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Executive Compensation in a SPAC Transaction—By Failing to Prepare, Are You Preparing to Fail?

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When it comes to mergers and acquisitions, 2020 may well be remembered as the "year of the SPAC." To date, there have been over 230 Special Purpose Acquisition Companies—or SPACs—which have held an initial public offering (IPO) in 2020, raising over $62B of capital in the process. Clearly, the combination of low interest rates, lofty public equity valuations, and a quicker, more cost-effective listing process has proven to be too enticing for many investors and aspiring public company management teams.

From a compensation standpoint, the key considerations in a SPAC deal are similar to those in a traditional IPO, but with a twist. Some of the most interesting dynamics created during a SPAC transaction include:

- The limited time for a SPAC sponsor to develop a deep understanding of the merger target's human capital strategy and ongoing talent requirements. Part of the appeal of a SPAC transaction is that they are fast-paced and can close within just a few months.
- Merger targets often lack the built-out compensation and incentive frameworks that would be typical at other late-stage growth companies. The easier on-ramp to public company status that SPAC deals provide means some companies are going public earlier than anticipated, and therefore might lack robust compensation policies.
- The transaction itself may not constitute a change in control (CIC) per the target's compensation plans and policies, if it does not meet the prescribed definition. Many incentive plans are designed with more traditional transactions in mind that do trigger a CIC.
- The set 24-month time horizon that SPAC sponsors have to find and complete a merger can create a sense of urgency that could lead to important pay decisions being set aside, or suboptimal decisions being made.

Given these factors, target company CEOs, CFOs, and HR teams—as well as directors at the SPAC sponsor—would be wise to consider the following questions.

Is there a full appreciation for the target company's human capital strategy and ongoing talent requirements?

Given the condensed deal timeline, and the parties' relative unfamiliarity with one another, it can be challenging for the target to communicate, and for the sponsor to fully appreciate, the target's human capital strategy and ongoing talent requirements. This has potentially important implications for negotiations around equity pool size for the post-merger company. This situation differs from a traditional IPO where venture capitalists and other partners typically take positions earlier in a company's lifecycle stage and are privy to these strategic decisions much sooner in the process. With "getting the deal done" being of primary concern, human capital and compensation strategy can easily get pushed to the side.

Does the target have the necessary compensation programs and policies in place to attract and retain executive talent leading up to the transaction and after?

In an ideal world, companies preparing to go public will have ample time to develop a comprehensive pay strategy and structure prior to the transaction. As noted, however, the shortened timeline in a SPAC situation means some degree of prioritization may be necessary. At a minimum, we recommend pre-merger target companies consider:

- The treatment of outstanding equity awards upon a SPAC transaction: Will equity be converted, cashed out, or cancelled for no consideration? We've seen all three situations and each has different implications for broader pay decisions and strategy.
- Key provisions of the new equity incentive plan: What is the "right" number of new shares to authorize given what's already outstanding and the company's future talent needs? Should the company include an annual evergreen feature, allow liberal share recycling, and impose board of director compensation limits? It's important to consider the company's needs from a human capital standpoint, as well as what's appropriate from a governance standpoint.
- Pay competitiveness and the retention of key personnel: Are cash compensation levels consistent with market practices and sufficient to attract and retain through a transaction? Similarly, are unvested equity holdings sufficient to retain through a transaction or should additional equity awards in conjunction with a transaction be considered? The uncertainty surrounding transactions means that key employees are ripe for poaching, and that proactive management of cash and equity compensation is a necessary exercise for aspiring public companies. These are areas which can be quite easily assessed and planned for with your advisors.
- Severance policies and other key executive contractual protections: What is reasonable non-CIC cash severance for a public company executive? How should protections differ in a change-in-control scenario? It's in shareholders' interests to ensure key executives have reasonable employment protections in place so they can focus solely on executing strategy and driving company performance.
- Adopting an employee stock purchase plan (ESPP): How effective are ESPPs in promoting broad-based employee retention, and how are the best plans structured? Many companies adopt ESPPs as part of their broader employee equity strategies, but they are not always necessary. Establishing key features, including purchase discounts, shares available, and annual share pool renewals are just some of the decisions which must be made when developing the plan design.

Pearl Meyer's research around SPAC compensation is ongoing and trends are still emerging. However, when compared with traditional IPOs, our data is pointing to a lower-than-typical dilution and overhang, a reduced prevalence of evergreen provisions, conversion of pre-merger equity instead of acceleration, and the deferral of defining board of director compensation programs until after the merger.

How does the 24-month SPAC time horizon affect the sponsor's and target's leverage in negotiations on key compensation related items?

A potential elephant in the room is the ticking clock which hangs over the SPAC to find a target and complete a merger with the prescribed 24-month timeline. While it's unlikely to be discussed openly, no doubt there is mounting pressure as time goes on for a SPAC to find and close a deal in the allotted timeframe and avoid unwinding the fund.

While it's too early to draw meaningful conclusions, intuition says this is a genuine factor which should be considered during the negotiation process. Who needs whom more? Given the importance of human capital strategy to long-term success, we think both sponsors and targets would be wise to move slowly and carefully consider the implications that things like equity pool size can have down the road. For example, from the target's perspective, a large equity pool gives them greater flexibility to attract and retain using equity. From the sponsor side, however, liberal share usage practices might enable more casual equity spending and increase dilution at the expense of shareholders. Retaining experienced and independent advisors will help both parties think through these decisions to arrive at optimal outcomes.

In Summary

The SPAC phenomenon is showing no sign of slowing down. With trends and best practices still emerging, engaging those familiar with the process is a must. A neutral party that can remind each side to consider numerous unintended consequences can help better the chances of success. When there is urgency to close a deal, by failing to prepare, you might be preparing to fail.

About the Author

Rob has 15 years experience in executive compensation and finance, specializing in life sciences and technology—especially emerging, high-growth companies navigating M&A and IPOs.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.