

Securing Executive Talent in Venture-Backed Organizations *Acting Like a Public Company before an IPO*

By Christine Moore and Theodore Sharp

Whether a private company is venture-backed and slated to go public or a mature stable company in its own right, it is critical that the executive team maintain a singular focus on company growth. Senior management needs to feel secure in their positions, since the shareholders, and in many cases, the buyers of a private company are essentially buying executive talent and vision.

Though widely applicable for private companies, severance/CIC arrangements are an important means of gaining the trust of the executive team in advance of a transition to public ownership, providing a measure of security and continuity of leadership by locking in key managers. They offer a measure of assurance to executives and shareholders alike that the company will remain stable as it transitions to the public arena, or in the event that the IPO doesn't transpire. Such arrangements can also be helpful in promoting retention and recruitment at companies that are not yet ready to embark on the road to public ownership.

This article explores the key considerations confronting growing private companies and companies that are going public in deciding whether and how to structure severance or change-in-control (CIC) arrangements. It includes the results of a Pearl Meyer & Partners study of 41 firms in the high technology, electronics and biotechnology industries that underwent an initial public offering in 2007 that illustrates typical severance/CIC practices.

Severance Arrangements

Security arrangements typically guarantee some level of compensation under specific circumstances, such as if the company is bought or if the executive is terminated without cause. Essentially, these arrangements allow executives to focus on the job at hand rather than being distracted by the possibility of losing their employment in the transition from one owner to another.

Among the key benefits to the company:

- Such arrangements provide an element of job and financial security to existing executives who may see the IPO process as destabilizing:
 - They give the employee an incentive to remain with the company during the IPO process.
 - Having a safety net in place encourages the management team to provide unbiased feedback and analysis of possible business opportunities (such as whether to sell the company or to undergo an IPO).
- The same benefits accrue if the exit strategy is not an IPO, but is instead a sale of the company without going public.
- They offer a safety net in recruiting executives who would be giving up a more stable situation at their current employer.
- Implementing a consistent approach to agreements helps avert potential conflict among executives upon disclosure of the exact terms in the public offering.

Security agreements can take several forms, including:

- Employment agreement
- Severance agreement or policy
- Change-in-control agreement or policy

Severance following termination absent a CIC, and severance following termination with a CIC, may be dealt with as separate agreements. However, we found that both generally are addressed in one agreement, which reduces the potential for conflicting agreements.

Typically, such agreements define the terms of the executive's current employment and what payment will be owed in the event of termination in certain circumstances. The executive usually is required to sign a non-compete and/or non-solicitation agreement in conjunction with the security arrangement or at the time of termination in order to receive benefits.

We find that pre-IPO companies have a mishmash of different agreements in place that typically were entered into under varying circumstances over a period of time. One of our clients had five different agreements for its top five officers, ranging from one year of salary and annual incentive as severance upon a termination after a CIC to no severance. A review of all the agreements prior to the IPO gave the company an opportunity to put in place consistent policies for similar levels of executives.

The remainder of this article highlights findings of the Pearl Meyer & Partners survey and our assessment of the typical elements found in these arrangements.

Report Highlights

- The IPO survey group consists of 41 firms: 23 in high technology and nine firms each in the pharmaceuticals and electronics industries.
- The majority of companies provide some form of severance for termination with and without a CIC for the CEO and named executive officers (NEOs).
- All firms with security arrangements provide some form of cash severance for termination of employment as a result of a CIC and/or termination by the company without cause when no CIC has taken place.
- About half the companies provide continuation of health and welfare benefits during the severance period.
- More than 60% of companies provide double-trigger equity vesting following a CIC, defined as a termination of employment that must occur within a certain period (e.g., one year following a CIC).
- Fewer than 25% of companies provide single-trigger equity vesting, meaning that equity would vest upon a CIC regardless of whether employment is terminated.
- Fewer than 25% of companies include a provision for a Golden Parachute Excise Tax gross-up in their CIC arrangements.

Severance Arrangement Terms

A severance arrangement typically includes:

- Cash severance
- Benefits continuation
- Treatment of unvested equity
- Non-compete/Non-solicitation agreements
- Golden Parachute excise taxes

Cash severance – If the executive is terminated without a CIC taking place, cash severance is usually based on a multiple of base salary. If the executive is terminated following a CIC, it may include a larger benefit calculated as a multiple of base salary plus target annual incentive. The multiple is usually higher in a CIC situation.

