

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

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## ■ Agenda

- **Introduction and Background.**
- **What is a Security Arrangement?**
- **Results from an Analysis of Security Arrangements in Recent IPOs:**
  - Biotechnology & Pharmaceutical Industry (21 Companies).
  - Initial Public Offering between 01/01/2007 to present.
- **Current Economic Environment.**
- **Where to go from Here?**
- **Questions and Answers.**

## ■ Employment Agreements / Security Arrangements

- **These terms generally refer to agreements (“Agreements”) between companies and their executives that:**
  - Defines the current employment relationship and terms.
  - Defines what happens at termination of employment.
  - Defines the post employment relationship.
- **Companies enter into these arrangements for a variety of reasons:**
  - Tool for recruitment or promotion.
  - Formalizes relationship.
  - Provides security for the executive and the company.

## ■ Employment Agreements / Security Arrangements

- **Employment Agreements and/or Security Arrangements can take several forms, including:**
  - Employment agreement.
  - Severance agreement or policy.
  - Change-in-control agreement or policy.
  - Mishmash.
- **Before implementing a new agreement, be sure to inventory all other plans or agreements that contain employment or termination provisions.**

## ■ Advantages / Disadvantages of Agreements

### ■ Advantages.

- Job and financial security to existing executives who may see the IPO or investor exit process as destabilizing.
- Shows potential investors that executive team is here to stay, even after IPO.
- The same benefits accrue if the exit strategy is not an IPO, but is instead a sale of the company without going public.
- Safety net for executives being recruited 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...or around the water cooler.

## ■ Advantages / Disadvantages (continued)

### ■ **Disadvantages.**

- May go against the company's culture.
- Investors may be opposed to some terms.
- Setting a precedent, if lower level executives feel slighted.
- May not want to lock into future costs.

## ■ Typical Agreement Terms

- **Typical Terms included in an Agreement.**
  - Length of term of the agreement.
  - Initial compensation.
  - Benefits and perquisites.
  - Types of defined severance.
  - Severance formula.
  - Equity treatment upon certain events.
  - Golden parachute excise taxes.

## ■ Agreement Terms

The term of agreement should be carefully considered.

- **Trends have been toward shorter terms.**
  - It may not be prudent to lock the company into a long-term deal.
  - One initial term of 2 years.
  - Annual automatic renewal.
  - Hard stop after a certain number of renewals forces both parties to take a fresh look at the landscape.
- **How long before or after a CIC should the agreement cover?**
  - 3 - 6 months before a CIC.
  - 2-years after a CIC.
- **Initial compensation.**
  - Base salary defined but no automatic increases.
  - Possibly guarantee first year bonus opportunity but not future.
  - Define initial equity grant but no guarantee for future grants.
  - Benefits and perquisites, if any.

## ■ Agreement Terms - Types of Defined Severance

### Severance Terms Should Cover All Contingencies.

- **Termination without cause.**
  - Usually triggers:
    - » Severance.
    - » Benefits continuation.
    - » Acceleration of unvested compensation (e.g., equity or SERPs).
- **Resignation for good reason by the executive.**
  - This is an “effective termination”.
  - Executive is allowed to resign and receive the benefits as if he/she were terminated.
  - Typical items that qualify as “good reason”.
    - » Diminution of duties (use at your own risk).
    - » Decrease in compensation.
    - » Change in reporting structure or title (e.g., small company CEO may become EVP).
    - » Relocation.
  - Occasionally, we find a voluntary termination window of a month or at the end of the first year after the CIC.

## Agreement Terms - Types of Defined Severance (Cont.)

- **Voluntary resignation.**
  - This is a rare occurrence, but it should be dealt with in an agreement.
  - If an executive resigns, its usually for good reason.
  - This type of termination usually results in no additional benefits being paid.
- **For cause.**
  - When an executive behaves badly, the company reserves the right to terminate him/her.
  - Cause will encompass:
    - » Illegal acts.
    - » Violation of other terms of contracts (e.g., confidentiality, personal use of company property, etc.).
  - Again, no benefits accrue to the executive when terminated under this type of provision.
- **Retirement.**
- **Disability or Death.**

