

# Change-in-Control Agreements After Say on Pay

*December 13, 2011*



## Meet the Presenters



**Margaret Black, Managing Director in the Los Angeles office of Pearl Meyer & Partners, has advised clients for more than 15 years on executive compensation tax issues, including those related to corporate mergers, acquisitions, divestitures and restructurings.**



**Dan Wetzel, Managing Director and head of the Pearl Meyer & Partners' Los Angeles office, has 20 years experience advising clients in the areas of executive and board compensation, including compensation design during mergers, acquisitions and IPOs.**



**Deborah Lifshay, Managing Director in the New York office, specializes in advising clients on compensation matters from a legal perspective, including securities disclosure, taxation and corporate governance issues, as well as contract negotiations and reasonableness opinion letters.**



## Overview

- **CIC Plans and Provisions: The History**
  - The Business Case
  - Historical Influences
- **2010 Proxy Revelations**
  - CIC payments and agreements among the Top 50 US-based companies
- **Looking Ahead to 2012**
  - Survey results for 2012 and expected actions
- **What's Happening in "Real Deals"?**
  - Say on Golden Parachute Payments
  - Voting Trends
- **A Report from the Frontlines**
  - What we're seeing in CIC design and actual transactions
- **Questions?**



# CIC Plans and Provisions: The History

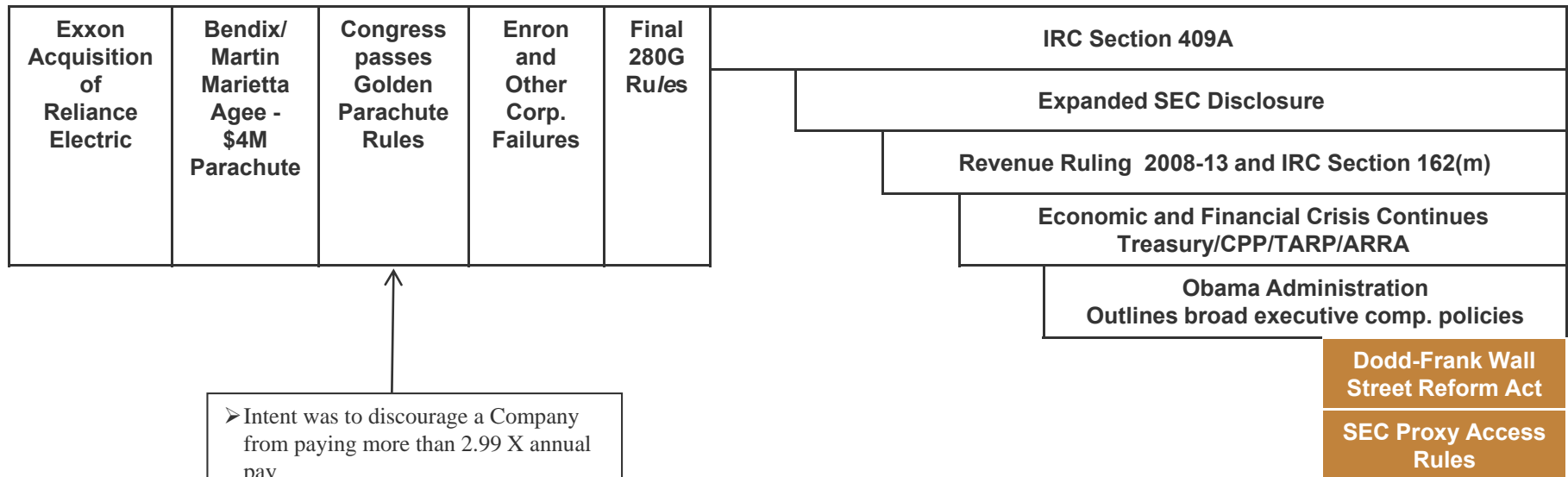
- **The Business Case for CIC Plans**

<i><b>The Business Case</b></i>	<i><b>The Competing View</b></i>
<ul style="list-style-type: none"><li>➤ Help align the interests of management with shareholders<ul style="list-style-type: none"><li>– Keep an executive objective in the wake of a takeover or sale of the Company</li><li>– Without them, management may be more likely to resist valid offers out of fears of losing their jobs</li></ul></li><li>➤ Make it easier to hire and retain executives<ul style="list-style-type: none"><li>– Especially in companies or industries more prone to mergers and acquisition</li></ul></li><li>➤ Assures payment of previously promised compensation and benefits</li></ul>	<ul style="list-style-type: none"><li>➤ Executives have a fiduciary responsibility to the Company<ul style="list-style-type: none"><li>– Should not need additional compensation to perform their duties in the wake of a CIC</li></ul></li><li>➤ In all companies there is a risk of termination and executives are generally well compensated without them</li><li>➤ Large CIC payments may entrench management, deter buyers, or divert purchase price dollars from shareholders to the benefit of management</li></ul>



# CIC Plans and Provisions: The History (Cont'd)

'79	'82	'83	'00-'02	'03	'05	'06	'08	'09	'10 -'11
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- Intent was to discourage a Company from paying more than 2.99 X annual pay
- Imposes a 20% excise tax on executives receiving pay in excess of that limitation
- Companies lose tax deductions for excess payments



## CIC Plans and Provisions: The History (Cont'd)

### *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*

2011

#### **Dodd-Frank Act signed into law July 21, 2010**

**Included executive compensation provisions that significantly modify governance and disclosure for all US public companies**

- Say on Pay(SOP)/Say on Frequency(SOF)/Say on Golden Parachutes (SOGP)
- Disclosure (pay for performance, pay ratio CEO/employee, Chairman/CEO standards, hedging policies)
- Independence Standards (Compensation Committee/Consultant)
- Clawbacks
- Special requirements for Financial Institutions – Compensation
- Proxy Access

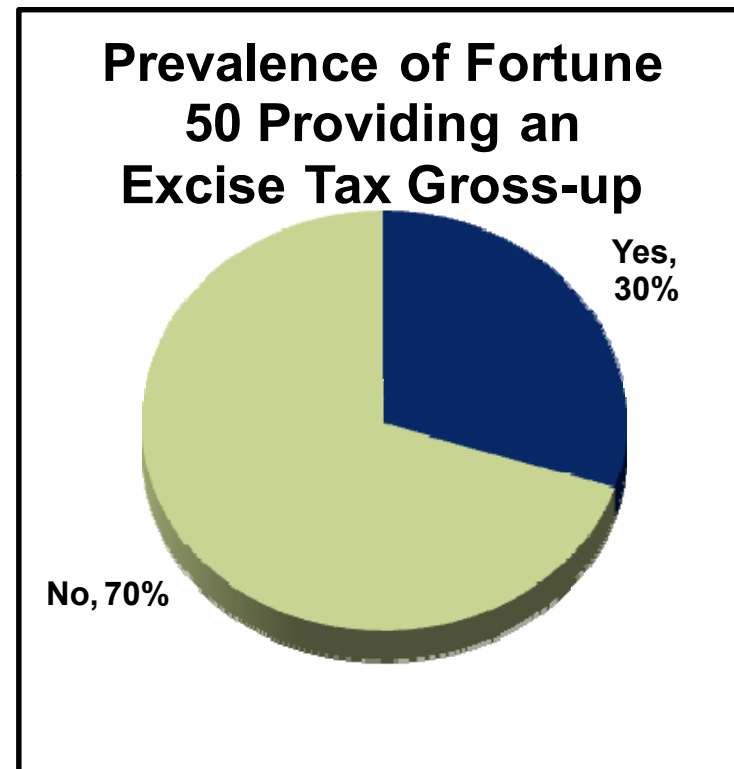
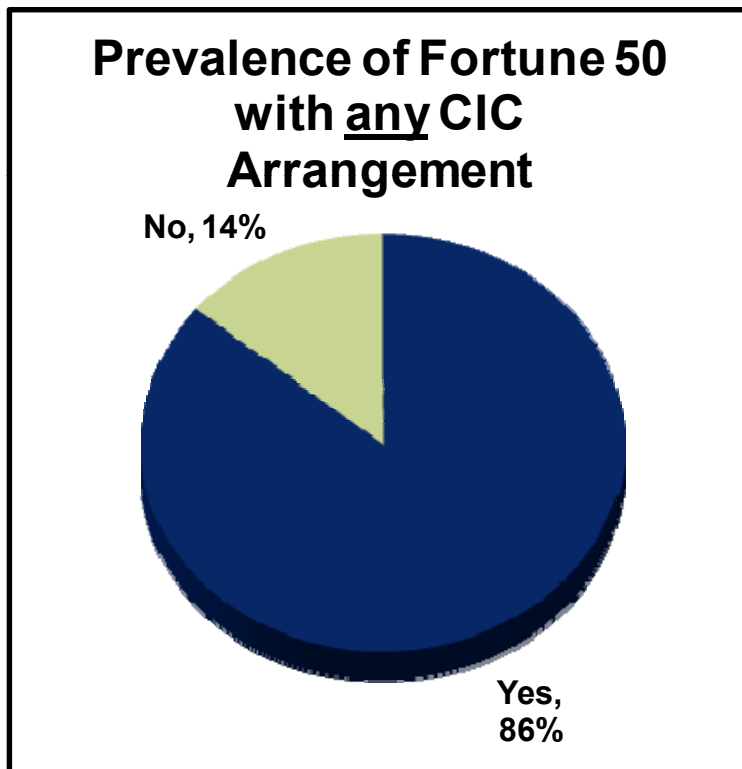
#### **SEC adopts final rules re: SOP/SOF/SOGP January 25, 2011**

- SOP/SOF effective for 2011 Proxy Season
- SOGP effective for transactions occurring after April 25, 2011



## 2010 Proxy Revelations

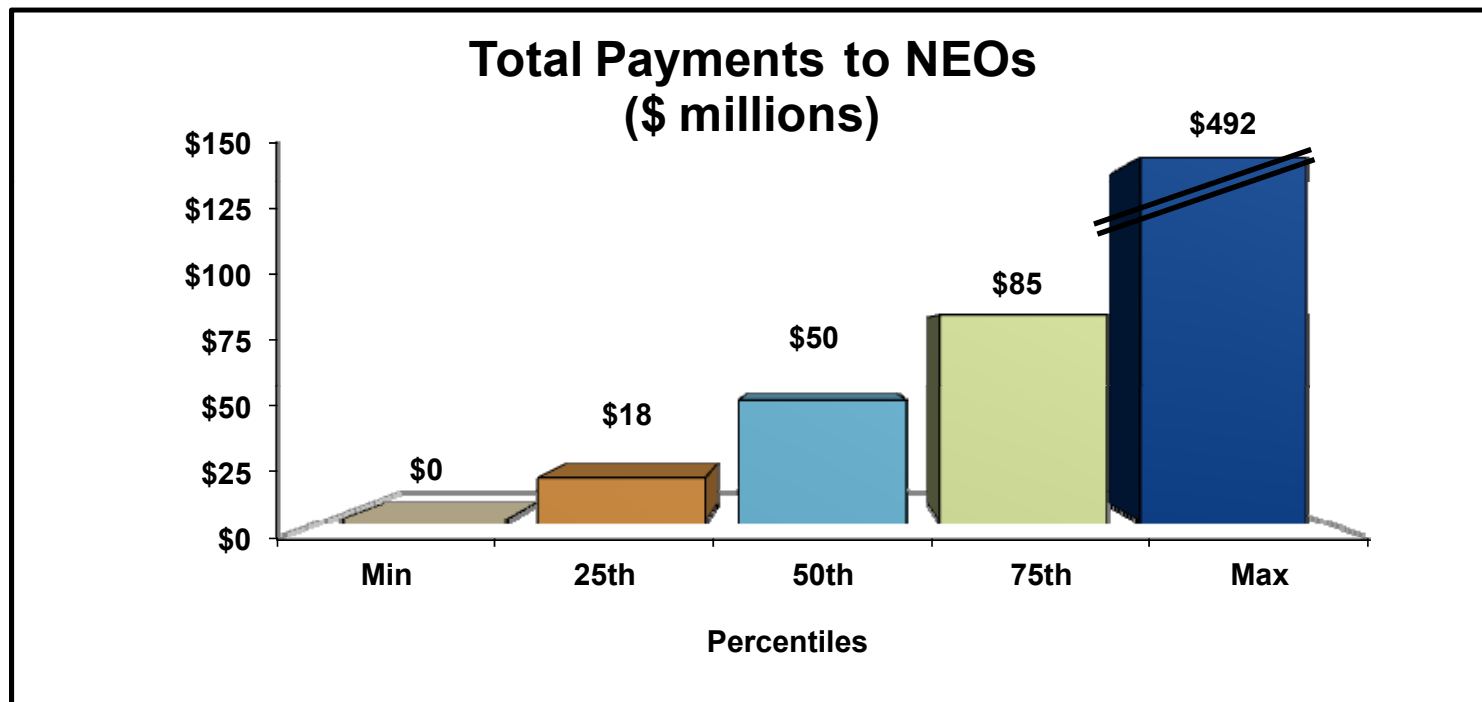
- A majority of the Top 50 U.S. Companies provide benefits upon a CIC and 30% provided excise tax gross-up protections in 2010





