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Is Distressed M&A Deal Activity on the Horizon?



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Get Your Compensation Plans Ready for a Change-in-Control

The global COVID-19 pandemic has put tremendous strains on businesses, financial markets, and merger and acquisitions (M&A) activity. For the first quarter of 2020, Dealogic reported a 35.5% decrease in year-over-year deal volume, the lowest Q1 volume since 2013. While deal activity declined sharply in the early months, a growing number of legal and investment advisors are now predicting a surge in opportunistic or distressed company M&A activity in 2020 and early 2021.

If this prediction holds, compensation committees of the most vulnerable companies should be gearing up to address a broad array of executive compensation issues now, before a formal sale process has begun or an unsolicited takeover offer has been received. Once a company is in play, things move at lightning speed and it can be difficult to implement new

programs or make changes to existing agreements.

The following are some critical activities that at-risk companies should begin to address now.

Identify and Inventory Change-in-Control (CIC) and Severance Protections

Identifying and understanding the terms of the company's current CIC and severance entitlements is a necessary initial step in the overall M&A process. Standard due diligence procedures require disclosure to a potential buyer(s) of all relevant executive and non-executive CIC and severance arrangements. In due diligence, the purpose is to identify potential liabilities that might crater a deal or require an adjustment to the purchase price. For the compensation committee and human resources team, these entitlements should serve as the starting point for assessing whether key employee retention is a significant concern. Companies need their talent to remain sharply focused on maintaining and growing the existing business, while simultaneously handling the increased responsibilities of working through difficult economic times and a potential transaction.

Time required shouldn't be underestimated. The company must be comprehensive in its search. CIC and severance benefits can be found in a myriad of compensatory documents, plans, and programs including the obvious and not so obvious ones such as those listed in Table 1 below. Review the documents thoroughly. Legal counsel should help work through any legal, tax, regulatory, and contract interpretation issues that come to the surface in the process.

CIC Payment/280G Quantifications and Review

The next critical step is for the company to estimate the potential dollar amounts of benefits and payments triggered—in the aggregate and by person—and as an overall percentage of the deal value. This exercise may require running alternative scenarios, such as using a range of potential transaction values and post-CIC employment outcomes. The company may also need compensation consultants, actuaries, and/or accountants at this stage to help button down expected costs and payouts and begin assessing retention risks.

Part of this exercise should be to not only understand the aggregate costs, but also whether there are risks that the application of the golden parachute rules under Internal Revenue Code (IRC) Sections 280G and 4999 will significantly erode intended economic benefits. Under the rules, if the present value of the CIC payments to an executive exceeds his/her "safe harbor"—meaning three times the executive's average taxable compensation over the five most recent calendar years preceding the CIC (or "base amount"), less $1—the company loses tax deductions for the amounts considered "excess parachute payments." Additionally, the executive is required to pay a 20 percent excise

tax on excess payments.

Since golden parachute quantification is driven by complex tax rules, boards and executives cannot rely on sheer logic to get through the process. Involving experienced advisors can help get an accurate picture of company costs, lost tax deductions and executive excise taxes. While the golden parachute limitations may appear relatively straightforward, there are numerous complexities inherent in most 280G calculations. Issues can emerge when least expected—but solutions may be available with the right set of facts. Approaches for mitigating an executive's excise tax is highly dependent on transaction timing, post-employment status outcomes, and each executive's individual facts and circumstances. Strategies to consider for reducing the sting are listed in Table 2.

Identify Retention Risks/Develop Retention Alternatives

Will the company's overall compensation programs, including its current CIC and severance plans hold senior leadership and key talent through the entire M&A process as needed? When CIC, severance, and benefits costs in existing arrangements are better understood, the company can begin to identify the potential gaps and employees that may be potential flight risks.