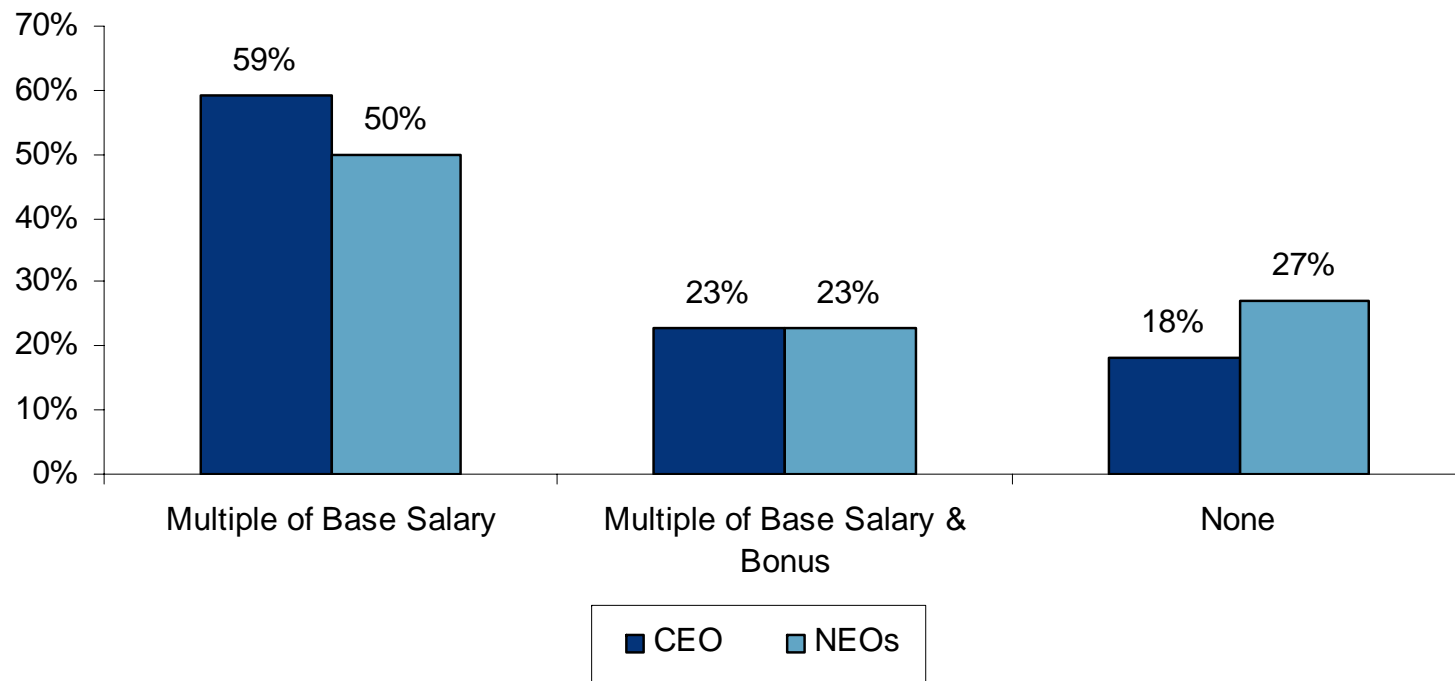
## ■ Agreement Terms - Severance Formulas

Severance can encompass several components of pay.

- **Cash payment.**
  - Base salary multiple.
    - » 2-3x remains the most prominent multiple for CEOs of mid-sized or large companies.
    - » CEO's of smaller companies are less (e.g. 1x)
    - » 1.5-2x (.5-1x) is the most common multiple for the next level of executives at larger or smaller companies respectively.
  - Bonus multiple.
    - » Usually mirrors the multiple for base salary.
    - » Calculation can vary based on how "bonus" is defined.
    - » It's fairly common to include a pro-rata bonus for the year in progress.