## 2010 Proxy Revelations

- Total reported benefits payable upon a CIC and termination for all NEOs was significant with a median payout of \$50.1 million

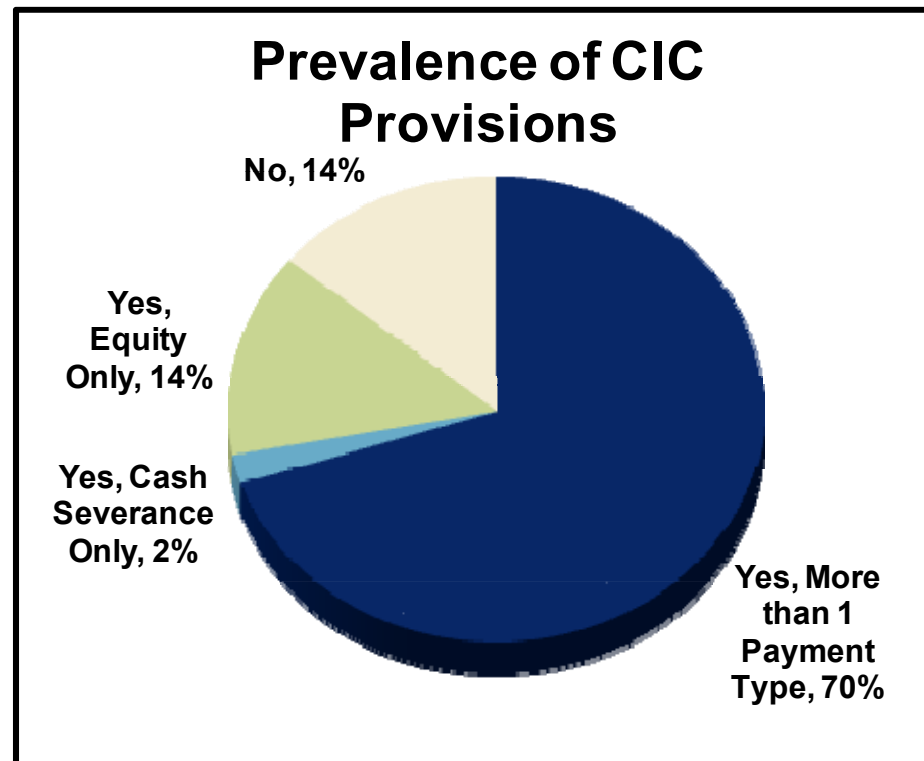


- These figures do not include significant “take-away” value of other vested benefits such as unexercised stock options and deferred compensation/SERP benefits



## 2010 Proxy Revelations (Cont'd)

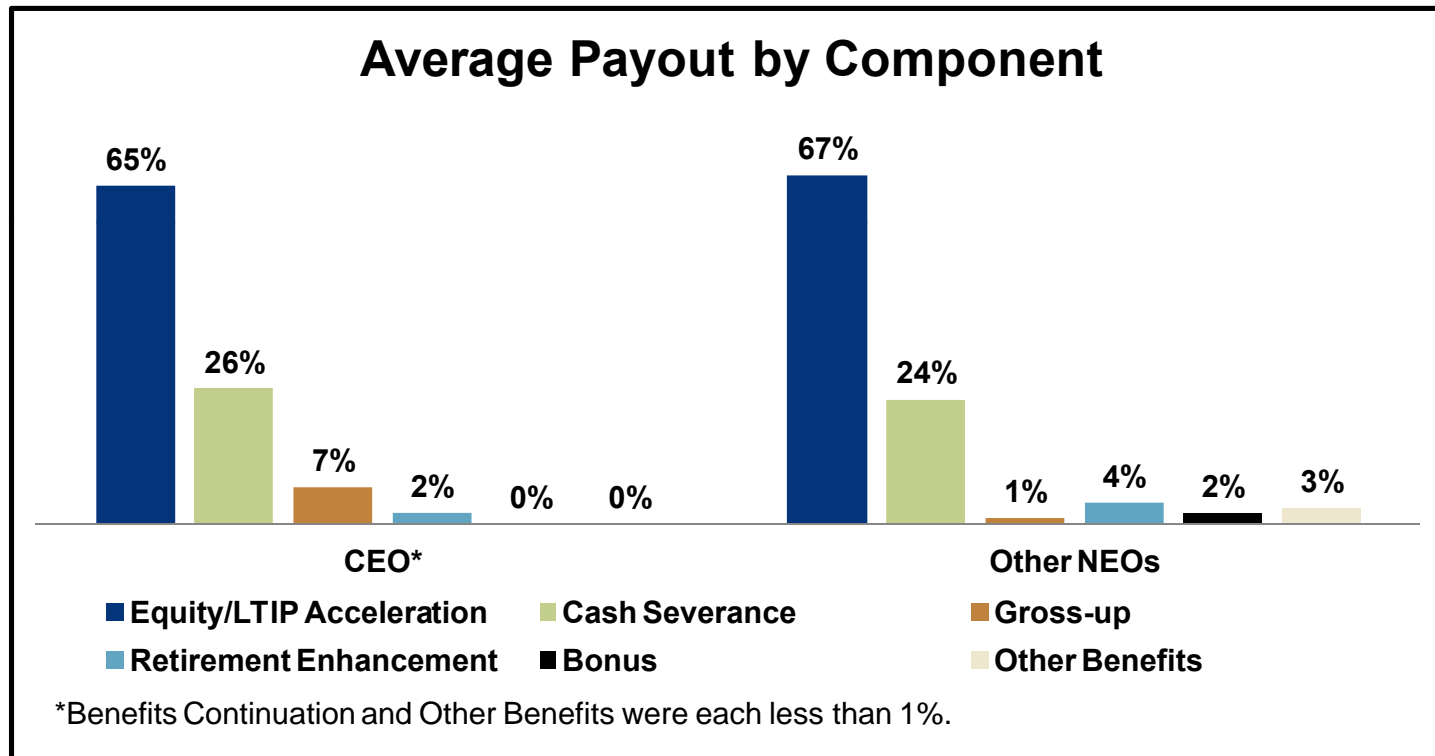
- The majority of Top 50 companies provide equity vesting accompanied by at least one other form of payment or benefit





## 2010 Proxy Revelations (Cont'd)

- As in prior years, the value of accelerated equity and cash severance was the most significant component of potential CIC payments

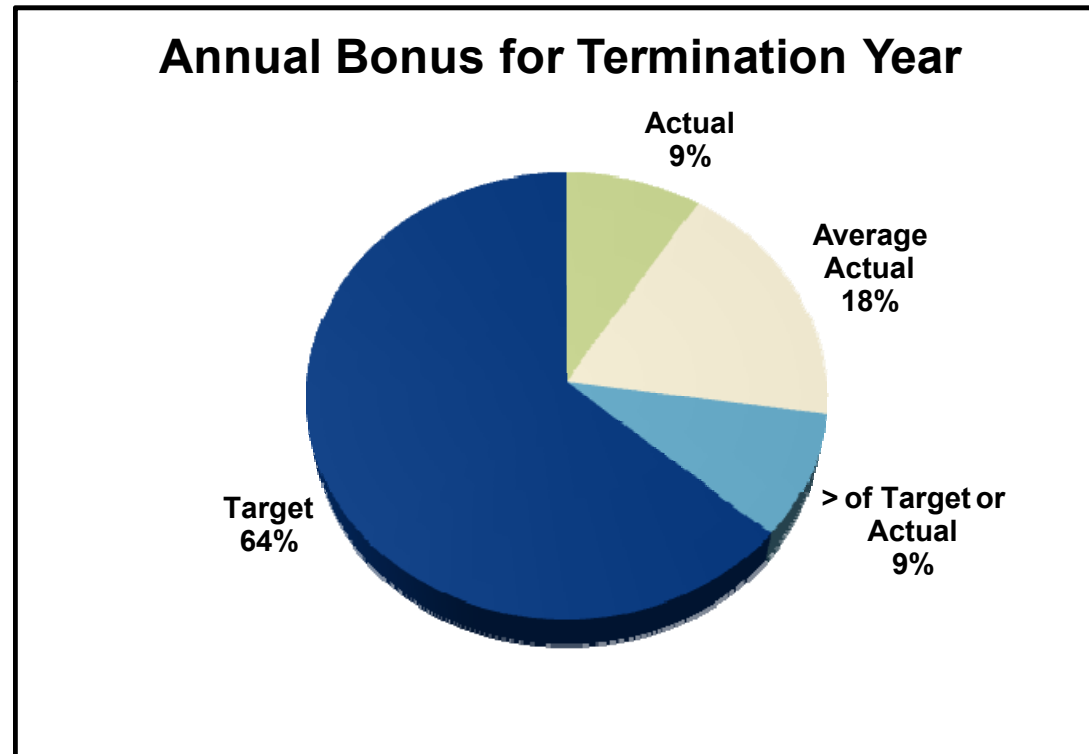


- On average, the proportion of individual types of payments between CEOs and other NEOs is very similar. However, for CEOs the value other benefits and bonus payments represents less than 1% total potential payments



## 2010 Proxy Revelations (Cont'd)

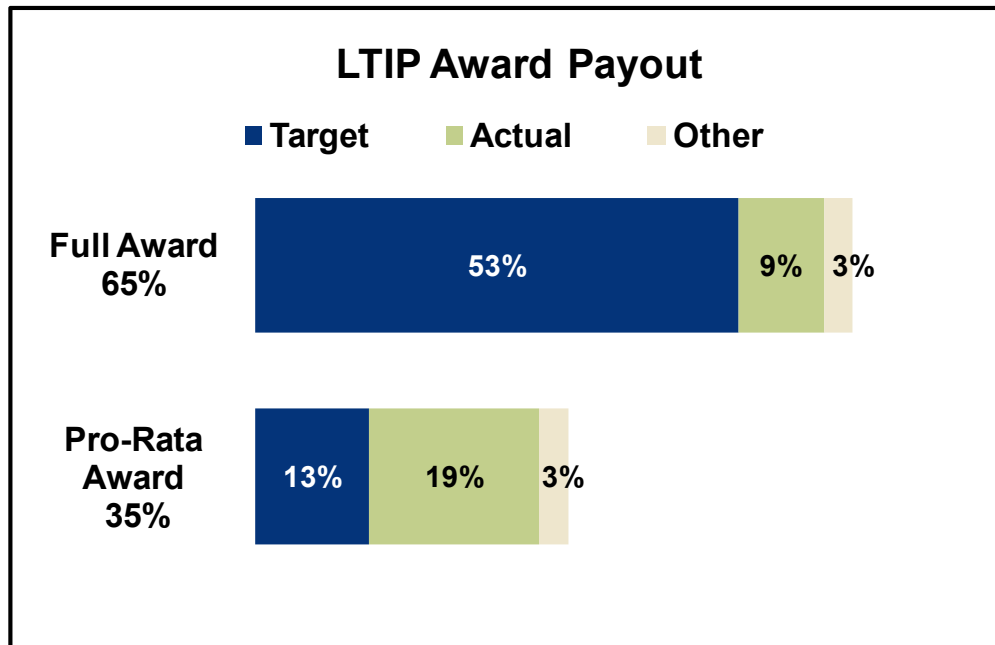
- **Performance Awards at CIC for Top 50 - Annual Bonus for Termination Year**
  - 78% did not report a bonus for the year of termination
    - » But this may be due to reporting on the last day of the performance cycle
  - If reported, the most prevalent approach was to disclose a pro-rated target bonus



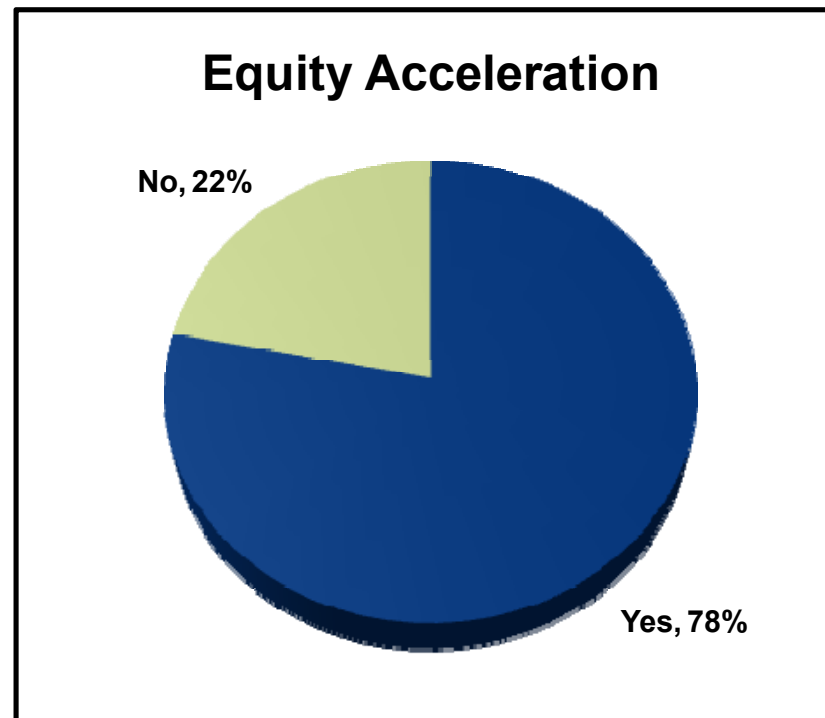


## 2010 Proxy Revelations (Cont'd)

- **Performance-Contingent Awards (“LTIP”) at CIC for Top 50**
  - 36% of the companies do not indicate vesting or payout mid-cycle LTIP awards upon a CIC
  - 64% indicated a payout may be possible with nearly two-thirds of these awards paid in full, generally at target level