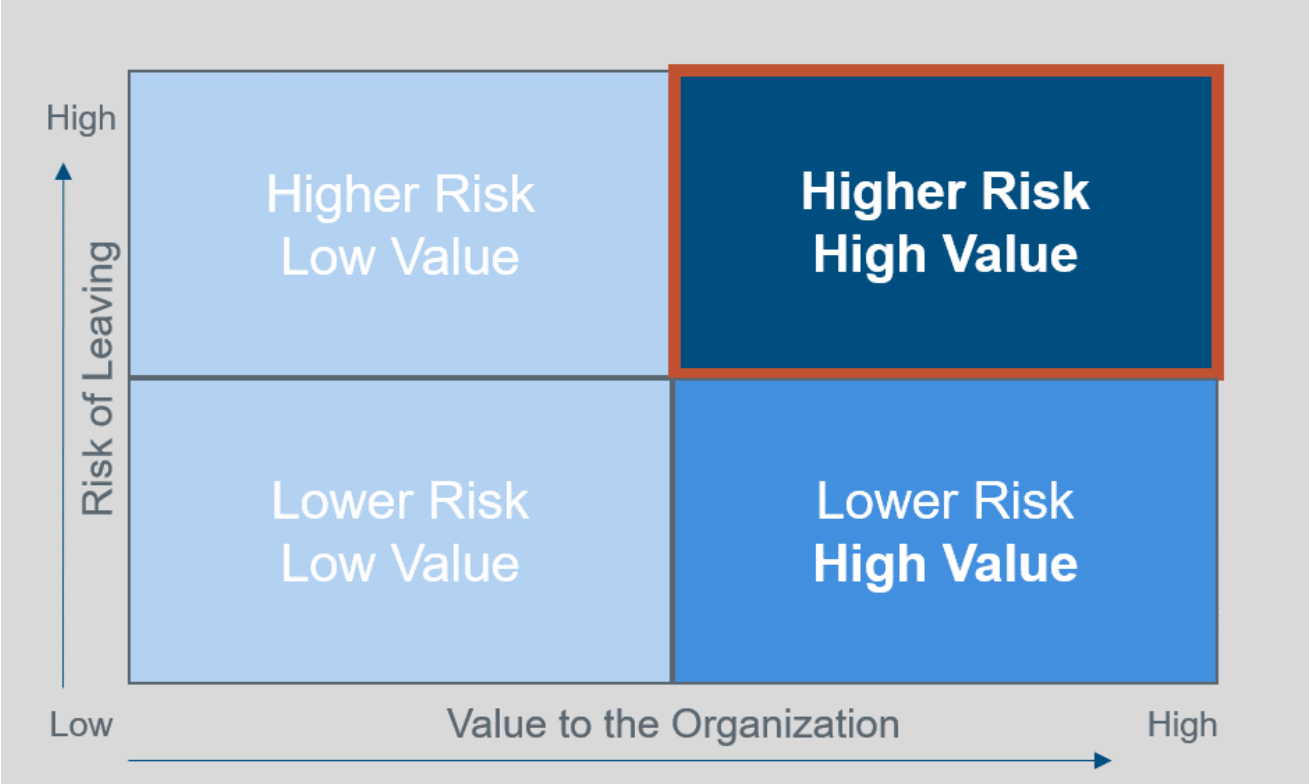
Factors influencing efficacy of the programs can be heavily impacted by the type of transaction (asset sale, stock sale, spin-off, etc.), buyer involved (strategic buyer versus private equity, etc.), and components of CIC benefits (for example, single-trigger benefits versus double trigger benefits). Nevertheless, even when businesses are not yet in a formal M&A process, it is appropriate to begin doing the legwork to retain talent.

Retention programs are designed to help deliver the business in a form and value that will be expected by sellers and buyers by motivating employees to stay and do the job required. Typical retention program alternatives include enhanced severance, retention bonuses and transaction bonuses which are further discussed in table 3.

Many organizations reserve a pool to fund CIC related retention incentives. While retention pools are common, they are less likely to include executive officers, who are more often protected by existing CIC and severance protections.

Companies often create a scorecard to determine eligibility for retention awards, and to calculate retention award values. The default approach is to have participation of retention programs focused on employees critical to the success of the business and who are also

most at risk. True risk of flight should be assessed, as illustrated below.



When developing a retention framework, the following are key questions to consider.

Retention Program Design Considerations	
Considerations	**Key Questions**
▪ Eligibility	▪ Who is critical to the success of the transaction or to the resulting companies over the longer term? ▪ Who is likely to leave if a retention award is not provided?
▪ Retention Period	▪ How long are critical employees integral to the success of the combined entity or how long is the expected transition period until the dust settles and employees feel comfortable with their new organization?
▪ Method and Timing	▪ Should the award be granted in single lump sum or in installments?
▪ Form of Payment	▪ Should the retention incentive be awarded in cash or equity?
▪ Conditions for Payout	▪ Typically, only a service-based component ▪ Performance may be included but this can undermine retention
▪ Level	▪ What award level is necessary to retain key employees?