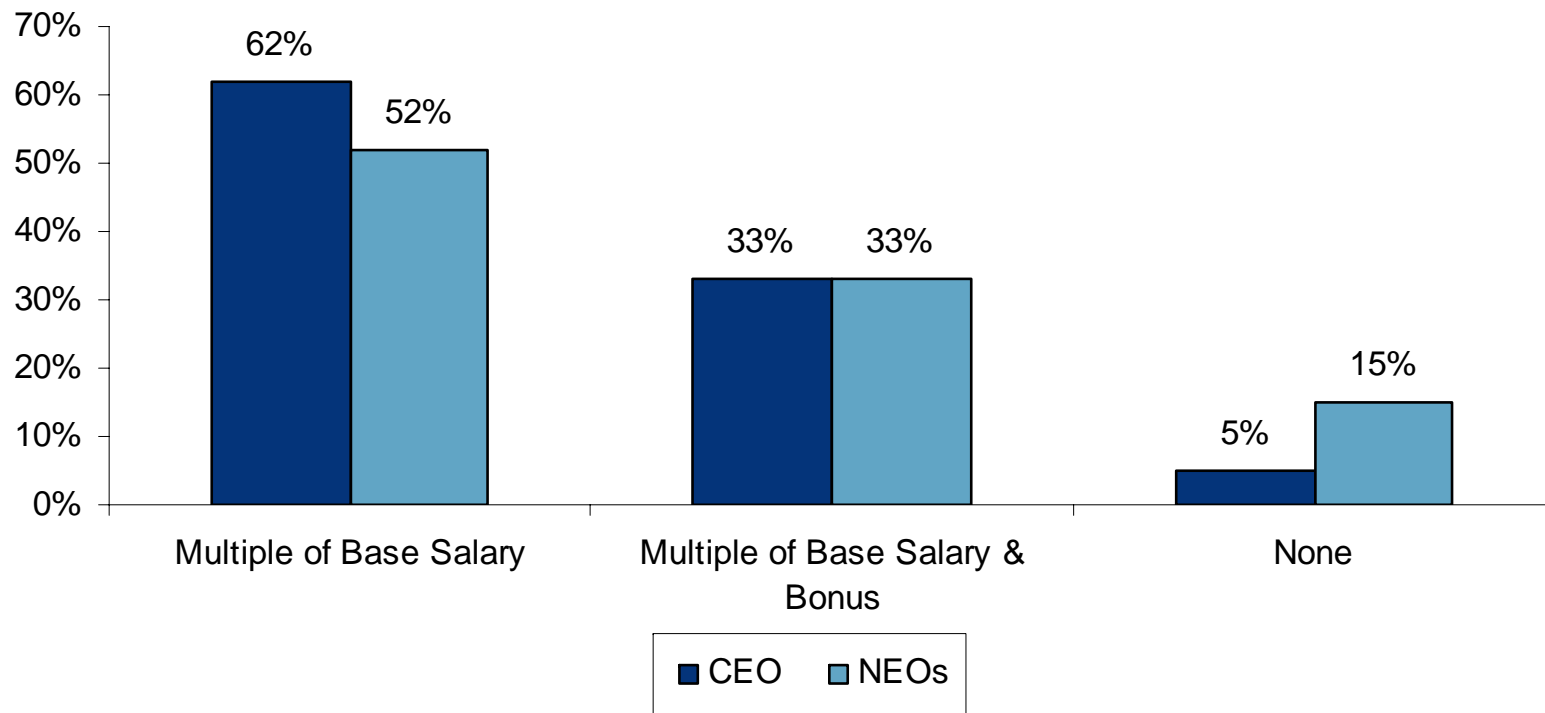
# Agreement Terms - Cash Payment - Severance (Termination Absent CIC)

### Cash Severance Payment (Absent a CiC)



# Agreement Terms - Cash Severance Payment (Termination Following CIC)

## Cash Severance Payment (Termination Following CIC)



## Agreement Terms – Benefits Continuation on Termination

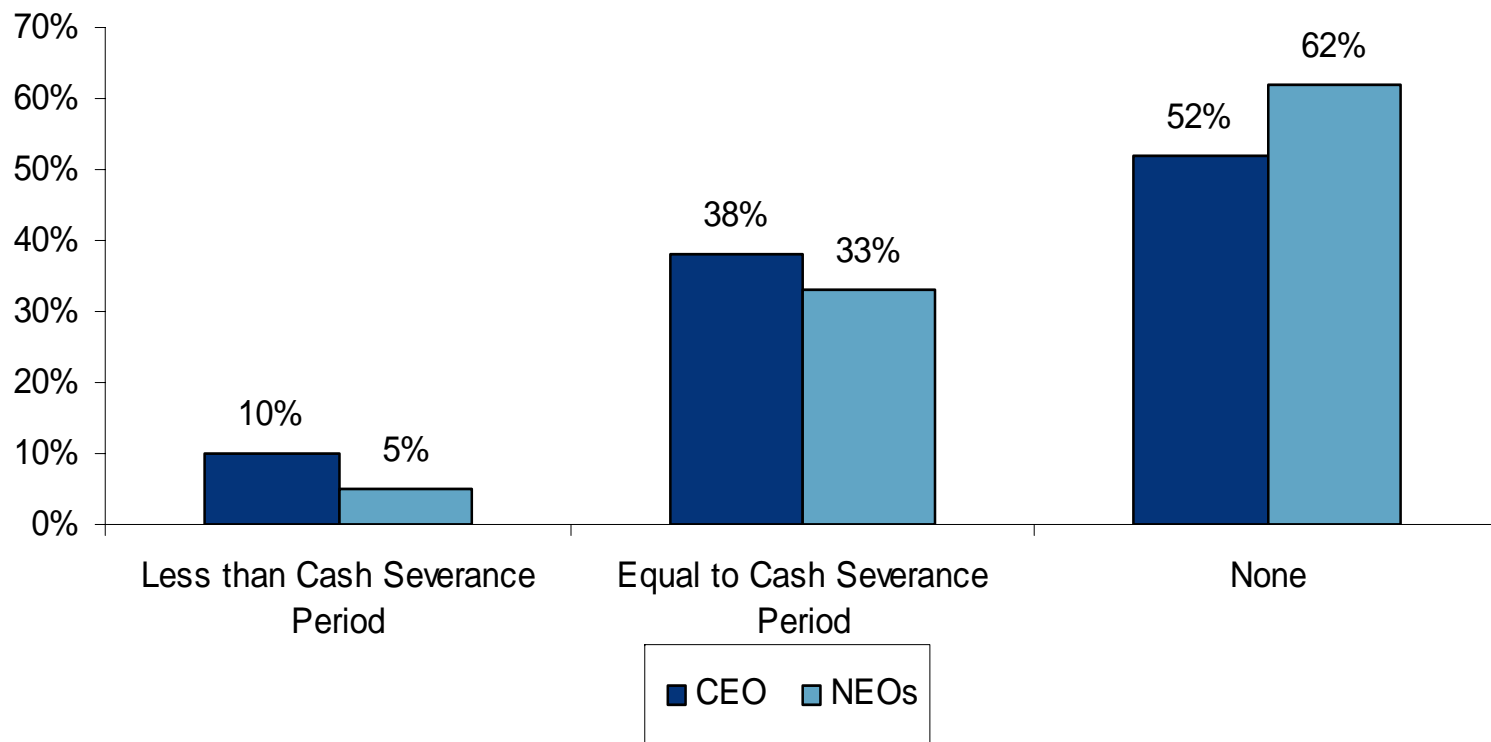
Continuation of benefits is common.