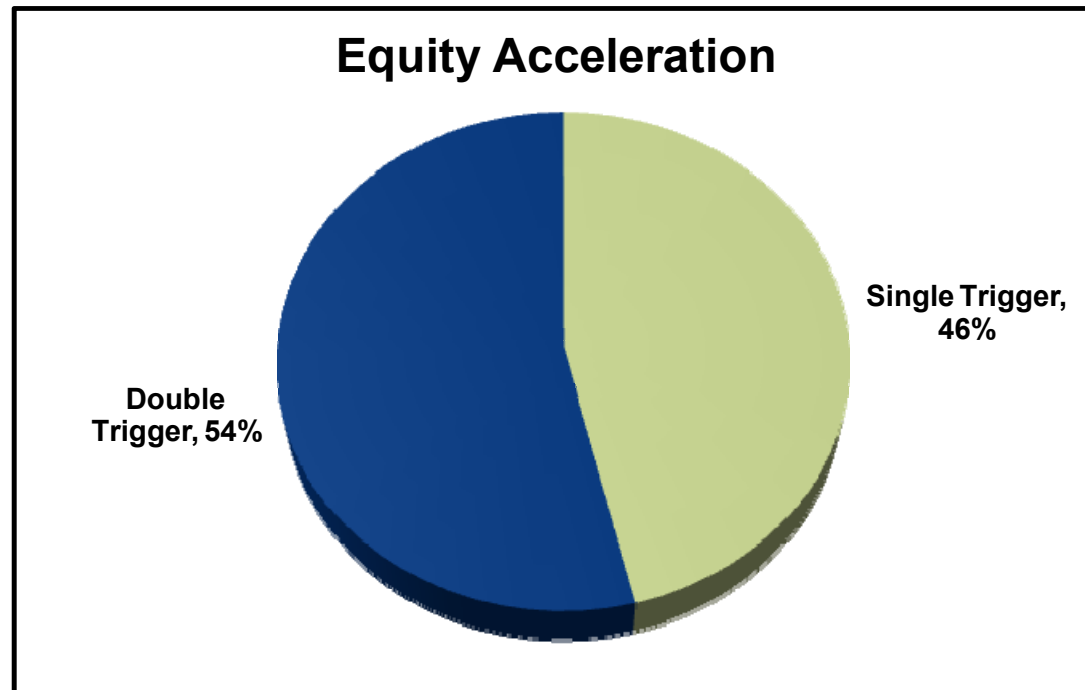


- **CIC Equity Acceleration Among Top 50**
  - The majority of companies provide for acceleration of equity upon a CIC (single trigger) or termination following a CIC (double trigger)
  - Although 22% of companies reported no acceleration tied to a CIC, 10% reported equity awards could accelerate under other termination scenarios
    - » 8% reported awards would accelerate upon retirement
    - » 2% reported awards would accelerate if involuntarily terminated



### ■ Trends in the Top 50 - CIC Equity Acceleration

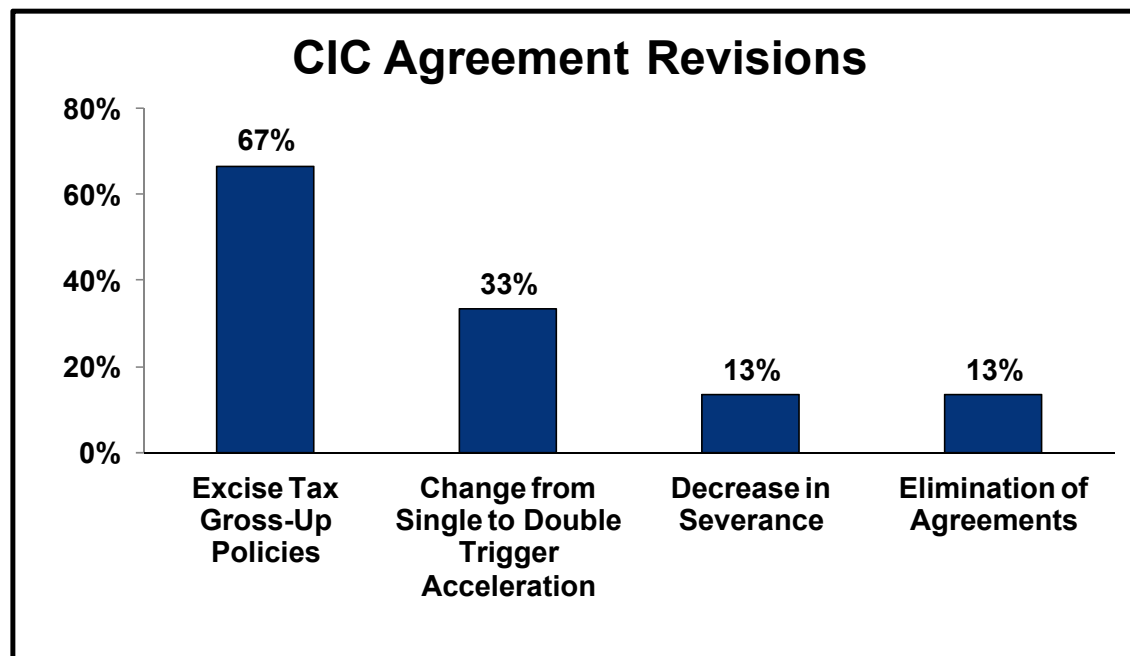
- Double trigger vesting provisions are gaining in prevalence
  - » In 2010, for the first time more of the top 50 reported having double trigger provisions for some form of equity than disclosed single trigger equity vesting
  - » Eight percent (8%) of companies moved to double trigger acceleration over the past year for some form of equity
  - » The change almost always applied to prospective equity grants only





## 2010 Proxy Revelations (Cont'd)

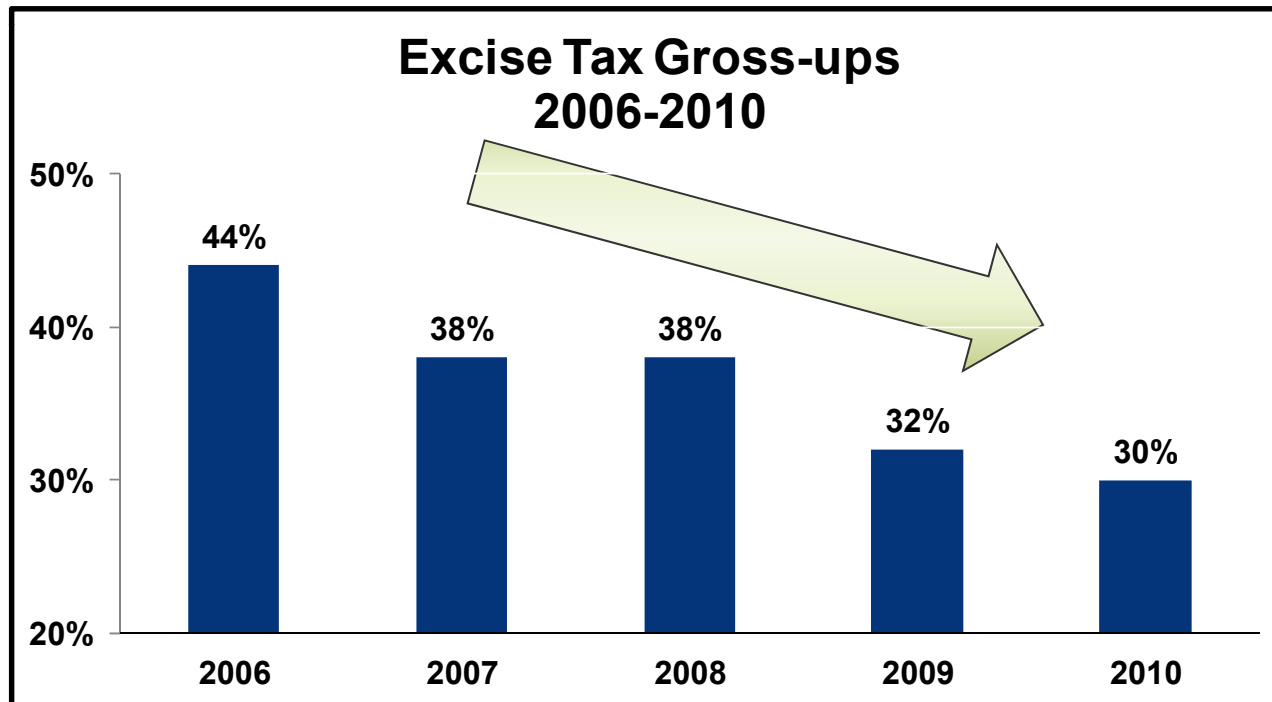
- **Trends in the Top 50 – 2010/2011 Revisions to CIC Agreements**
  - 30% made changes to CIC provisions
    - » Changes in excise tax gross-up policies
    - » Change from single trigger to double trigger acceleration
    - » Decrease in severance, such as a change in the multiple
    - » Elimination of CIC Agreements or employment agreements





## 2010 Proxy Revelations (Cont'd)

- **Trends in the Top 50 - Excise Tax Gross-Ups**
  - Excise Tax Gross-Up prevalence is diminishing
    - » At the end of 2006, 44% of the current Top 50 companies reported having excise tax gross-up provisions
    - » However, in 2010, only 30% of the Top 50 reported these provisions