Adjust/Implement Compensation Arrangements

A deep dive into the company's existing compensation plans and agreements and a review of retention risk very often uncovers matters that are better addressed prior to a transaction occurring.

For example, it may be appropriate to increase the number of executives covered under the current CIC severance plan or that are eligible for accelerated vesting upon a CIC, or it may be necessary to clear up confusing contractual language to reflect the original intent.

Also, adjustments to existing incentive programs are commonly needed in advance of a CIC. Compensation committees frequently struggle with how to determine performance results for short-term and long-term incentive plans given an impending transaction will interrupt the original performance cycle. Agreements and plans are not always written with enough specificity so that results can be determined in all occurrences; these types of issues require judgement and use of discretion based on the facts and circumstances for

each company.

Furthermore, based on the work described above, it may be appropriate to approve retention vehicle frameworks or address 280G golden parachute issues. Companies should always be mindful of the optics of all changes made, along with the costs of any adjustments made (in absolute dollars and in relation to overall deal value).

Conclusions

With a growing number of investment advisors predicting a surge in opportunistic or distressed company M&A activity in 2020 and early 2021, compensation committees of at-risk companies should get a head start by addressing the many compensation issues that are certain to arise once the company is in play. Employees need to remain focused on maintaining/increasing business once a transaction is on the horizon, but the reality is they can be distracted by the uncertainties that lie ahead. Developing a plan to maintain key talent through the M&A process in advance will prove to be invaluable.

Table 1: CIC and Severance Data/Documents	
Documents/Benefits	**Special Notes**
▪ Agreements providing for severance or enhanced severance following a CIC	▪ Look for employment agreements, CIC severance agreements, severance plans, offer letters, and severance policies
▪ Equity and other long-term incentive (LTI) arrangements	▪ Find and review plan documents and grant agreements; special vesting provisions may also be found in employment agreements ▪ Look for accelerated or enhanced vesting provisions as a result of a CIC or termination following a CIC
▪ Short-term incentive plans/bonuses	▪ May provide for enhanced or guaranteed payouts upon the occurrence of a CIC or termination following a CIC, such as paying a pro-rated bonus at target levels
▪ Qualified and non-qualified retirement plans	▪ Look for enhancements or accelerated payouts of benefits as a result of layoff, involuntary termination/good reason, or a CIC ▪ Non-qualified plan trusts may also require funding in the event of a CIC
▪ Health and welfare benefits	▪ May be in the form of lump sum settlements, cash reimbursements, enhancements, or continued benefits following involuntary termination/good reason or retirement ▪ Special provisions may also be found in employment agreements, severance plans and policies, and employee handbooks
▪ Perquisites and life insurance continuation	▪ Special provisions may also be found in employment agreements, severance plans and policies, and employee handbooks ▪ May include key man or split-dollar life insurance arrangements
▪ Employee loans	▪ Look for terms providing for forgiveness in the event of involuntary termination/good reason or CIC
▪ Non-compete and non-solicitation provisions	▪ May be separate standalone documents or found within provisions of employment, severance, equity, or other agreements
▪ Retention bonus/transaction bonus documentation	▪ Provide agreements, plans, and awards that may trigger or be implemented

Table 2: Strategies to Reduce Golden Parachute Excise Taxes	
Strategy	**Special Notes**
▪ Adding contractual terms covering excise taxes or reductions in benefits	▪ Defining what happens to potential payments in the event there are potential excise tax liabilities can significantly improve the after-tax benefits to executives if the current arrangements are silent
▪ Subjecting CIC payments to a valid and enforceable non-compete	▪ Amounts that can be allocated to a non-compete covenant are not considered CIC payments and are not included in the 280G calculations
▪ Accelerating the vesting of potential CIC payments in advance of a transaction	▪ Vested benefits are generally excluded from the 280G calculations; as a result, accelerating benefits a year or more in advance of a transaction can reduce potential parachute payments
▪ Accelerating taxable income to increase base amounts and Safe Harbors	▪ If a CIC is likely, a company can consider accelerating income into the year prior to the CIC to increase executive base amounts and golden parachute safe harbors. This is most often done by exercising stock options, accelerating the vesting of taxable awards (restricted stock awards and RSUs that settle at vesting), and accelerating earned bonuses; however, before taking any such action, companies must carefully navigate a myriad of other tax rules, including the deferred compensation rules IRC Section 409A
▪ Other approaches	▪ With the right set of facts, there may be other, more technical solutions available to mitigate or eliminate a company's golden parachute exposures

