Pearl Meyer

TRENDS & ISSUES

The Strategic Role of the Compensation Committee in a Successful M&A Process

From an executive compensation perspective, most initial discussions related to mergers and acquisitions (M&A) focus on golden parachutes, excise taxes, and gross ups. While these topics are critically important, compensation committees and boards must also be prepared to address a broader and more strategically impactful number of executive compensation issues before, during, and after the M&A process. Here, we identify and summarize what questions directors should be asking and when, to ensure success as they oversee and guide a merger or acquisition. We also offer specific guidance for boards as they examine change-in-control (CIC) provisions and 280G calculations (see the sidebar on pages 4-5).

Select and Retain Talent

"Overall, the key is to avoid the extremes of inertia and revolution..."

Any significant merger or acquisition will result in leadership changes. The key is to select and retain the people best suited to lead the new organization and fulfill the strategic intent of the transaction. In parallel with conducting a process to assess talent for the new entity, directors should examine the existing executive compensation arrangements for both companies and ask several key questions. Are there effective retention mechanisms in place for retaining key personnel? What additional agreements, guarantees, or awards might be helpful during the transition period, when anxiety and uncertainty are high?

Failing to recognize any limited retention strength, or to adopt near-term retention enhancements, increases the risk of losing people who are critical to the transaction's success. Does the deal have a "Good Reason" termination provision that might be triggered by reduced job responsibilities following a merger, thus allowing a key individual to voluntarily resign with severance and/or equity vesting benefits? If so, what can be done to mitigate that or similar concerns?

On the other hand, there are likely to be redundant positions in the new entity, and both planned and unanticipated exits of some executives could result in significant expense to

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the company. It's important to clearly understand the leadership landscape and factor in these costs, as well as to determine whether there are any options for lessening some of the expense.

A comprehensive review and summary of existing stock holdings, outstanding equity awards, severance protections, and other contractual guarantees is an important part of this process.

Adjust Outstanding Compensation Arrangements

Any major M&A activity will materially impact near-term and long-term business results. With such a significant portion of executive pay delivered via incentive plans, the compensation committee and board will need to decide how to adjust performance goals or performance results to account for the transaction. For example, are any windfall gains or losses likely to occur in the short-term incentive plan results? If so, can or should the impact of the transaction be excluded from the financial results used to determine short-term incentive payouts? What implications might there be in terms of disclosure and tax deductibility under various adjustment scenarios? Some of these questions can be addressed up front in the plan design process, but many will require judgment and the use of discretion based on the facts and circumstances of the transaction.

Adjustments to long-term incentive arrangements are often more challenging. With so many companies now using performance shares linked to multiyear performance periods, there are likely to be several outstanding grants with overlapping performance periods that may require adjustment. It may make sense to exclude the impact of the transaction from short-term results and payouts. However, since the rationale for the deal was probably to enhance long-term performance and shareholder value, inclusion of transaction impacts in long-term incentive plans and payouts does seem logical. A word of caution: adjusting performance goals can impact the accounting and tax treatment of the awards if not contemplated in the initial plan design.

Careful review of existing incentive-plan provisions and consideration of various adjustment scenarios is important for preserving plan effectiveness, retaining the right leaders, and setting the stage for the future entity.

Establish New Compensation Arrangements

Once the committee and board have addressed the immediate issues of selecting and retaining talent and appropriately adjusting outstanding incentive awards, the next step is to assess the impact of the transaction on executive compensation arrangements going forward. For large transactions, there will almost certainly be changes to the executive compensation strategy, the program designs, the performance measures, the calibration of pay and performance, and other policies and practices.

Consider whether the size and complexity of the organization has changed such that the entire benchmarking strategy and executive compensation peer group should be revisited.

Has the strategy or focus of the organization changed in such a way that existing performance measures and performance expectations should also be adjusted and recalibrated? At the highest level, determine what, if anything, should be done differently in the new plan to ensure that the merged organization can attract, motivate, and retain the talent necessary to deliver on the transaction's promise and provide superior long-term shareholder returns.

Comprehensive and thoughtful review and reconsideration of the executive compensation philosophy, strategy, and program design is necessary to ensure alignment and effectiveness going forward.

Communicate Effectively

Communication is critical throughout the entire M&A process. The board requires clarity of intentions, objectives, process, and involvement. Executives need to understand the board's role; the roles of various executives; the existing pay programs, protections, and policies; and any changes or new arrangements adopted during the M&A process. Advisors need to be up to speed on the overall objective, process, time line, and roles and responsibilities. Shareholders should understand *which* decisions are made during the process and *why* they were made. In other words, constant and effective communication is critical to transaction success.