The severance can be paid out as a lump sum or over time. Some companies find it easier to pay a lump sum rather than keep the executive on the payroll. Others prefer to stagger the cash cost, although such an arrangement may have tax consequences under the deferred compensation rules under Section 409A.

Benefits – Continuation of medical, dental and life insurance benefits is commonly provided to the executive in conjunction with cash severance. Benefits are typically paid for the duration of the cash severance period, with the executive required to continue contributing the requisite payroll deduction toward the premiums.

Study finding:

CEO and NEOs

- *The majority of companies that provide cash severance also provide benefits continuation for the period of the severance (e.g., 1x severance typically carries 12 months of benefits continuation).*
- *Surprisingly, some companies don't provide continuation.*
- *This finding holds true for CIC and non-CIC situations.*

Treatment of unvested equity – Equity incentives are the primary element of executive compensation at emerging companies. They offer significant retention value when designed with vesting restrictions, since executives typically want to preserve the equity value they have worked hard to build, often in lieu of accepting better cash opportunities at established companies. Many view equity as their “investment” in the company prior to the IPO, and are particularly concerned how it would be treated upon termination of employment.

The scenarios typically addressed in regard to equity include:

- **Termination absent a CIC** – Treatment may depend on the specific circumstances:
 - The Company may find it appropriate to offer accelerated vesting upon termination without cause by the employer or if the executive resigns for good reason, as defined in the agreement. Alternatively, continued vesting for a period of time may be offered post-termination. In either case, accommodation is generally provided for some, but not all, of the unvested equity.
 - No additional vesting is granted upon resignation of the executive, absent good reason, or termination for cause by the employer.
- **Vesting Following a CIC – Single-Trigger** – Companies may provide accelerated equity vesting upon a CIC in the form of partial (e.g. 50%) or full vesting. There is growing sentiment against single-trigger acceleration, on the ground that it eliminates any retention value at the date of the CIC and leaves the acquiring company with no retention leverage.
- **Vesting Following a CIC – Double-Trigger** - Vesting is accelerated only upon termination following a CIC by the acquiring company or, for good reason, by the

executive. This is the most prevalent form of equity vesting and recognizes that the executive led the company to an exit and should reap some benefits of the sale upon termination.

Study finding:

Termination absent a CIC (both CEO and NEOs)

- *About 25% of the companies provide some form of additional vesting.*
- *The additional vesting is provide for termination without cause by the company, but not if the executive resigns or is terminated for cause.*

Termination after a CIC (both CEO and NEOs)

- *About 25% of the companies provide single-trigger vesting acceleration (either partial or full vesting) upon a CIC, which is consistent with our experience and confirms the trend away from single-triggers.*
- *60% of the companies provide double-trigger acceleration. In our experience, the other 15% of the companies will also informally, and through negotiation, provide acceleration upon termination. In some cases, the acceleration is provided in equity plan documents rather than security or severance agreements, although we prefer to include vesting in the security agreements.*

280G Considerations - CIC arrangements may also cover all or part of the “Golden Parachute” excise tax imposed under IRC sections 280G and 4999. This punitive 20% excise tax imposed on payments made to executives as a result of a CIC, can significantly reduce the value recognized by executives upon a CIC. There are several approaches that can be taken in CIC arrangements.

- **Gross-up:** Providing additional severance to cover the excise tax can be costly to the acquiring company and favors the executive. It is mainly offered by larger companies.
- **Reduction:** Reducing the severance paid to the executive to avoid triggering the excise tax favors the acquiring company. It is particularly punitive to the executive when total taxable compensation for the executive has not been high prior to IPO, a common outcome in such circumstances.
- **Best Net Benefit:** The executive is given the choice of taking on the tax liability him or herself or accepting a reduced payment. This option is neutral to both parties, although the company loses its deduction on any payment subject to the excise tax if the executive chooses to pay the tax. Keep in mind, however, that most pre-IPO companies are not taxpayers in the first place.
- **No action:** The excise tax is not addressed in the agreement, which acts like a best net benefit since the executive decides whether to pay the tax or ask for a reduction.

Study finding:

About 75% of surveyed firms do not address any 280G tax consequences for their CEO or NEOs, which accords with our experience. This “no action” acts as a best net benefit, in that it permits the executive to choose between paying the tax or asking for a reduction in the benefit. Among the companies that had gross-ups, 17% provided for CEOs and 7% for NEOs.