### ■ Benefits.

- Medical, dental, vision, life and some disability insurances.
- Typically, continuation period matches severance period.
- Mitigation is not a common practice, but it should be.
  - » Mitigation requires that the benefits continuation be discontinued when the executive is eligible for similar benefits through his/her next employer.
  - » Medicare should be considered in these provisions.

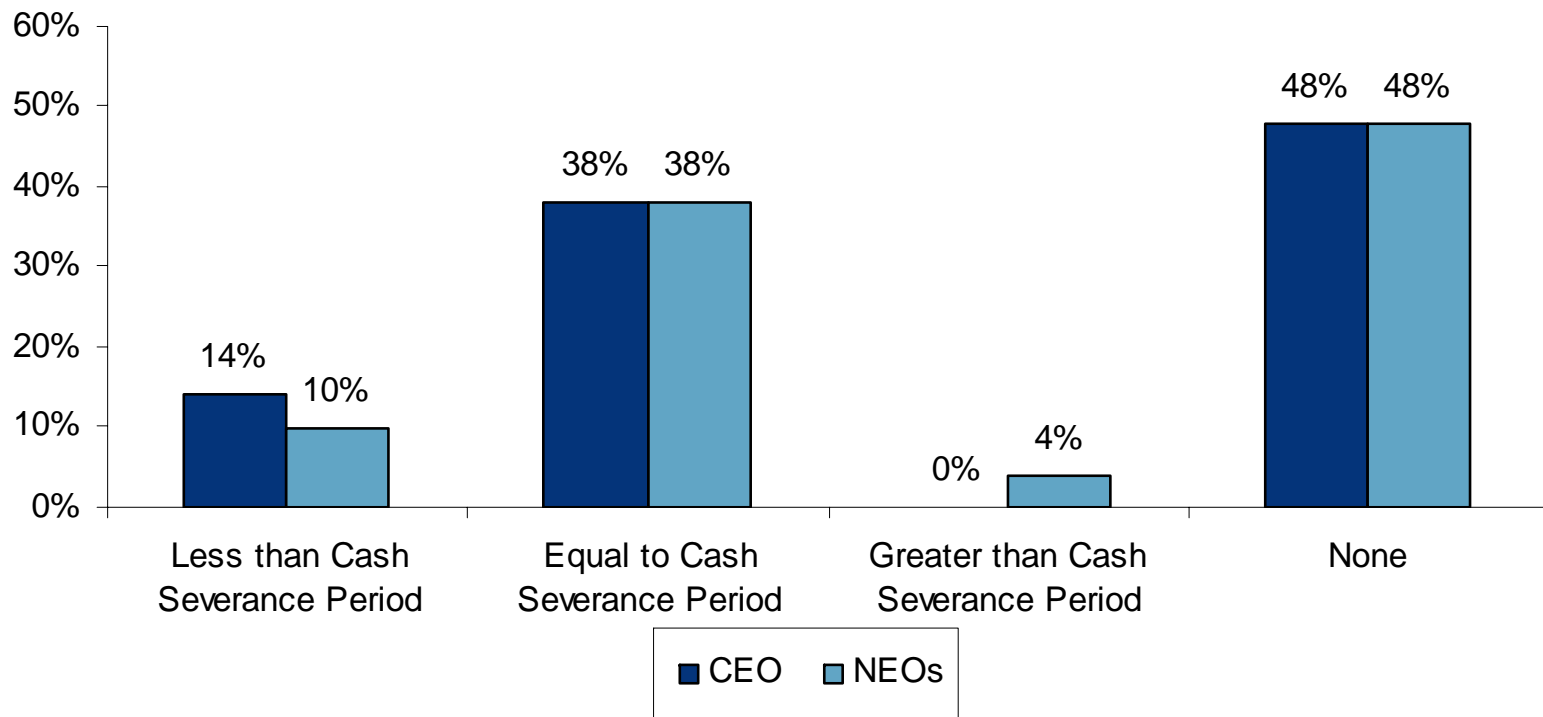
## Agreement Terms - Benefits Continuation (Termination Absent CIC)