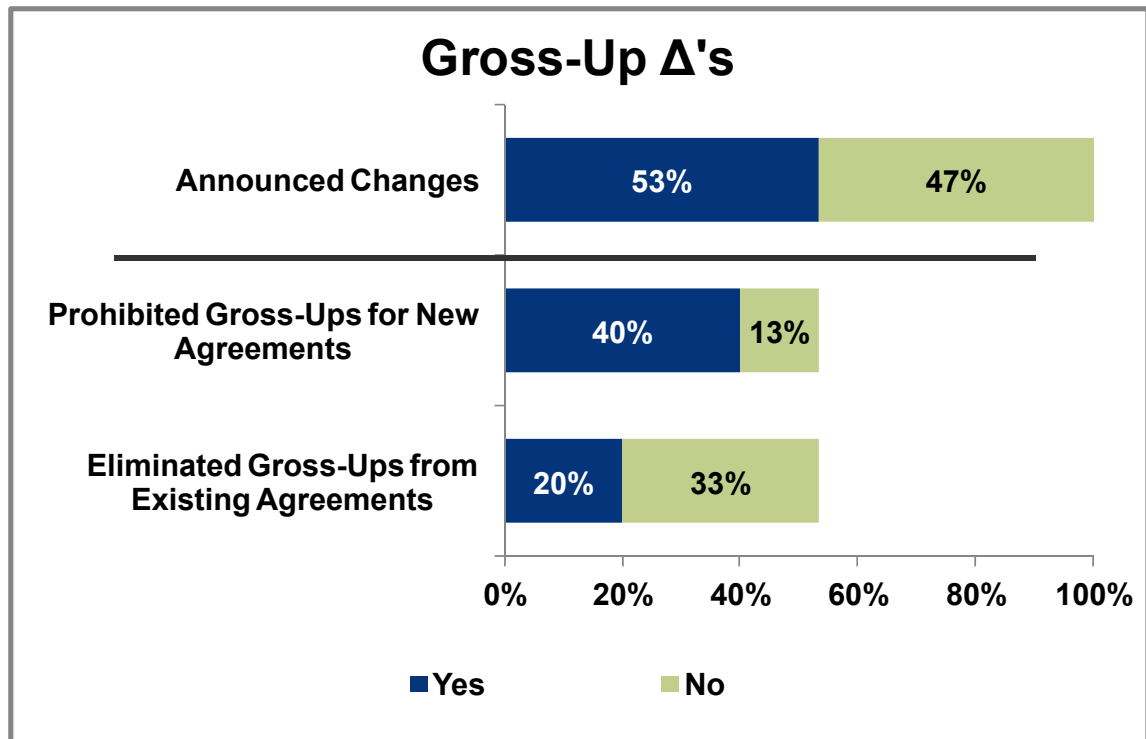




## 2010 Proxy Revelations (Cont'd)

### ■ Trends in the Top 50 - Excise Tax Gross-Ups

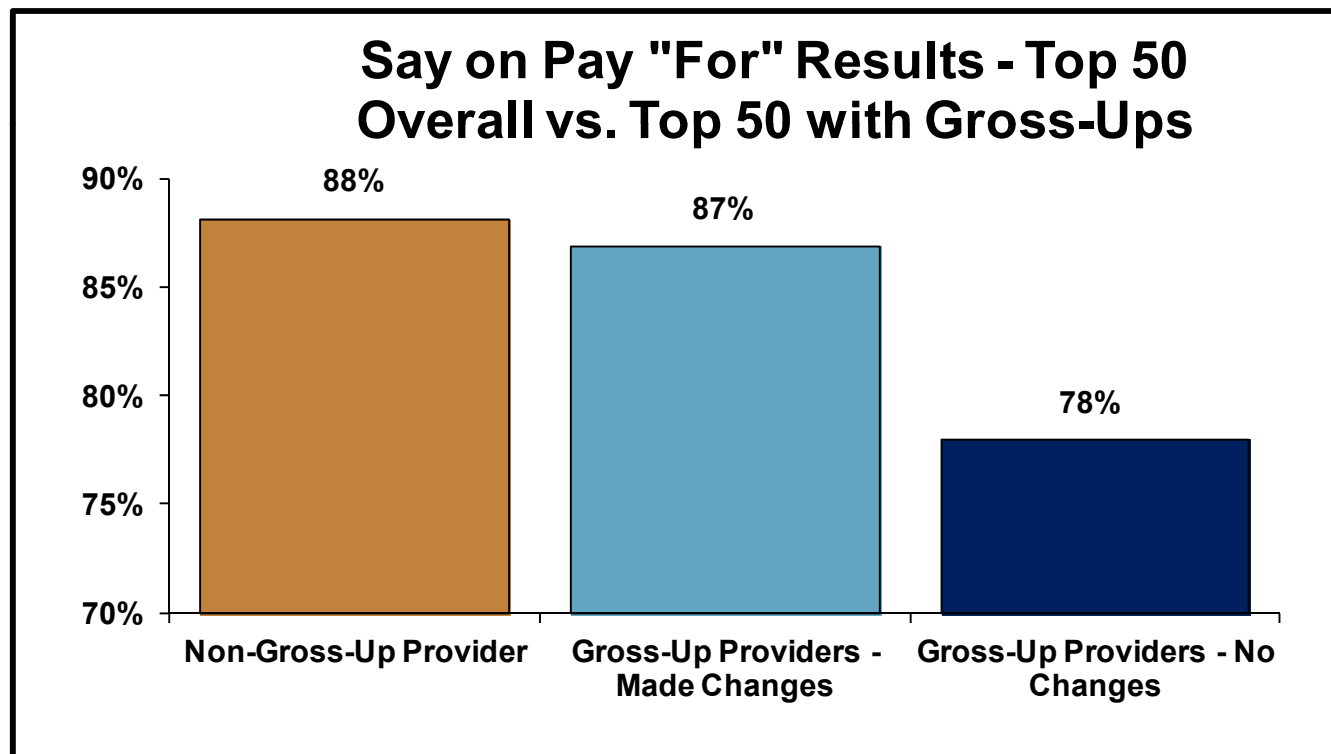
- » Of the 30% of companies that reported excise tax gross-ups in 2010, over half have announced related changes to their programs including:
  - Amending existing agreements to remove gross-ups entirely, or
  - Prohibiting gross-up provisions for new employees or under new agreements
- » Less than half of the companies will continue with the same approach in future years





## 2010 Proxy Revelations (Cont'd)

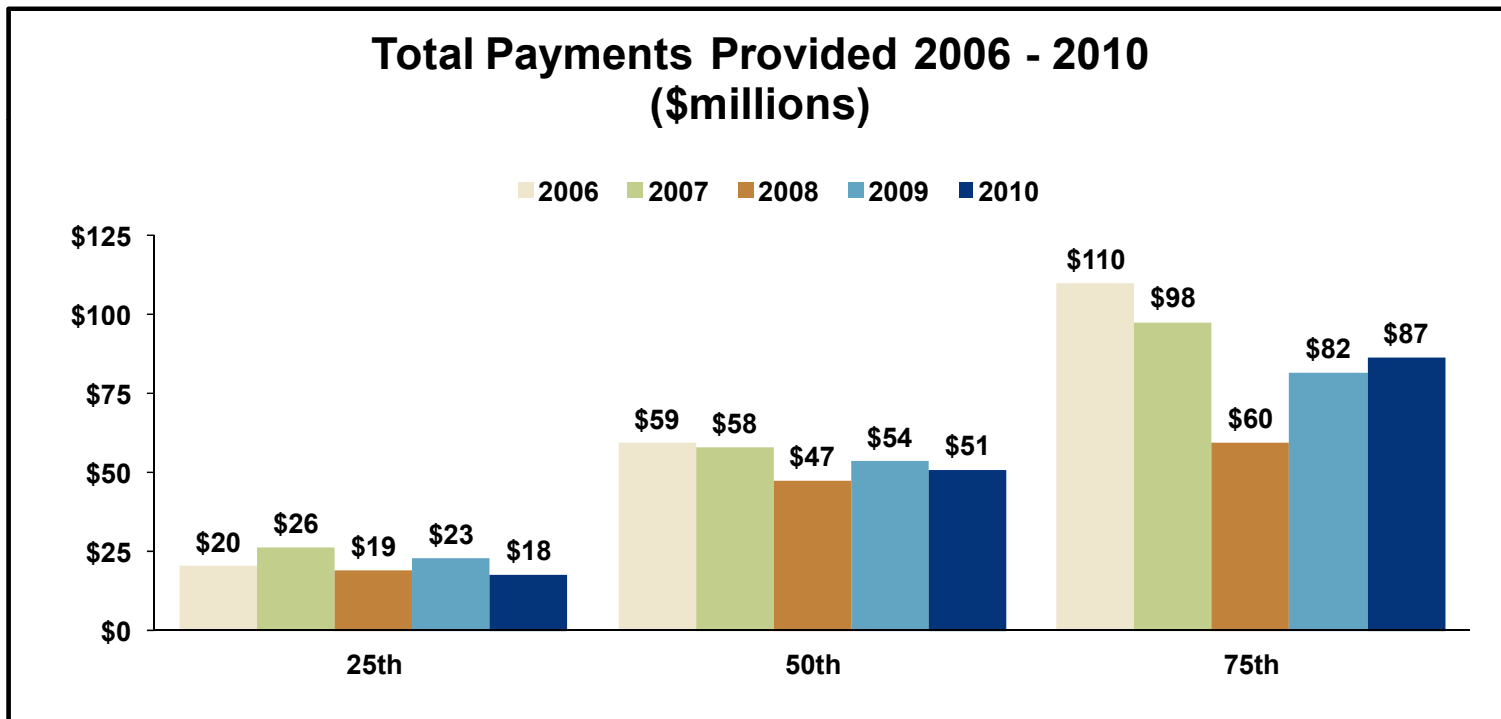
- All of the Top 50 with excise tax gross ups passed their annual Say on Pay vote
- However, those companies who announced changes received more favorable voting results than those who did not make changes





## 2010 Proxy Revelations (Cont'd)

- **Trends in the Top 50 - CIC payments (2006-2010)**
  - Estimates decreased from 2006 to 2008 due to decreases in stock prices and the elimination or restructuring of certain CIC provisions by some companies
  - Rebounding stock prices in 2009-2010 have increased CIC estimates

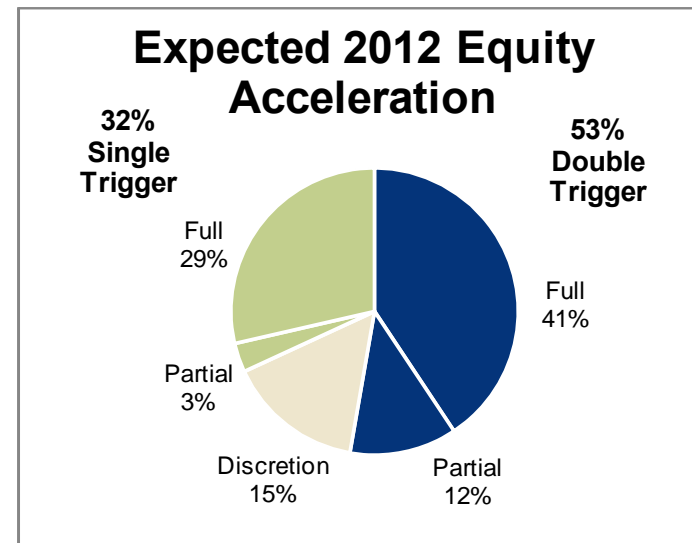
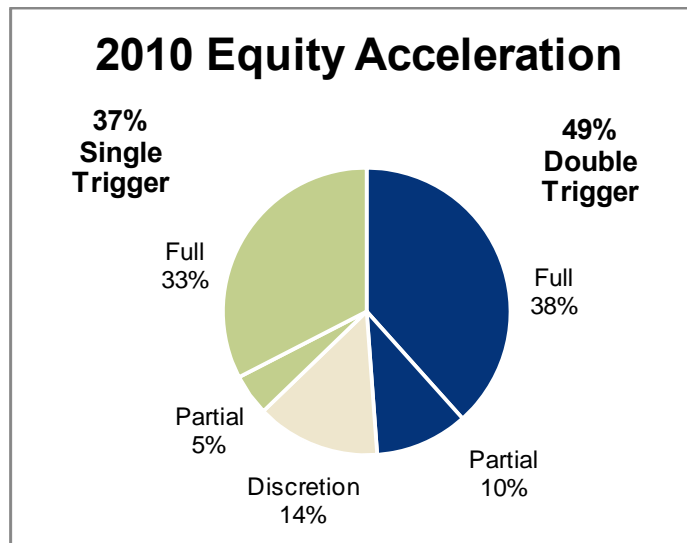


Note: Data in 2006 is based on 44 of the 50 companies which were required to file under the new disclosure regulations.



## Looking Ahead to 2012

- **PM&P launched an online survey “Looking Ahead to Executive Pay Practices in 2012” to assess critical executive pay topics, including anticipated changes to severance and CIC plans and benefits**
  - Overall, 10% - 15% of companies for each of FY 2010, 2011 and 2012 have or expect to adjust severance provisions
    - » On average, 6% of respondents are curtailing CIC provisions while 7% will be increasing their CIC provisions
  - While limited change has or is expected to occur for equity acceleration in the event of a CIC, it is noteworthy that double trigger vesting is expected to be the majority practice for 2012





## Looking Ahead to 2012 (Cont'd)

- Gross-Up provisions are on the decline

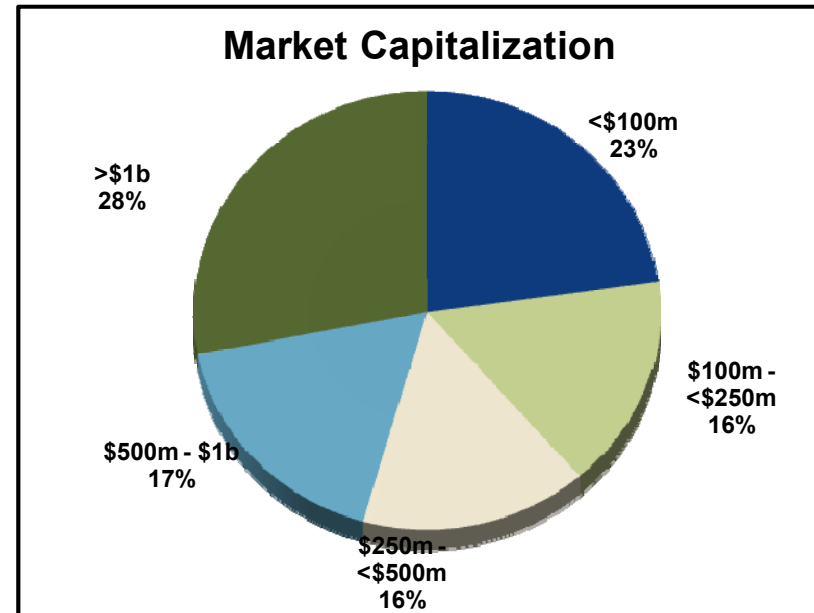
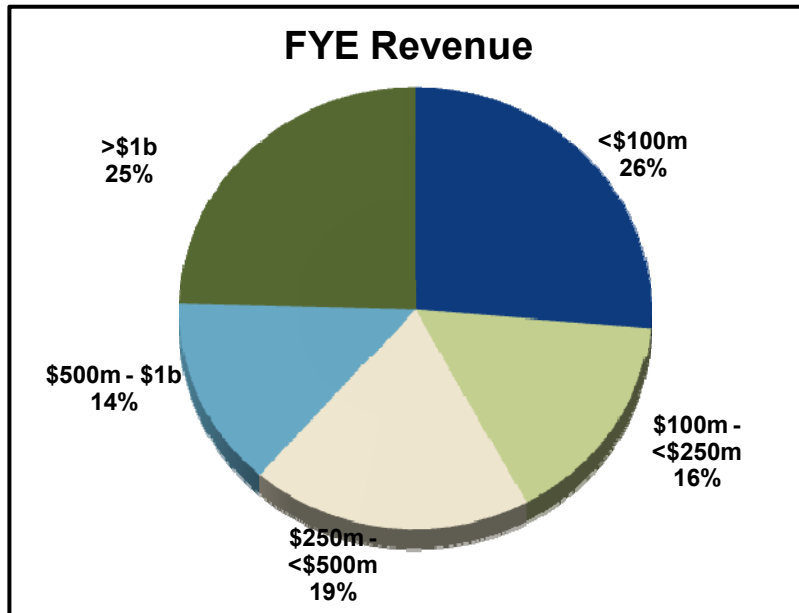
Provision	FY 2010	FY 2011	Expected FY 2012	Change 2010 to 2012
Gross-up	59%	58%	45%	-14%
Scale Back	32%	32%	39%	7%
Best After-Tax	8%	11%	15%	7%

