11 | 2014
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The Magazine of WorldatWork®

# When Performance-Based Payouts Meet Change in Control

Do you know enough about how your long-term-incentive program works during a change in control?

Boards of directors, management and institutional investors have increasingly emphasized pay for performance when designing executive compensation programs. As a result, long-term-incentive plans with performance-contingent features (performance LTIPs) are gaining in prevalence and becoming a larger proportion of total compensation. More than one-third of reviewed publicly held companies that were acquired from 2011 through the end of 2013 reported potential payouts of performance LTIP awards, according to a review of 341 say on golden parachute company disclosures.

Among these companies, which were reviewed by the authors' company, a significant percentage reported changes in the expected disposition of the awards. While some of these were required by the original terms (e.g., when awards are not assumed by the buyer), a number of changes were dictated by the deal structure or made shortly before the

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change in control. Award disposition can create innumerable challenges for target companies and potential buyers, given the magnitude of payouts and for a number of highly technical reasons. Last-minute changes to awards may create management distraction and potential disagreements between target and buyer, trigger unfavorable tax treatment under Internal Revenue Code Sections 280G, 409A and 162(m), and be viewed with suspicion by institutional investors.

This article examines performance LTIP payouts as revealed in say-on-pay and golden parachute disclosures from 2011 through 2013. Using these disclosures as a backdrop, key design issues were identified that companies have encountered in actual deals. Following are strategies to minimize difficulties when these plans are designed and implemented.

## Performance LTI Plan Design Features

### Payment triggers

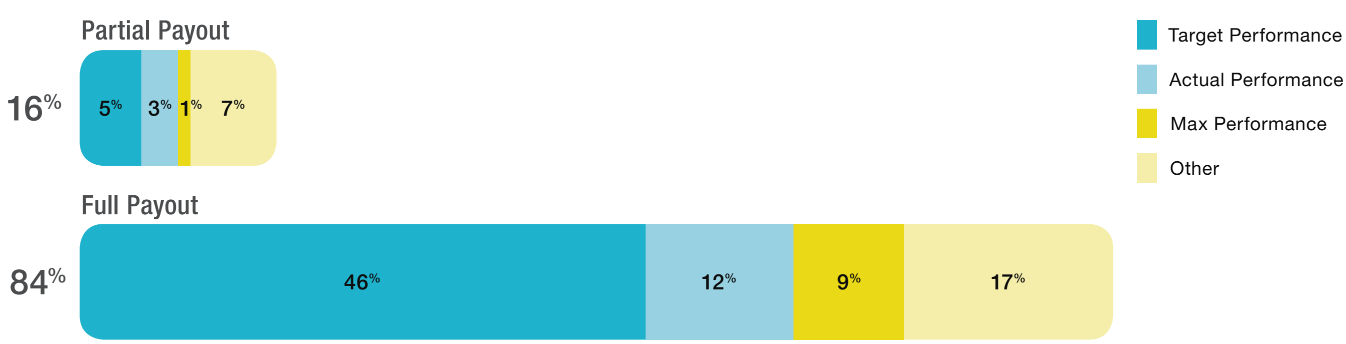
In most changes in control, the accelerated vesting of performance LTIPs is triggered either upon the closing of the transaction (single trigger) or within a time period shortly before or after the change in control because of an executive's qualifying involuntary termination or resignation with "good reason" (double trigger). Many plans have hybrid provisions that indicate awards will use double-trigger vesting provisions when the awards are assumed or exchanged by the buyer; but if not assumed, the awards will be accelerated and paid at closing. Some plans are silent about the treatment of awards in the event of a change in control but allow the board of directors to exercise discretion to accelerate vesting or modify payouts.

Of the companies undergoing transactions with performance LTIP awards, approximately 90 percent disclosed potential payments. The majority of these were single-triggered benefits (73 percent), while 27 percent reported double-trigger payouts or a mix of double- and single-trigger benefits. Many companies reporting no payouts of their performance LTIPs indicated performance levels had not been met at the time of the change in control and, therefore, awards were to be forfeited.