### Benefits Continuation (Absent a CiC)



# Agreement Terms - Benefits Continuation (Termination Following CIC)

## Benefits Continuation (Termination Following CIC)



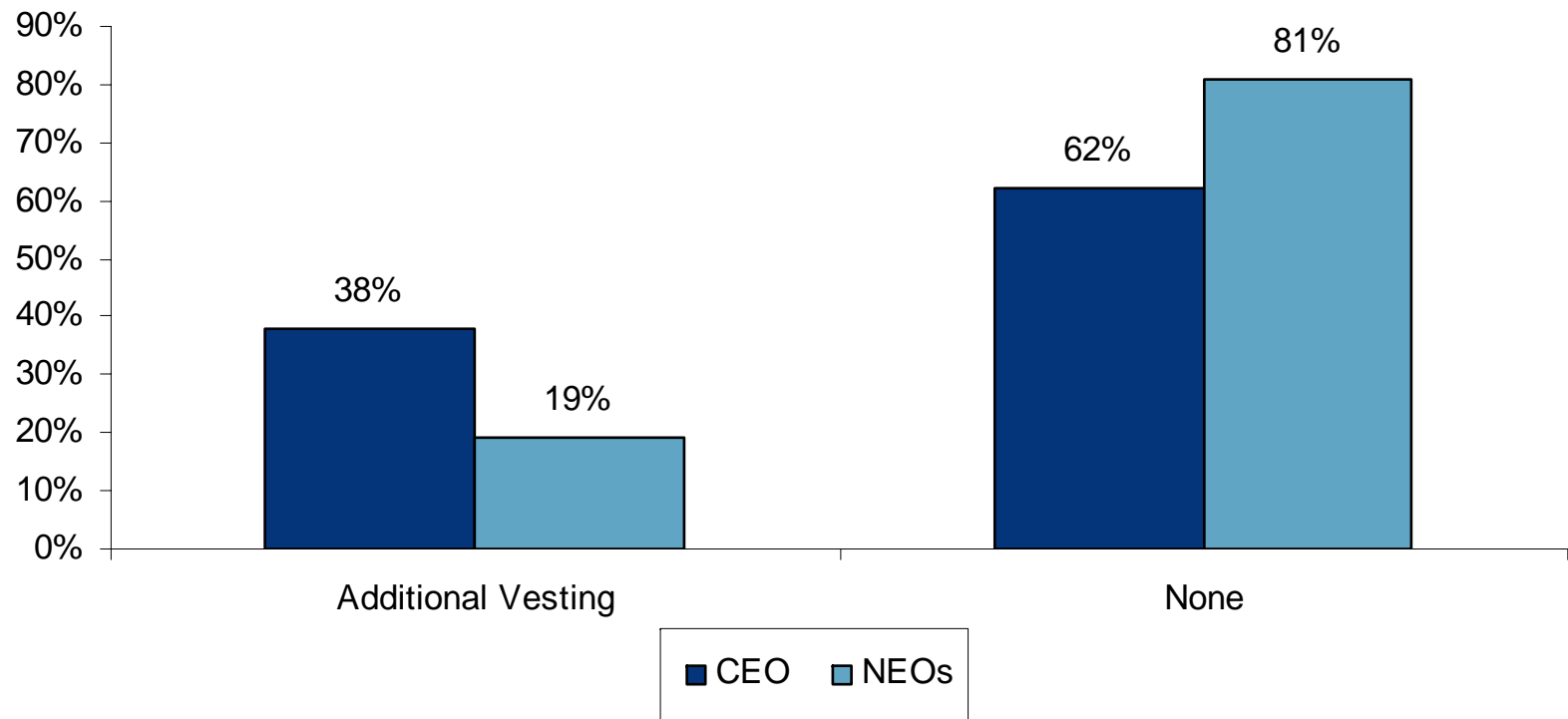
## Agreement Terms - Treatment of Unvested Equity Upon Termination

Executives want their equity preserved.

- **Equity incentives are the primary element of executive compensation**
  - Provide Retention Value.
  - Offer potential Opportunity for large returns.
  - Executives may take less cash for bigger equity opportunity.
- **The scenarios typically addressed in regard to equity include:**
  - Termination absent a CIC.
  - Vesting Following a CIC – Single-Trigger.
  - Vesting Following a CIC Upon Termination – Double-Trigger.