Key: >50% 25% - <50% <25%



## Say on Golden Parachute Payments

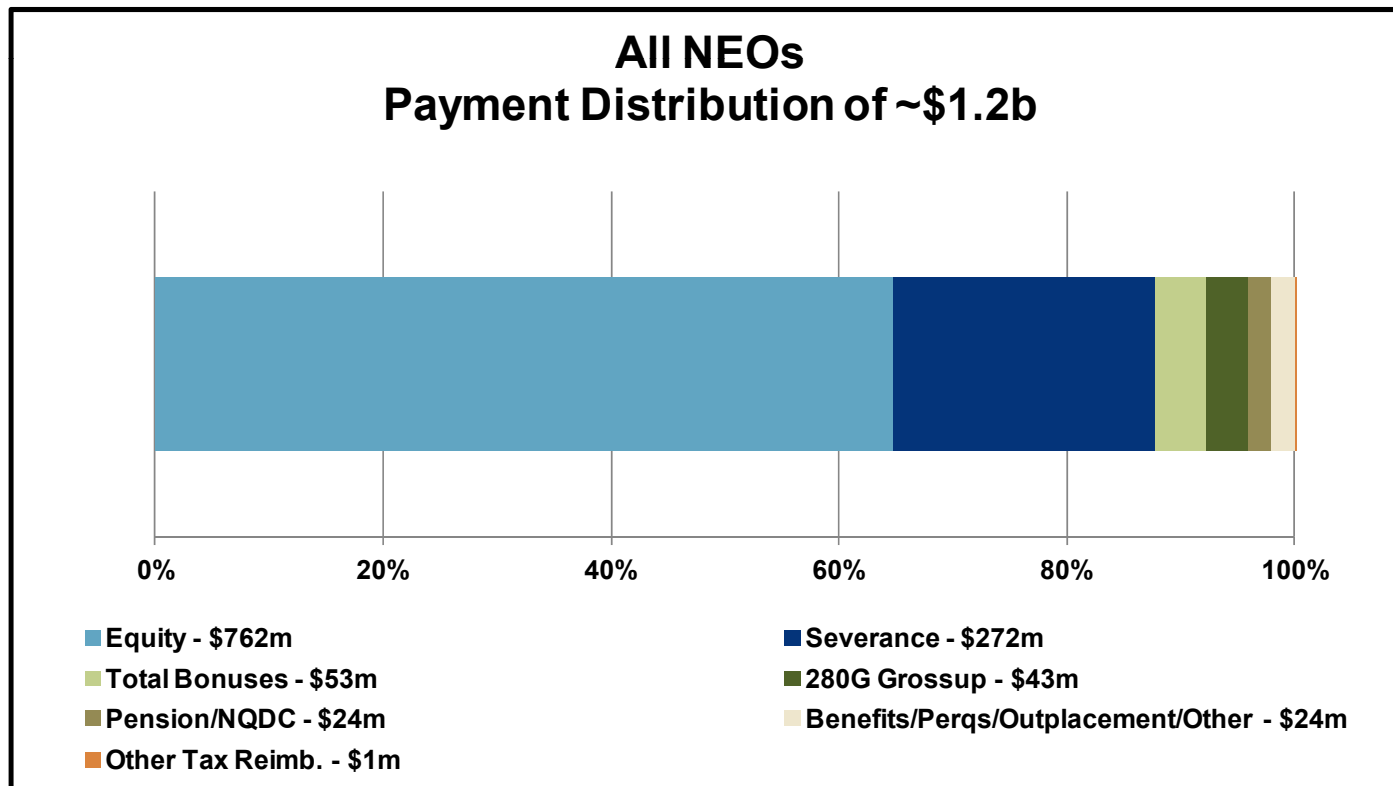
- The Dodd-Frank Say on Golden Parachute (SOGP) rules became effective for transactions occurring on or after April 25<sup>th</sup>, 2011
- PM&P tracked 57 companies that disclosed their SOGP pay arrangements as of October 31, 2011
  - 50 companies had disclosed their vote results as of December 9, 2011
  - 7 have not disclosed specific vote counts





## Say on Golden Parachute Payments (Cont'd)

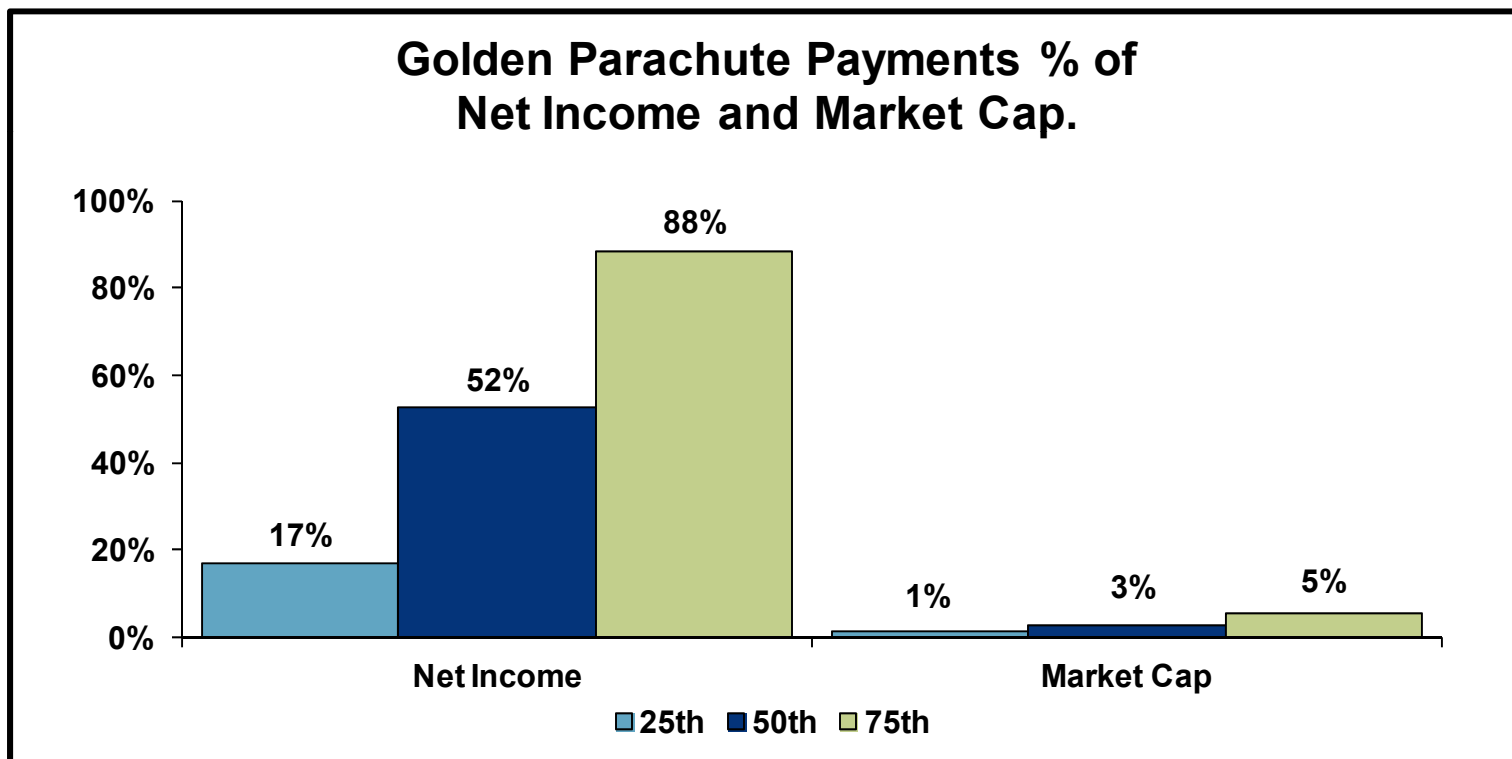
- 95% of the companies we tracked provided some form of golden parachute payment to their NEOs representing approximately \$1.2 Billion in golden parachute payments
- The majority of the value delivered is in the form of equity payments
- Severance comprises the next major component





## Say on Golden Parachute Payments (Cont'd)

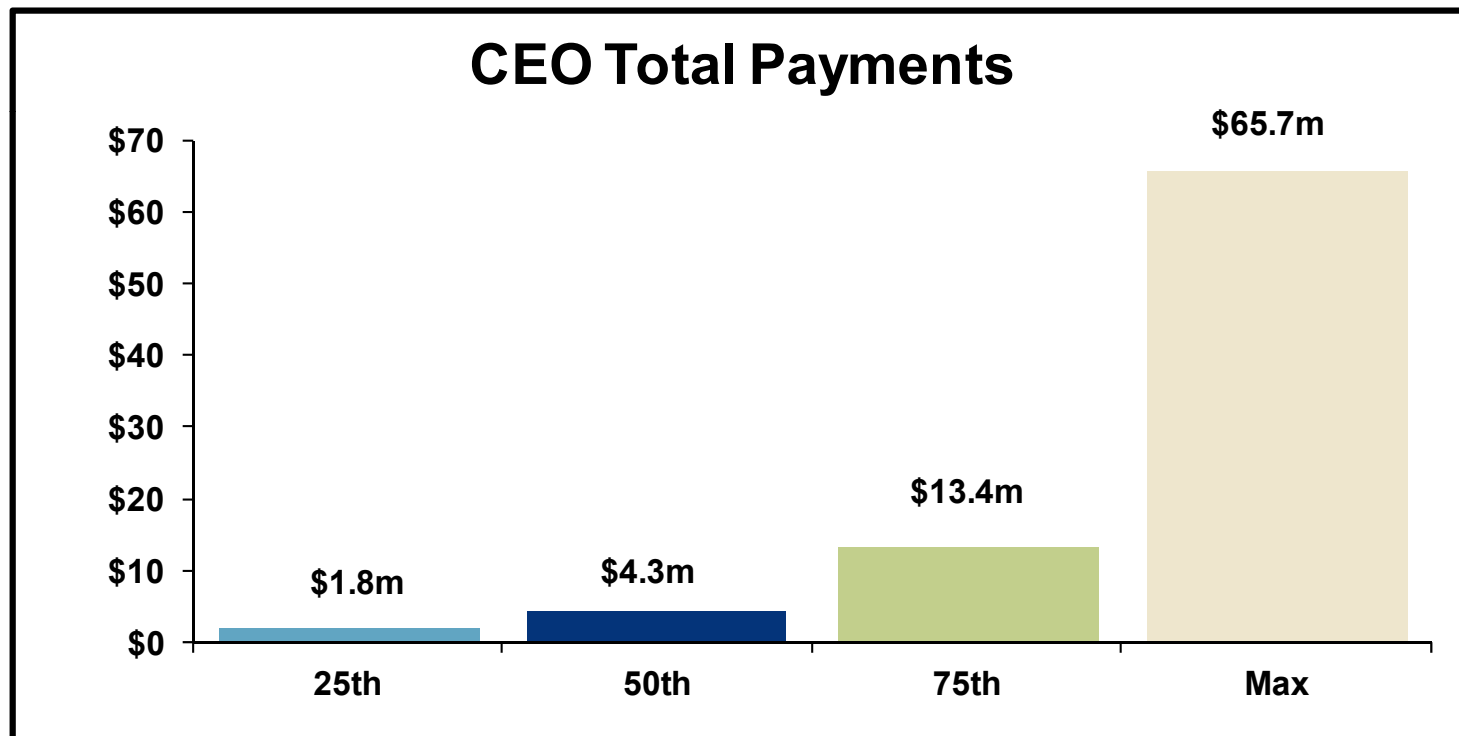
- At median levels, total company payments to their executives were:
  - 3% of the Market Capitalization
  - 52% of the company's trailing 12 month Net Income