From an external disclosure perspective, compensation committees and boards should be prepared for both immediate and eventual disclosures. Immediate disclosures typically include 8-K filings and/or press releases related to acquired or departed executives and/or material changes to executive compensation arrangements. Eventual disclosures typically include the annual compensation discussion and analysis (CD&A) and other proxy disclosures. Both immediate and eventual disclosures are opportunities to effectively communicate with multiple stakeholders, and these opportunities should not be overlooked or missed.

Proactive and thoughtful communications and disclosures are critical to transaction success.

Overcome Uncertainty

A successful M&A process helps executives who are simultaneously creating and experiencing significant change while seeking to maintain motivation and focus. Overall, the key is to avoid the extremes of inertia and revolution—overcoming uncertainty, resistance to change, or the desire to simply conform compensation plans to current "best" practices. Compensation committees and boards serve a crucial role in this regard, ensuring that any changes support and reinforce both the near- and long-term business and leadership strategies of the combined organization.

Sidebar: Change-in-Control Payouts and IRC Section 280G

When facing an impending transaction, compensation committees all too often find themselves addressing myriad complicated issues arising from the change-in-control (CIC) provisions in their executive compensation programs. The intent of these provisions is to protect executives and company benefits in the event of a CIC so that executives will remain focused and support a transaction even if job loss is likely post-closing. However, when golden parachute liabilities under Internal Revenue Code (IRC) Sections 280G and 4999 are triggered, the intended CIC benefits to executives can differ significantly from those originally intended.

What are the most common mistakes made by companies that are CIC targets?

1. **Not reviewing CIC plans and payouts regularly**
   While potential CIC "payouts" are developed for proxy disclosure, there is no specific requirement to regularly quantify the impact of 280G exposures for most executives. As a result, boards often defer examining payouts until a CIC is looming.

   Fixing programs is more difficult on the eve of a deal, when boards are under a heightened level of scrutiny to demonstrate prudence in their decisions and because of a presumption in the regulations which provides that payments made under agreements entered into or modified within one year of a CIC are presumed to be made as a result of the CIC. Quantifying CIC packages and 280G exposures on a regular basis can help to identify the trouble spots far enough in advance for boards to take appropriate action.

2. **Not considering the impact of non-competition provisions**
   Payments that are demonstrated with clear and convincing evidence to be reasonable compensation for post-CIC services are not considered parachute payments and can be excluded from the 280G calculations. Under the 280G regulations, post-CIC services include refraining from performing certain services, such as those that would apply under a legally valid non-compete agreement. Therefore, allocating CIC payments to non-competition agreements can substantially reduce the 280G impact.

3. **Not identifying post-CIC reasonable compensation**
   In addition to assigning values to non-compete restrictions, post-CIC reasonable compensation treatment can be considered for a number of other payments earned for post-CIC closing services, such as retention awards, performance equity, and consulting agreements. Many non-practitioners mistakenly think that this provision can apply easily, but the burden of proof is substantial and should not be assumed.

4. **Not understanding the impact of performance-based awards on the 280G results**
   Many companies have moved to granting performance-based pay in lieu of time-based equity awards in order to drive performance and address shareholder and institutional advisory concerns. However, awards vesting upon a CIC that are subject solely to service-based vesting conditions qualify under a special rule in the 280G regulations that significantly discounts the value of the payout considered in the 280G calculations.

Performance-based awards are not covered by this special rule, and the full value of any payout must be included in the 280G calculations unless it can be characterized as reasonable compensation for post-CIC services.

5. **Guaranteeing annual bonus levels and performance-based awards in anticipation of a CIC**
   In the midst of deal negotiations, the target and acquirer commonly agree to modify current arrangements, such as paying or guaranteeing annual bonuses and in-cycle performance-based awards. Practically, it may be difficult or impossible to continue with target-company performance metrics post-closing. But target company executives are often surprised to learn that these payments are included in the 280G calculations. And when considered CIC payments, these payouts must be included in the 280G calculations in their entirety unless properly characterized as reasonable compensation for post-CIC services.

6. **Not assessing pre-CIC reasonable compensation**
   Although the full amount of bonuses and performance-based pay earned for pre-CIC services are included in the 280G calculations, characterizing payouts as reasonable compensation for pre-CIC services can potentially reduce the excise taxes owed on those payments. As with assessing reasonable compensation for post-CIC services, there must be clear and convincing evidence.

7. **"Do it Yourself" 280G calculations**
   Quantifying CIC payments and preparing 280G calculations is a complicated, fact-specific, and data-driven process—the devil is in the details. Many companies will make costly errors running 280G calculations on their own, as the public information available on 280G does not sufficiently cover the subtlety of the rules. When a $1 change could result in millions of additional excise tax payments, it is clearly worth the time and effort for companies to bring in expertise with substantial experience on 280G matters to assist with the effort.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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