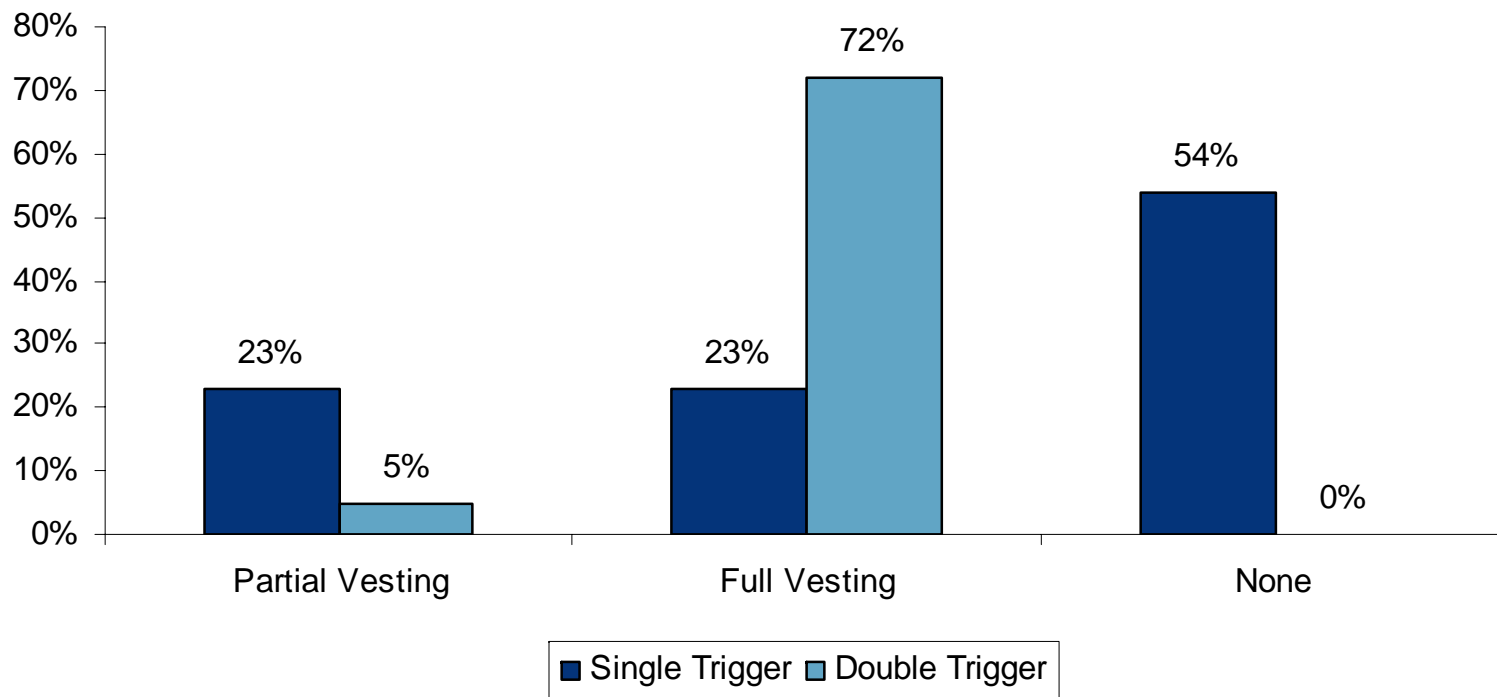
## Agreement Terms - Treatment of Unvested Equity Upon Termination (Termination Absent CIC)