## Say on Golden Parachute Payments (Cont'd)

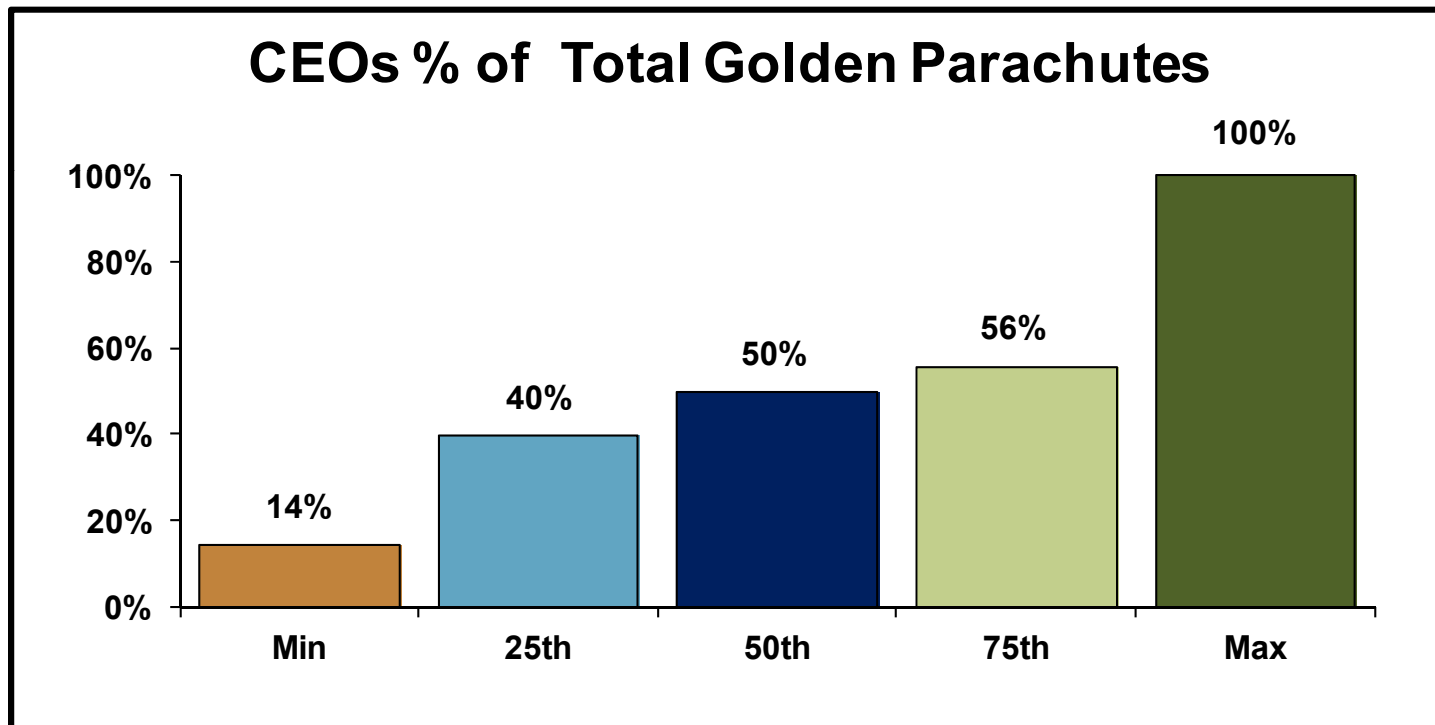
- **CEO Golden Parachute Payments**
  - Golden parachute payments made to CEOs are \$4.3 million at the median
  - One CEO has \$65.7 million of potential golden parachute entitlements





## Say on Golden Parachute Payments (Cont'd)

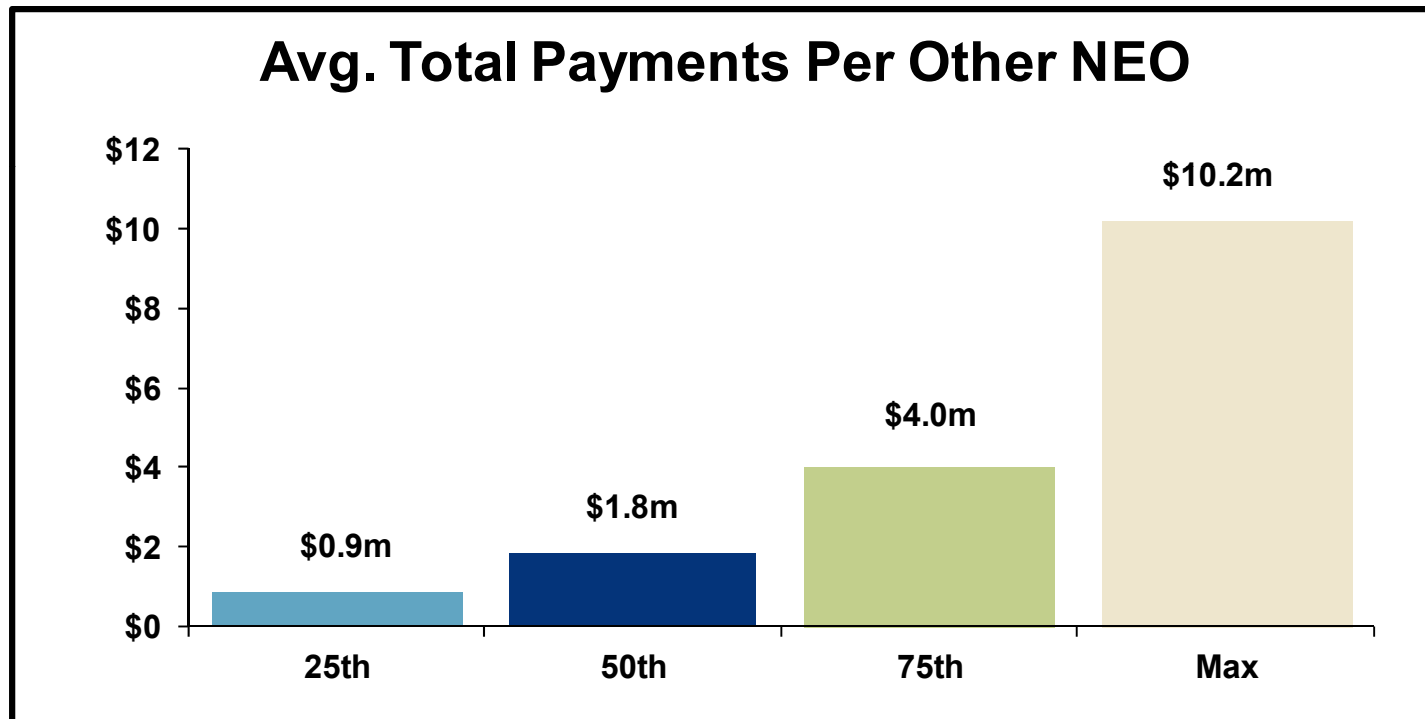
- **CEO Golden Parachute Payments**
  - At the median, approximately 50% of company payments are being provided to the CEO





## Say on Golden Parachute Payments (Cont'd)

- **Golden Parachute Payments – Other NEOs**
  - Average total payments per NEO (excluding the CEO) is \$1.8 million at the median

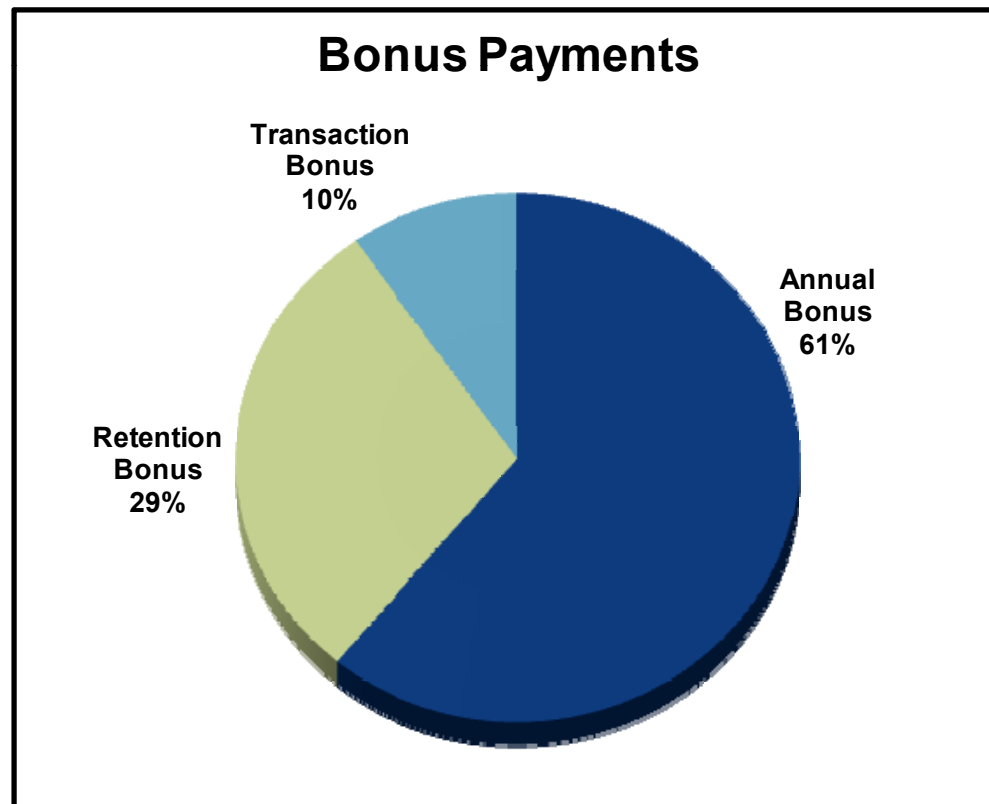




## Say on Golden Parachute Payments (Cont'd)

- **Bonus Payments**

- Company bonus payments are generally in the following forms:
  - » Annual short-term incentive for the year of termination or upon the CIC
  - » Retention bonuses
  - » Transaction bonuses

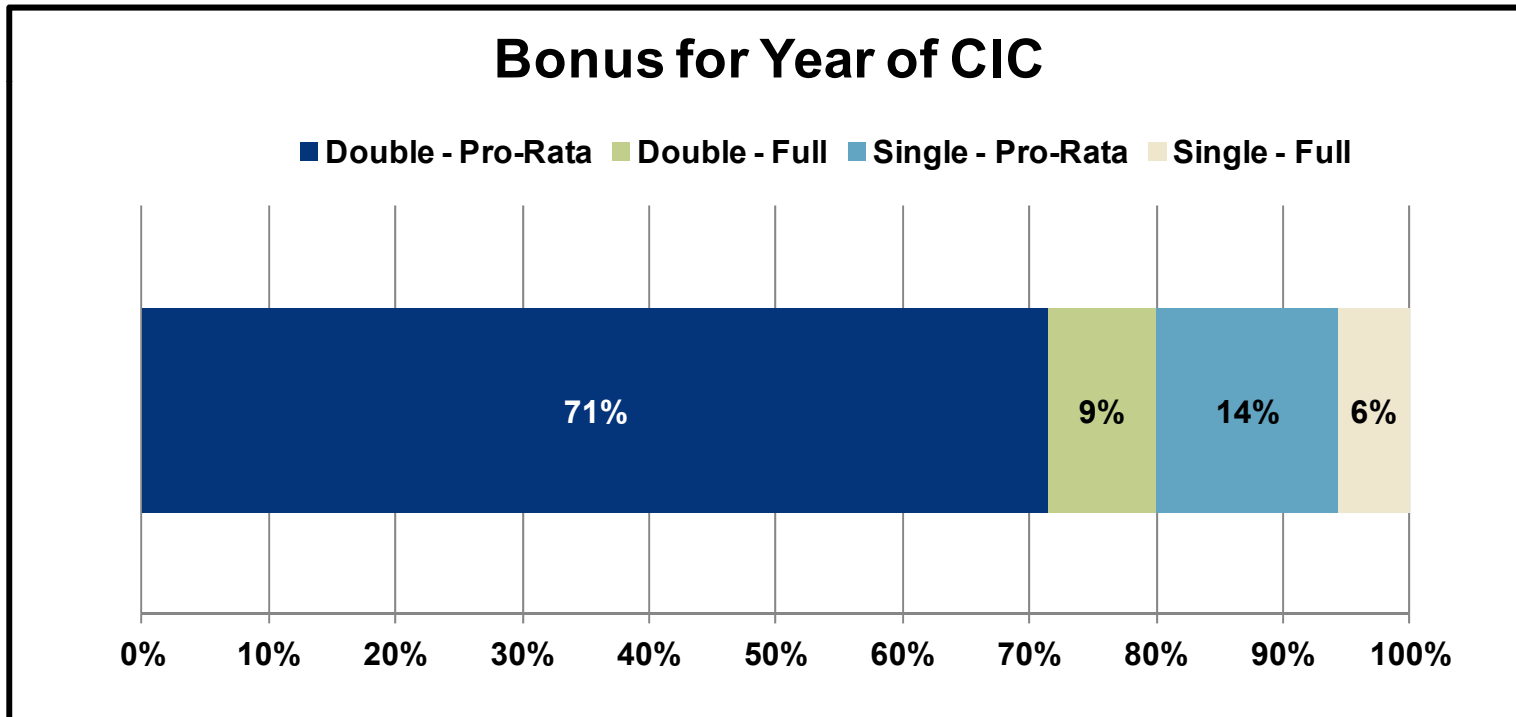




## Say on Golden Parachute Payments (Cont'd)

### ■ Annual Incentive Payments

- 61% of companies disclosed a bonus payout for the year of the CIC
- Double trigger pro-rated bonus payouts are the most prevalent
- Two-thirds payout based on target bonus opportunities