With the increasingly held view by institutional shareholders that

**FIGURE 1**

**LONG-TERM-INCENTIVE PROGRAM PAYOUT LEVELS UPON A CHANGE IN CONTROL**




Source: Pearl Meyer & Partners

single-trigger benefits provide a "windfall" for executives, and the growing trend toward plans containing double-trigger equity provisions, these numbers might seem a bit surprising. In some transactions, however, it can be difficult or impossible for a buyer to continue existing LTIP awards (e.g., in all cash deals or in going-private transactions). Also, buyers often have valid business reasons to discontinue the programs. For example, a buyer's current pay mix/philosophy for comparable executives within its own organization might not include similar types of awards, or the measurement of the performance criteria will no longer be possible after the change in control.

**Payment levels and performance measurement**
When a transaction occurs, performance cycles are likely to be midstream with payouts uncertain. Therefore, plan provisions to determine appropriate payment levels in the event of a transaction are a critical element for performance-long-term-incentive plans.

The companies reviewed used various terms for performance goals prior to the change in control. Sixty-seven percent of the companies used three-year performance cycles, with one-year cycles the next most typical (16 percent). A few companies (3 percent) disclosed longer cycles (at or above five years), which were typically associated with options with stock price hurdles. Short cycles (one to two years) were commonly coupled with further service requirements (commonly three to five years).

When a transaction truncates the LTIP performance period, most companies calculate the award value without applying any adjustment for the shorter performance/service period. Approximately 84 percent of companies making performance LTIP payments paid the entire award rather than paying a reduced or prorated award based on the period of service elapsed (16 percent). (See Figure 1.) In several instances, companies prorated some awards but not others. For example, grants made after the transaction documents were signed would be prorated, while previous grants were paid in full.

In actual deals, using target performance levels to determine payouts was the most common approach (51 percent) with the next most common approach the use of actual results measured prior to the award determination — either at change in control or upon termination (15 percent). A few companies determined payouts assuming maximum performance results (10 percent). Nearly one-quarter (24 percent) of companies used a combination of these approaches. For example, awards were determined combining actual performance results where measurable and target results otherwise.

**Timing for performance determination**
Complexities abound when awards continue after closing. Performance metrics and goals set by a target company might no longer be appropriate or measurable post-transaction. Because of the vast array of uncertainties, many performance LTIPs provide that the determination of award levels will occur at the time of the change in control, with the original service-based vesting provisions continuing post-closing. These LTIPs typically contain double-trigger features that will provide for vesting of awards if an executive has a qualifying termination. Although removing the performance element of pay post-closing is not ideal, this approach provides some level of assurance to target executives that they will not be penalized if pre-established performance goals are unattainable or indeterminable post-closing.

## Plan Design Modifications

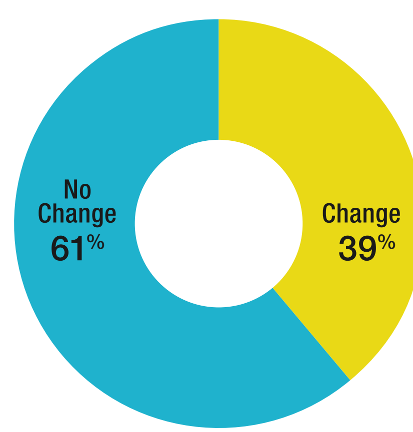
Because of the complexities inherent in transactions and in performance LTIP designs, as well as the proxy disclosure rules, it is not surprising that a significant number of companies (almost 40 percent) reported changes from prior proxy disclosures. (See Figure 2.)

**84%**

**OF COMPANIES MAKING PERFORMANCE LTIP PAYMENTS PAID THE ENTIRE AWARD.**

FIGURE 2

**PERFORMANCE OF LONG-TERM-INCENTIVE PLAN CHANGES DURING A CHANGE IN CONTROL**




Source: Pearl Meyer & Partners

**Adding language to provide clarity in the event of a change in control can reduce potential disputes, but in some cases may create additional technical issues.**

In many cases, changes were required by the deal structure or the original award terms (e.g., awards were not assumed by the buyer).