Table 3: Three Types of Retention Plans	
Type of Plan	**Characteristics**
1. Enhanced Severance	**Continuation of pay over time or as a lump sum** **May include continued health and welfare benefits and/or outplacement benefits**
Provisions	▪ Payment contingent upon involuntary termination within a limited period following a CIC or upon termination in anticipation of a CIC ▪ Examples: - *Extending duration of pay continuation period* - *Enhancing pay definition to include target bonus in addition to salary* - *Increasing minimum and maximum awards*
Market practice	▪ Commonly provided to a broad population ▪ Pay period often extended in a down economy (reflects greater difficulty in finding other employment)
Advantages	▪ Relatively low-cost way to provide additional retention value (no payment without termination post-CIC) ▪ Limited cost allows company to address employment uncertainty for broader population
Disadvantages	▪ Rewards employees who terminate so unlikely to retain high at risk/high value employees ▪ Generally modest values may be insufficient if the M&A process is lengthy
2. Retention Bonus	**Typically, a fixed cash award, but may be provided in equity**
Provisions	▪ Payment is contingent upon continued service to a specified date(s): ▪ Examples: - *Vesting: 50% at CIC closing and 50% at 6 months post-CIC* - *Vesting: 30% in six months after the award is granted; 70% in 12 months after the award is granted, with acceleration upon earlier of CIC closing and termination* ▪ Vesting/payment may be accelerated upon termination without cause ▪ Usually three or four eligibility tiers with different award values - *Higher award values usually reserved for executives or when the desired retention period exceeds one year*
Market practice	▪ Used often, but participation is more selective than in enhanced severance
Advantages	▪ Size and timing of retention bonuses can be individually customized ▪ Selection criteria typically target high at-risk employees
Disadvantages	▪ Potentially costly if most participants end up staying and receive awards ▪ If paid before CIC, additional retention bonuses may be needed
3. Transaction Bonuses	**Two Types: Deal Support and Value Sharing** **Typically paid in cash, but pre-CIC equity awards are also possible**
Provisions	▪ Deal Support bonuses reward for significant workload in bringing the transaction across the finish line or to those responsible for post-deal integration work - *These two work streams may have separate incentive plans/pools and payout terms* ▪ Value Sharing awards reward key senior managers for maximizing shareholder value realization in the deal
Market practice	▪ Deal Support bonuses - *Awards for achieving successful closing typically limited to deal team; is typically paid in cash at closing* - *Awards for post-deal integration work typically paid in cash once milestones are achieved* - *Paid entirely in cash the vast majority of cases, with payments based on a percentage of salary* ▪ Value Sharing awards - *Structured as a percentage of deal value, flat dollar amount, or fixed number of shares; awards can be significant* - *Restricted to senior management, including the CEO, who can have a more direct impact on that value* - *Payment most often occurs at closing, with possible acceleration on termination (company cannot fire executive to avoid payment)* ▪ May not be appropriate to award if value from existing compensation programs is already significant
Advantages	▪ Rewards the individuals most responsible for bringing transaction to a close ▪ Value Sharing awards are strongly linked to value contribution - *Larger award size and limited participation focus executives on closing a deal favorable to shareholders*
Disadvantages	▪ Only addresses retention for a select group ▪ Institutional investment advisory services such as ISS and Glass Lewis discourage the use of "single-trigger" CIC benefits, viewing them as windfalls; large payouts may result in a negative say-on-golden-parachute (SOGP) vote recommendation ▪ May need to modify the plan design or provide additional retention value if the deal price and/or timing differ from original expectations

About the Authors

Margaret has 30+ years experience advising on tax, compensation, and benefits matters, with a focus on corporate transactions, change-in-control provisions, and IRC compliance.

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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.