimburse CVS for any reasonable attorney fees incurred by CVS in seeking equitable relief and/or damages due to the employee's material breach (or threatened breach) of the separation agreement.

Based on the foregoing facts, the EEOC asserts that CVS, through its use of the separation agreement, has intended to deny employees the full exercise of rights secured by Title VII of the Civil Rights Act (i.e., the right to file charges with the EEOC and to participate and cooperate with an investigation conducted by the EEOC). The EEOC further asserts that this denial of rights interferes with the EEOC's statutorily assigned responsibility to investigate charges of discrimination.

In addition to seeking to permanently enjoin CVS from using the current version of the separation agreement, the EEOC is seeking a court order requiring CVS to:

- Reform the separation agreement to be consistent with Section 707 of Title VII of the Civil Rights Act;
- Implement policies that provide for the full exercise of the right to file a discrimination-based charge and participate and cooperate with the EEOC (including a corrective communication to **all CVS employees** regarding such right);
- Train appropriate company personnel about employees' rights to file charges and communicate with the EEOC; and

- Permit any former employee who was subject to the separation agreement 300 days to file a charge of discrimination with the EEOC.

Meridian comment. *Published commentary by employment attorneys suggest that the EEOC lawsuit against CVS is somewhat of a long shot. However, regardless of the merits of the lawsuit, it serves as a reminder that severance and release agreements are often so inherently complex that a typical employee (who is typically not an attorney nor represented by one) may not fully understand which rights are being waived or retained. We recommend companies review existing severance and release agreements with their legal counsel to determine whether the agreements adequately and clearly advise a former employee of his or her retained rights.*

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