The most common modification was a change to the reported payment trigger. (See Figure 3.) For example, some awards were reported as double trigger in annual proxy post-termination tables and they were subsequently reported as single-trigger awards in the say-on-pay and golden parachute disclosures.

Another common revision was in the prescribed payout levels. For example, award agreements had indicated payouts at target levels in a change in control, but in the deal, performance levels were reported as being determined using actual results through the change in control. Other actions included:

- Amending awards to clarify amounts vesting as a result of the transaction
- Amending programs to fix performance levels and amounts payable prior to the change in control, rather than upon termination post-closing
- Changing key terms on the most recent grants (such as prorated vesting, double-trigger vesting or use of target performance levels for newly awarded grants)
- Reducing or waiving award performance conditions shortly before announcement of the transaction
- Waiving acceleration of awards in exchange for new awards by the buyer
- Changing payout dates.

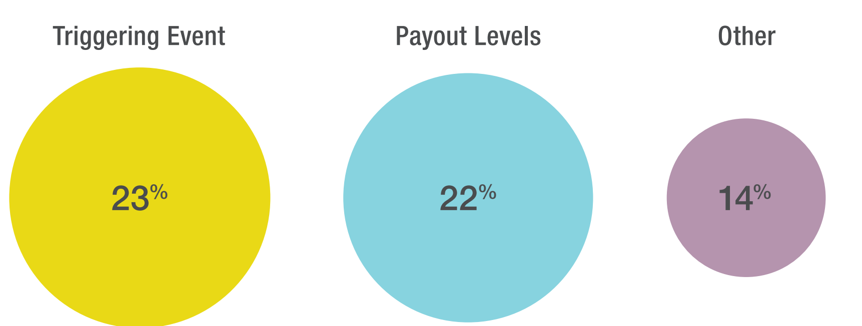
## Avoid Plan Design Pitfalls

Some critical lessons for designing and implementing performance LTIPs can be learned from the companies that have lived through the challenges of determining payouts in real transactions.

- **Review clarity of payment/vesting language.** Performance LTIP award agreements for a number of companies included change-in-control-related vesting language identical to the language provided in time-based awards. However, this standard time-vested language typically lacks the necessary clarity on how vesting should be applied to the performance elements of the LTIP (i.e., in a change in control, whether the award should be based on minimum, target, max or actual results). Award agreements should clearly describe how performance should be measured in the event of a change in control.
- **Specify change-in-control performance determination and timing.** Many companies in the survey with double-trigger provisions made amendments to provide that awards would be measured by performance results through or close to the change in control, rather than post-closing when a termination occurs. Performance goals and metrics should be reviewed to determine whether maintaining and measuring performance results are even possible based on the company's selected measures. Adding language to provide clarity in the event of a change in control can reduce potential disputes, but in some cases may create additional technical issues.
- **Assess potential for post-deal announcement grants.** Many companies will face delays in closing transactions because of regulatory requirements. Alternatively, a deal might arrive in the middle of the annual grant process. In these instances, companies must decide whether grants should be made in the ordinary course of business and/or with the same design terms. A few companies faced with these challenges modified key terms. For example, new grants provided for

**FIGURE 3**

**TYPES OF CHANGES AS A RESULT OF CHANGE IN CONTROL (as a % of all companies)**




Source: Pearl Meyer & Partners

prorated vesting upon a change in control or qualifying termination, or specified the use of targets to measure performance results instead of using actual results. Boards of directors should consider whether changes in design and approach are appropriate when deals are in view.

- **Maintain board discretion.** Maintaining a moderate level of board discretion to modify acceleration or otherwise dispose of the awards is helpful to companies as they face the complexities and technical issues of actual deals. However, providing discretion to modify terms should be evaluated to ensure fiduciary risks are moderated and to avoid/mitigate any unfavorable tax consequences under IRC Sections 280G, 409A and 162(m).

## Prepare for Complexity

As companies increasingly turn to performance LTIPs to help drive performance, boards of directors and management should be mindful of the range of complex issues that can arise when administering these programs in a change in control. They are well advised to uncover issues up front that might cause adverse economic, legal and tax implications. Award agreements should be designed after careful evaluation of how a variety of possible deal outcomes might affect vesting and performance provisions. ws

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