### Equity Vesting (Termination Absent CIC)



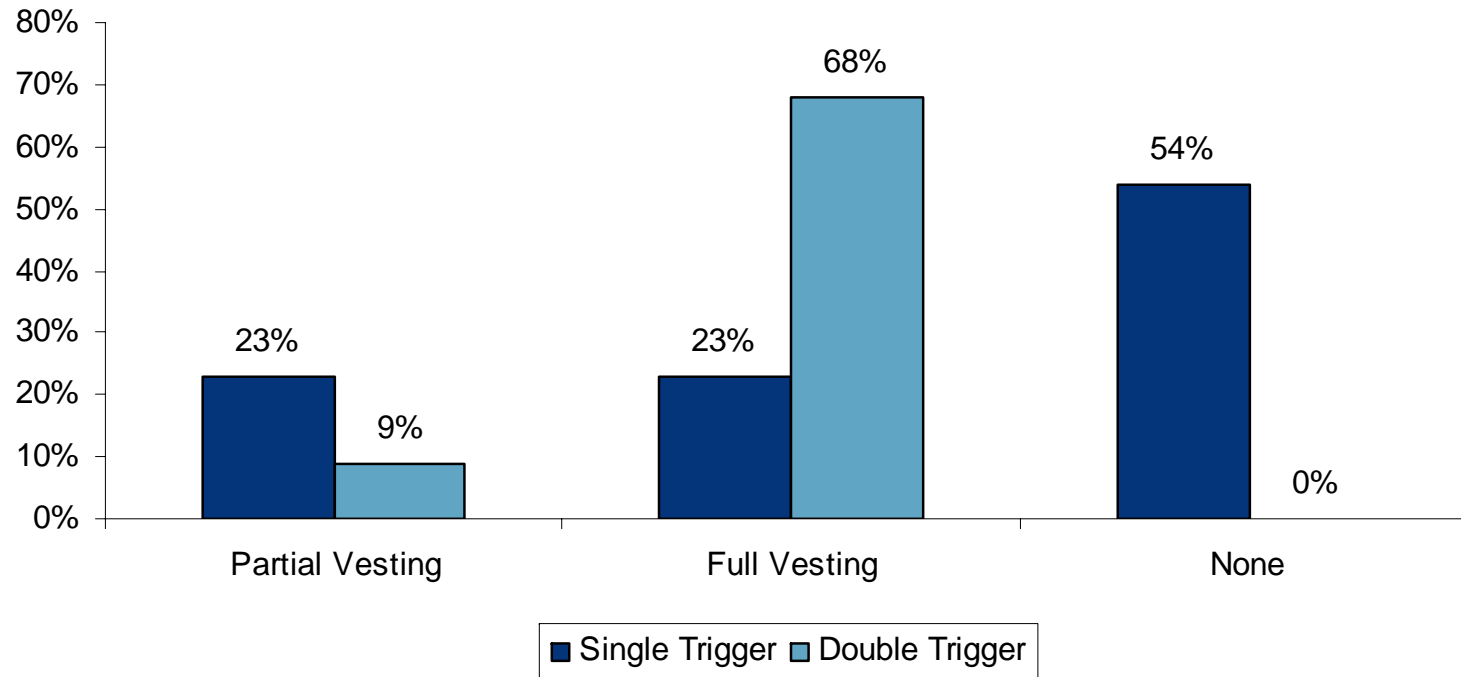
## Agreement Terms - Treatment of Unvested Equity Upon Termination: CEO (CIC) Single / Double Trigger

### CEO Equity Acceleration (CiC)



## Agreement Terms - Treatment of Unvested Equity Upon Termination: NEOs (CiC) Single / Double Trigger

### NEO Equity Acceleration (CiC)



## ▪ Agreement Terms - Golden Parachute Excise Taxes

In a CIC, Some Related Payments May be Subject to Excise Tax.

- **The IRC §280G “Golden Parachute” excise tax.**
  - When CIC related payments to top executives amount to more than 3x an executive’s 5-year average W-2 income, payments more than 1x the average income are subject to a 20% excise tax.
- **There are several approaches that can be taken in CIC arrangements.**
  - Shareholder vote exemption.
  - Cut Backs / Reduction.
  - Gross-up.
  - Efficient Gross-Up.
  - Best Net Benefit.
  - No Action.

## Agreement Terms - Golden Parachute Excise Taxes (cont.)

### ■ **Private Companies.**

- 280G applies to all companies, but there is an exemption for smaller and private companies.
- If 75% of the shareholders vote to approve CIC payments, the company is exempted.
- Its not as easy as it sounds!
  - » Who gets to vote?
  - » When does the vote take place?
  - » How are the CIC payments disclosed?
  - » Does everyone trust each other?
- Plan Ahead!

## Agreement Terms - Golden Parachute Excise Taxes (cont.)

- **Private Companies (cont.).**
  - A few strategies to help you prepare.
    - » Have the shareholders approve the CIC plan.
    - » Calculate the possible CIC payments whenever any component of compensation changes or new grants are made.
    - » Get the payments approved again and again.
    - » Keep an open dialogue with the shareholders.
    - » Keep up with the current practices.
  - If you can't get an exemption...

## Agreement Terms - Golden Parachute Excise Taxes (cont.)

### ■ **Cut-backs.**

- Some contracts will cut-back severance or other CIC benefits if the excise tax is triggered.
- It is argued that this may be a stumbling block to executives supporting (or even considering) a CIC in some cases.
- A mandatory cut-back may prevent the company from delivering the intended level of value to executives.
- There is a trend away from cutbacks.

## Agreement Terms - Golden Parachute Excise Taxes (cont.)

### ■ **Gross-ups.**

- A gross-up causes the company to make the executive whole for the tax if it is triggered.
- This can be very costly: typically more than 2x the actual excise tax due.
- The company loses its deduction on the original payments and the gross-up.
- Full gross-ups are not common in pre-IPO and / or small companies.
- There is a brewing investor backlash resulting from disclosure of gross-up liabilities in proxies.
- It is argued, however, that it eliminates the problem of executive support for a CIC.