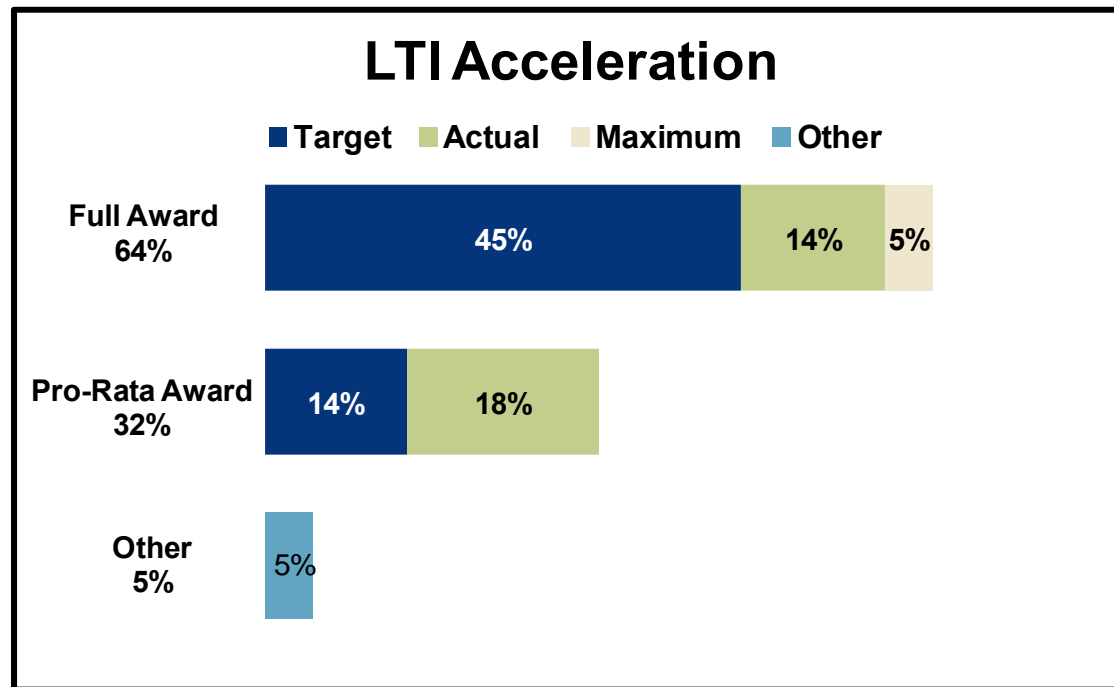




## Say on Golden Parachute Payments (Cont'd)

- **Performance-Contingent LTIP Awards**

- Payouts of LTIP awards in actual transactions are similar to those disclosed for the Top 50
  - » 64% of companies paying out LTIP awards paid in full, generally at target level
  - » 32% of the companies paying out paid pro-rated LTI awards
  - » 5% indicate other methods unique to their circumstances

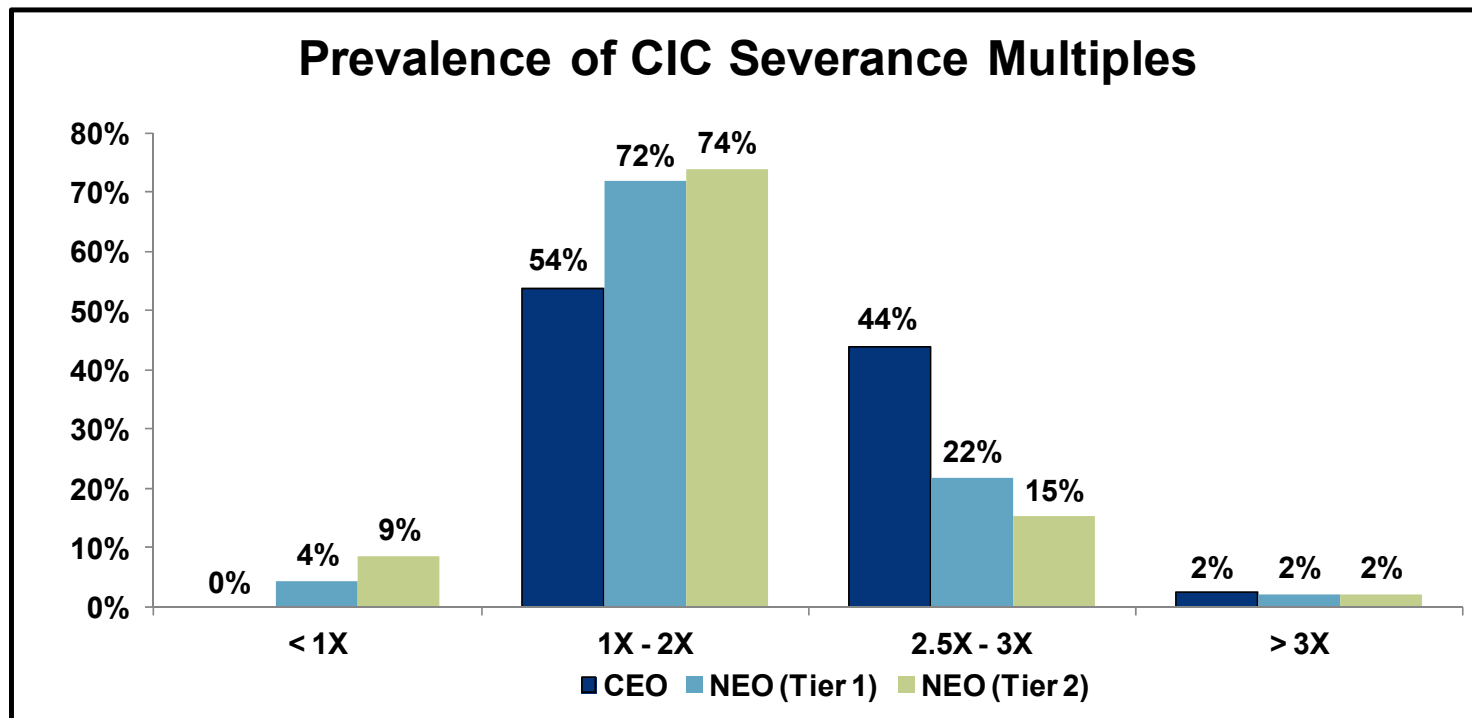




## Say on Golden Parachute Payments (Cont'd)

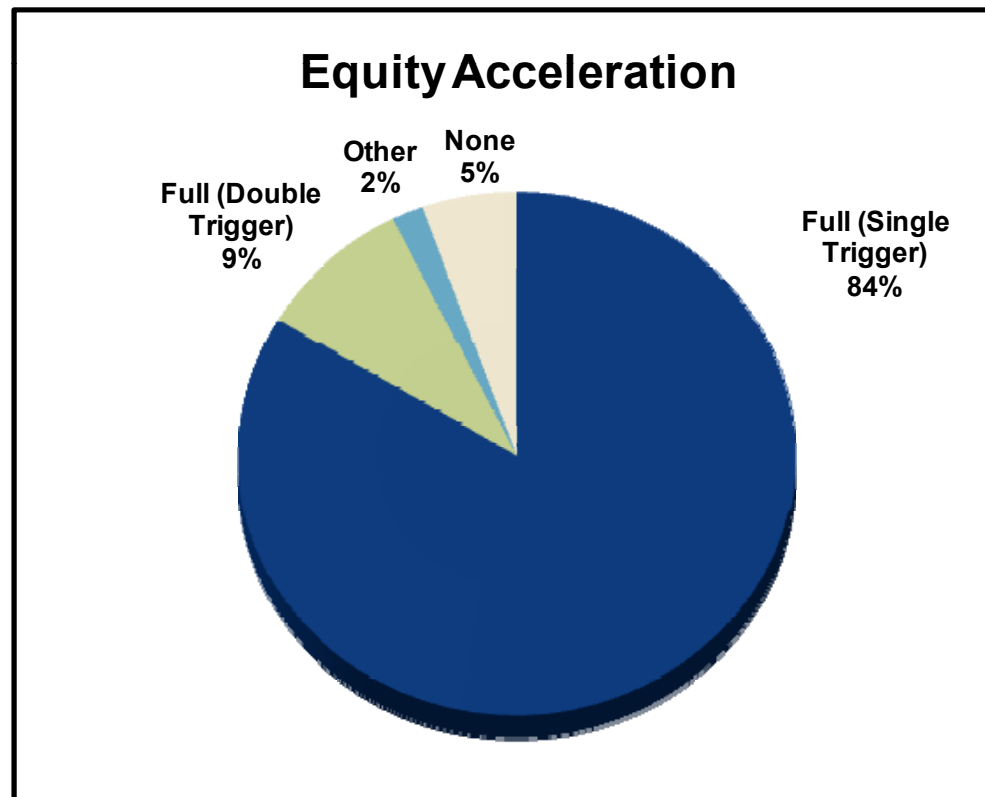
### ■ CIC Severance Formulas

- More than half of the companies use base salary and annual incentive components for both CEOs (64%) and NEOs (53%)
  - » 45% of companies use target annual incentive
- The second most common basis is using base salary only (few use flat payments)
- The most common severance multiple (for those using a multiple) for a CEO and other NEOs is 1X to 2X



### ▪ Equity Acceleration

- Although double-trigger vesting is gaining ground on the design side, it appears that in actual transactions, vesting is most often happening at the CIC
  - » 84% reported single-trigger vesting for the equity and almost 10% disclosed double-trigger vesting

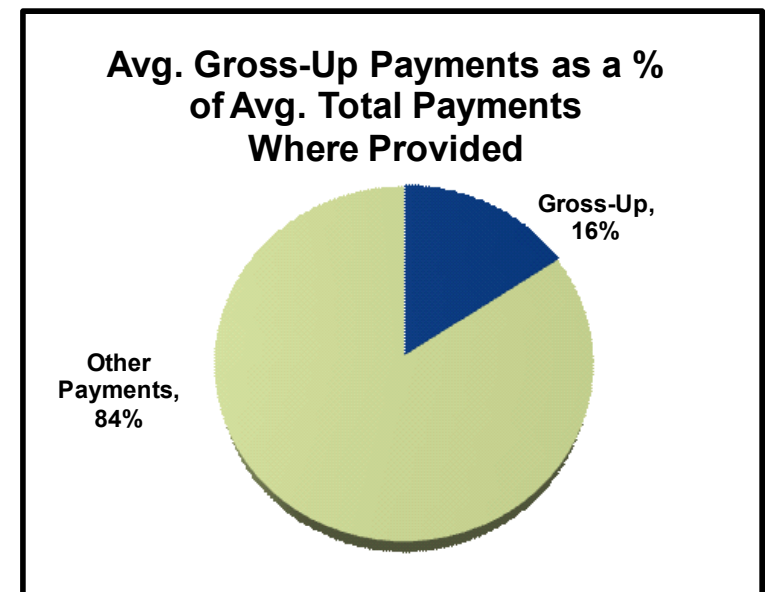
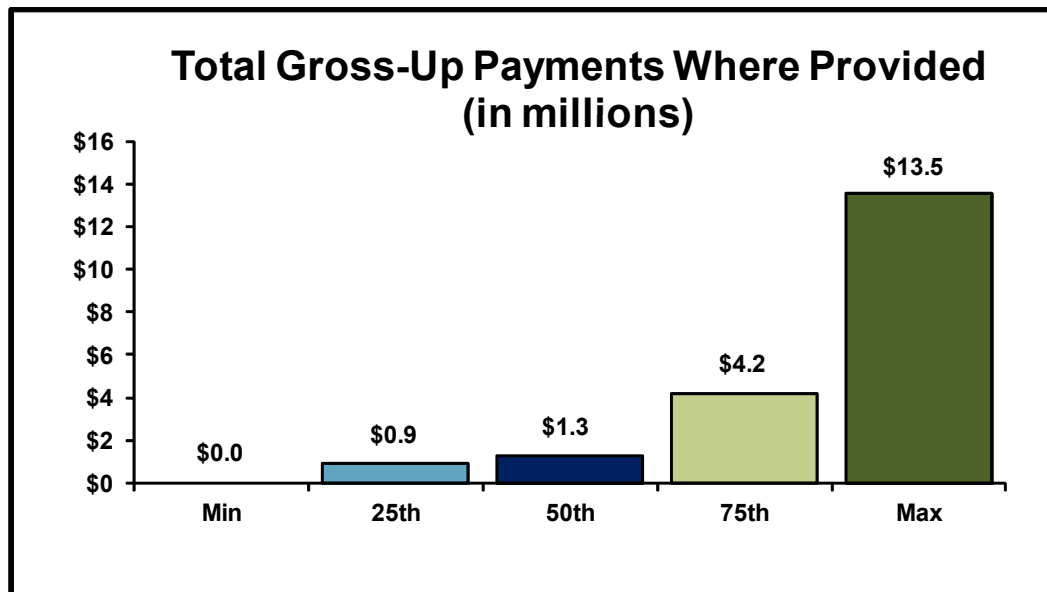