As a general rule, Boards should consider severance and CIC protections based on factors that are particular to their own company, industry and circumstances. The external competitiveness of proposed provisions should be weighed against their effectiveness in aligning the objectives and financial interests of shareholders and executives. An optimal agreement will address both goals, provided that market practices are supportive of interest alignment.

Among the questions Directors should ask about a proposed severance agreement:

- Is it consistent with industry practices?
- Does the company have any existing severance arrangements in place?
- What is the total potential cost to the company?
- Are retention incentives sufficient to keep the executive focused on the job?
- How much trust has been built up between management and the Board?
- Are severance arrangements for all the NEOs consistent?
- What is the likely shareholder reaction, given that companies now must disclose any severance payable to executives in the event of a CIC or termination?

It is important to note that an arrangement may differ from market practices, but still be appropriate in terms of that organization’s ability to align shareholder and executive interests. On balance, we believe standardized security arrangements provide more advantages to a company than disadvantages, as long as agreements are thoughtfully designed and carefully implemented.

Guidelines

The following table summarizes the components of standard employment agreements for private and pre-IPO companies, based on the Pearl Meyer & Partners survey and our own experience.

Element	CEO	NEOs
Severance (Termination Absent CIC)		
Cash Payment	0.5x - 1.0x Base Salary	0.25x - 0.75x Base Salary
Benefits Continuation	Equal to Cash Severance Period	Equal to Cash Severance Period
Equity Vesting	None	None
Severance (Termination following CIC)		
Cash Payment	1.0x – 1.5x Base Salary and Annual Incentive	0.5x – 1.0x Base Salary and Annual Incentive
Benefits Continuation	Equal to Cash Severance Period	Equal to Cash Severance Period
280G Considerations	No Action	No Action
Equity Vesting		
Single-Trigger	None	None
Double-Trigger	Additional Vesting On All Unvested Equity	Additional Vesting On All Unvested Equity

For more information, please contact:

Christine Moore
 Vice President
 Pearl Meyer & Partners
 132 Turnpike Road, Suite 300
 Southborough, MA 01772
 Direct: 508-630-1491
chris.moore@pearlmeyer.com

Theo Sharp
 Managing Director
 Pearl Meyer & Partners
 132 Turnpike Road, Suite 300
 Southborough, MA 01772
 Direct: 508-630-1498
theo.sharp@pearlmeyer.com

Appendix

Element	CEO	NEOs
Severance (Termination Absent CIC)		
Cash Payment	41% Multiple of Base Salary 32% Multiple of Base Salary and Bonus 27% None	39% Multiple of Base Salary 22% Multiple of Base Salary and Bonus 39% None
Benefits Continuation Equity Vesting	10% Less than Cash Severance period 44% Equal to Cash Severance period 2% Greater than Cash Severance period 44% None	0% Less than Cash Severance period 42% Equal to Cash Severance period 7% Greater than Cash Severance period 51% None
Equity Vesting	29% Additional vesting 71% None	24% Additional vesting 76% None
Severance (Termination following CIC)		
Cash Payment	37% Multiple of Base Salary 43% Multiple of Base Salary and Bonus 20% None	37% Multiple of Base Salary 34% Multiple of Base Salary and Bonus 29% None
Benefits Continuation	10% Less than Cash Severance period 46% Equal to Cash Severance period 0% Greater than Cash Severance period 44% None	5% Less than Cash Severance period 42% Equal to Cash Severance period 5% Greater than Cash Severance period 48% None
280G Considerations	17% Gross-up 7% Other (Reduction / Net Benefit) 76% No Action	7% Gross-up 12% Other (Reduction / Net Benefit) 81% No Action
Equity Vesting		
Single-Trigger	10% Partial Vesting 15% Full Vesting 75% None	10% Partial Vesting 12% Full Vesting 78% None
Double-Trigger	15% Partial Vesting 55% Full Vesting (includes single trigger partial vesting) 15% None	29% Partial Vesting 44% Full Vesting (includes single trigger partial vesting) 15% None



Pearl Meyer & Partners
Comprehensive Compensation®

www.pearlmeyer.com

NEW YORK

445 Park Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA

One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON

132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE

3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO

123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON

Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES

550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com