## Agreement Terms - Golden Parachute Excise Taxes (cont.)

### ■ **Efficient Gross-up.**

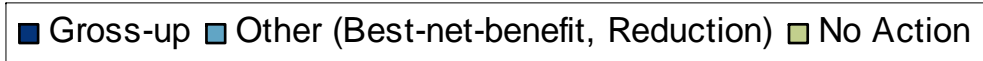
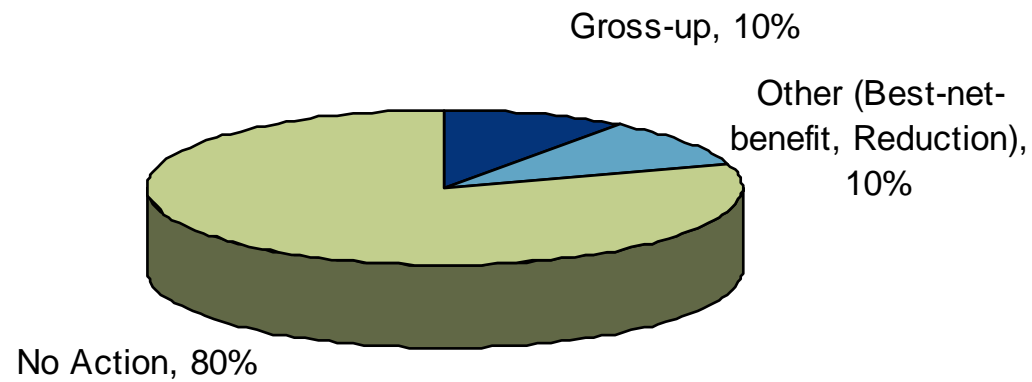
- This commits the company to a gross-up, but only if the payments are a certain percentage above the limit (i.e., the company will pay a gross-up, but only if a cut-back of 15% doesn't cure the problem).
- This addresses the inefficiency of paying a gross-up.
- These types of provisions are becoming more prominent.

## Agreement Terms - Golden Parachute Excise Taxes (cont.)

- **Best-net benefit.**
  - Allows the executive to decide whether to pay the excise tax or cut-back his/her payments in order to avoid the tax.
  - The only liability to the company is the lost deduction if the executive chooses to pay the tax.
- **No Action.**

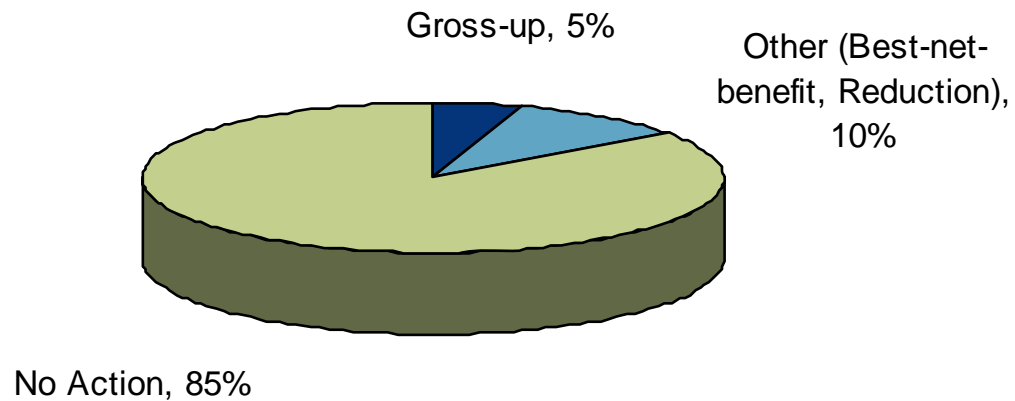
# Agreement Terms - 280G Considerations: Severance (Following CIC)

## CEO - 280G Considerations



# Agreement Terms - 280G Considerations: Severance (Following CIC)

## NEOs - 280G Considerations



■ Gross-up ■ Other (Best-net-benefit, Reduction) ■ No Action

## ■ Current Economic Environment

Even private companies, should understand the broader market.

- **“Say-on-pay” initiatives**
  - Currently, only shareholder proposals.
  - Non-binding vote on executive compensation.
- **RiskMetrics Group**
  - Corporate governance “best practices”.
  - 2009 Proxy Voting Policy (Draft) – “withhold” recommendation:
    - » Excessive CIC payments (*i.e.*, more than 3x).
    - » “Single trigger” CIC payments.
    - » Gross-ups?
- **Fidelity Investments**
  - Mutual fund proxy voting guidelines – “against” vote:
    - » “Golden parachutes” – gross-ups, single trigger for cash incentives, more than a 3x “double trigger”.

## ■ Where to Go From Here?

Make informed decisions.

- **Understand components of security agreements.**
- **Review current agreements and disparities among the executives.**
- **Have a game plan (avoid making quick decisions when hiring an executive).**
- **If you do go public, the agreements for the top executives will have to be disclosed!**
- **If you are public, changes will be disclosed and may cause shareholder voting problems.**

## ■ Where to Go From Here? (Cont.)

### Make informed decisions.

- **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?

## ■ Closing

- **Questions?**

**Thank you!**