## Say on Golden Parachute Payments (Cont'd)

### Excise Tax Gross-Ups

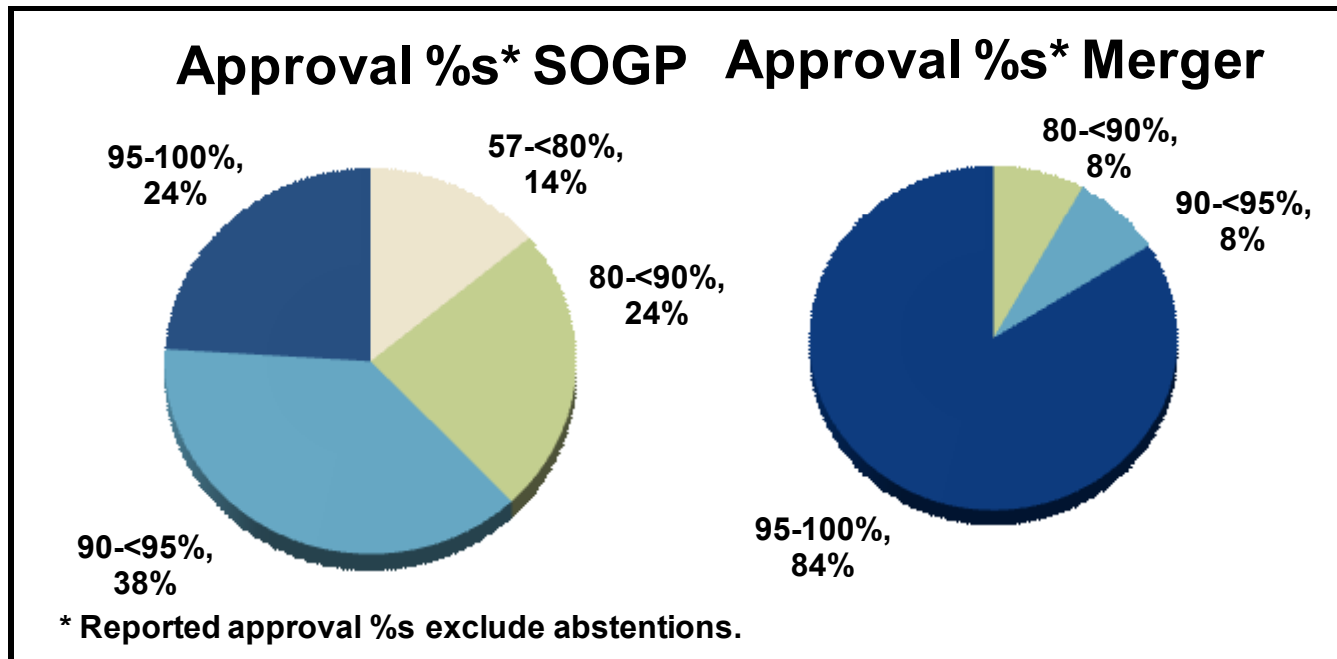
- Only 23% of companies reported liabilities for excise tax gross-ups in transactions
- Among companies providing NEOs with excise tax gross-up protection, the value of excise tax gross-ups varied significantly. The average payment was approximately \$3.3 million
- When excise tax gross-ups were not provided, companies often provided for best after-tax provisions or provisions that would scale an executive back to the golden parachute safe harbor





## Say on Golden Parachute – Voting Trends

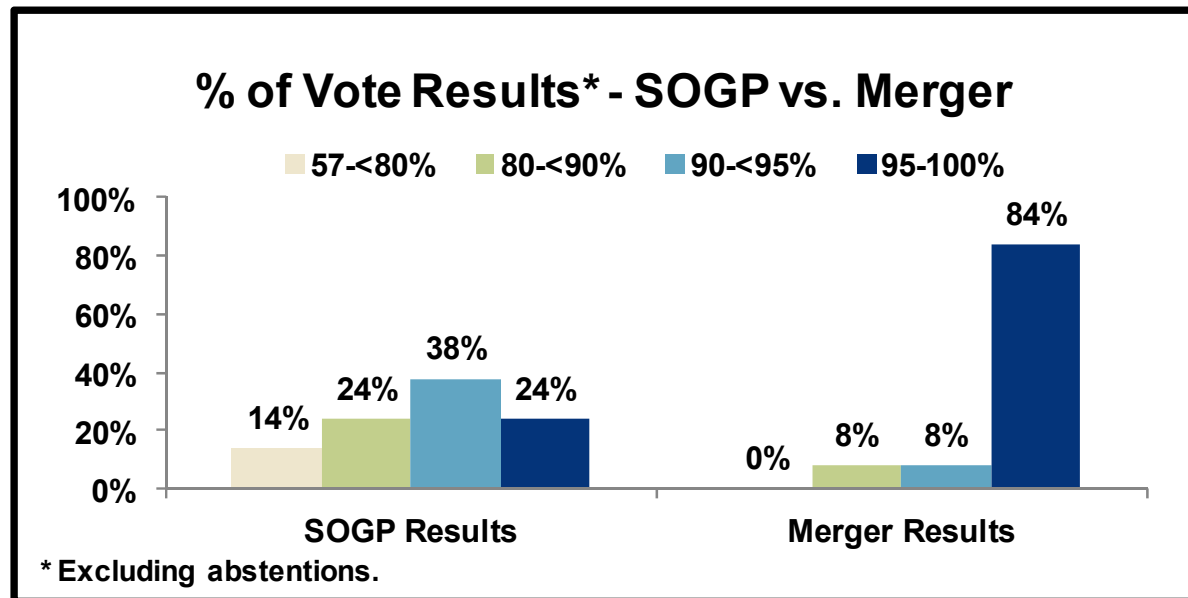
- **So far, support for golden parachute provisions has been overwhelming**
  - Every company that has held a SOGP vote and reported the results received majority support with 86% of the companies garnering upwards of 80% approval (excluding abstentions)
  - The lowest level of support so far has been a 57% positive vote for Citadel Broadcasting Corporation/Cumulus Media transaction





## Say on Golden Parachute – Voting Trends (Cont'd)

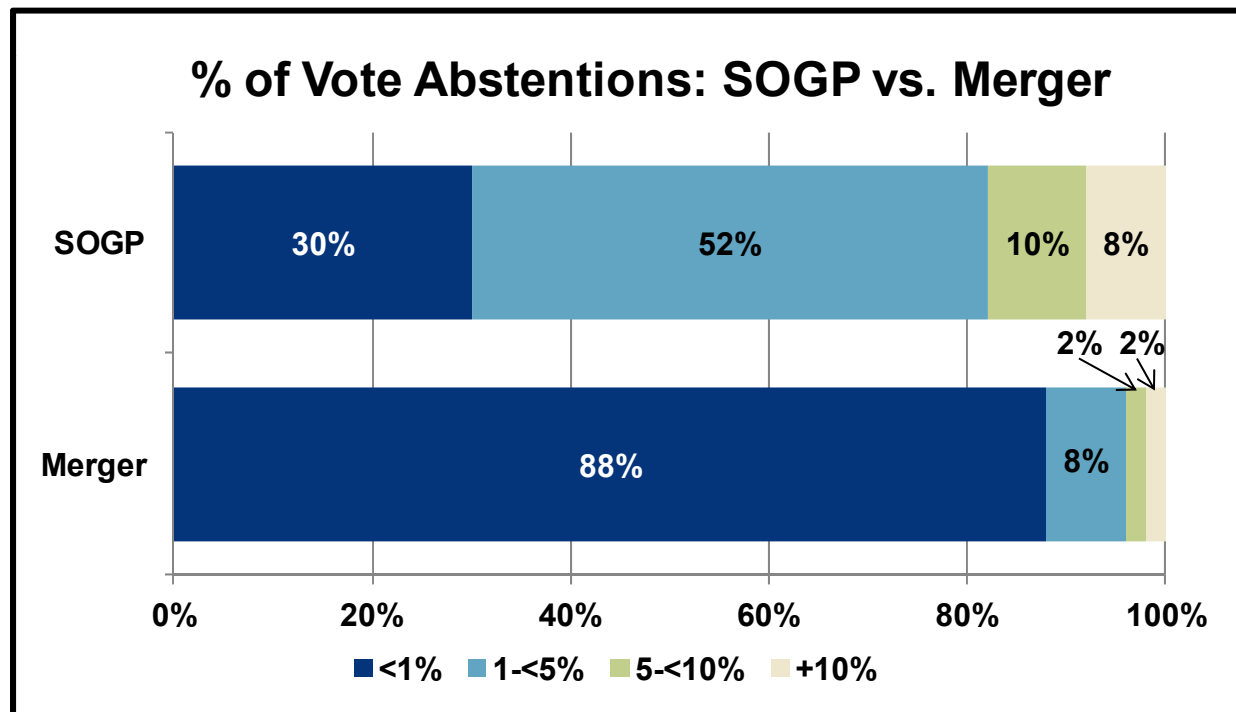
- **Despite support for golden parachute provisions, voting results for SOGP is less enthusiastic than for voting on the transactions**
  - Median support for transactions is 99%, whereas median support of SOGP payments is 91%
  - 4 of the 50 companies that had tabulated voting results received less than 90% overall shareholder support for the transaction itself, 19 of the 50 companies received less than 90% support for the SOGP measures





## Say on Golden Parachute – Voting Trends (Cont'd)

- Additionally, there were considerable abstentions for SOGP votes while relatively few shareholders abstained from voting on the transactions
  - In the Nobel Learning/Academic Acquisition transaction, while none of the shareholder abstained from the merger vote, 44% of shareholders abstained from voting on the SOGP measure





## Say on Golden Parachute – Voting Trends (Cont'd)

### Shareholder Advisory Firm Recommendations

- As of October 31, ISS had issued reports on 45 of the 57 transactions we tracked
- ISS reported in favor of the SOGP measures in all but 4 of those transactions
- The following “problematic pay practices” were cited by ISS in these 4 cases

Transaction	Problematic Pay Practices
Warner Music Group/Airplanes Music LCC	modified single-trigger severance arrangement and a success bonus paid before the transaction had been either consummated or approved by the shareholders
SAVVIS/CenturyLink	excise tax gross-ups entered into within one year of the transaction
Citadel/Cumulus	modified single trigger protections and excise tax gross-ups within one year of the transaction
APAC Customer Services/JP Morgan	excise tax gross-ups within one year of the transaction

- Although recommendations of advisory firms appear to have some influence on voting, a negative ISS recommendation has not yet prevented companies from obtaining at least majority support for their golden parachute payments



## A Report from the Frontlines

### ■ Severance

- There is some movement to reduce CIC severance either by reducing multiples or providing benefits through involuntary termination programs
- Many of the more generous severance provisions were removed in the last several years including:
  - » Voluntary “walk-away” provisions following a CIC
  - » Multiples in excess of 3x base salary and bonus
  - » Use of long-term components when computing severance
  - » Use of maximum or highest bonus over a period of years as the bonus component
  - » Enhanced retirement benefits

### ■ Equity Acceleration

- There is a movement for companies to implement double trigger acceleration provisions in new agreements
- However, single trigger acceleration in transactions remains the most common approach



## A Report from the Frontlines (Cont'd)

### ▪ Excise Tax Gross-Ups Provisions

- Removal of gross-ups from existing contracts is difficult but more common these days
  - » Some boards have taken a hard line approach and removed the provisions as the agreements are close to expiration
  - » IRC Section 409A (the deferred compensation rules) has made compensating executives for removal of gross-ups more difficult
- New gross-ups for new executives are uncommon
  - » Institutional shareholder concern and identification as one of ISS' problematic pay practices has been a significant driver
- Some companies have elected not to amend agreements to reduce other benefits if they are unable to eliminate the gross-up or other “problematic pay practices”
- With gross-ups less common and performance-based pay in favor, far more executives are potentially negatively affected by the golden parachute rules
  - » Companies are beginning to monitor potential 280G exposure and review their company plans with an eye towards facilitating reduction of excise tax exposure



## A Report from the Frontlines (Cont'd)

### ▪ Real Deal Challenges

- Although double trigger provisions are preferred by many institutional shareholders, there are practical issues that make these difficult to administer
  - » Continuing performance-based pay beyond closing can be difficult, if not impossible
  - » Changing performance based metrics prior to the end of closing can create unanticipated IRC Section 280G issues that are difficult to solve without significant analysis
- As discussed previously, with gross-ups less common and performance-based pay in favor, far more executives are actually negatively affected by the golden parachute rules
  - » Executives and companies will have different levels of comfort for taking tax positions
- However, technicalities in IRC Sections 280G and 409A have made renegotiating target CIC agreements difficult



## Key Definitions / Terms

### ■ **Golden Parachute and Excise Tax Basics**

- When an executive's CIC related payments exceed the safe harbor, the value that exceeds the base amount is subject to a 20% excise tax
  - » Base Amount – the average of the executive's last five years' taxable income from the company (typically Box 1, W-2 wage income) prior to the CIC
  - » Safe Harbor – value of the three times the Base Amount less \$1

### ■ **Gross-up**

- This is an additional payment made by a company to cover an executive's excise taxes
- Full Gross-up – covers all excise taxes and any income and excise taxes. Intended to leave the executive whole for any excise taxes imposed
- Efficient Gross-up – if parachute payments are more than a specified percentage or amount over the safe harbor, a gross-up is provided, if not, the excess is scaled back to the safe harbor

### ■ **Scaleback**

- A reduction in payments to the amount of the safe harbor
- When scaled back, there are no excise taxes



## Key Definitions / Terms (Cont'd)

- **Best After-Tax**
  - The company reduces the CIC payments to the safe harbor only if the executive is better off on an after-tax basis (considering income taxes and excise taxes)
- **Single trigger vs. Double trigger**
  - Single trigger – refers to any vesting or payment that occurs strictly because the CIC took place
  - Double trigger – refers to vesting or payments that occur following a CIC and termination from the company



**Thank You! Questions after the event, please contact:**

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