

Assessing the Need for Retention during M&A



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When a transaction is on the horizon, companies may already have a number of compensatory programs in place that will serve to not only reduce employee anxiety and turnover, but also align employee behavior with shareholder interests. These programs include general severance arrangements, outstanding retention plans, and accelerated value of benefits (either upon a change-in-control [CIC] or after both a CIC and subsequent employee termination) such as unvested equity or retirement benefits as well as enhanced cash severance specifically related to a change in control of the company.

But the unique characteristics of each impending transaction often requires a reassessment of whether existing programs will be sufficient to hold needed talent through the uncertain times ahead. For example, if the company's stock price has risen significantly over the past several years and equity grants have been made annually, equity participants may have sufficient holdings to retain them through and after closing so long as there is sufficient protection upon termination. Conversely, in a declining stock environment, the same employees may view the risk of termination as outweighing any potential benefit and may seek employment opportunities elsewhere before the transaction is complete.

These issues are complicated by the potential impact of a transaction on various employee groups and their participation in the various compensation plans. For example, financial buyers often intend to keep the existing management group post-transaction, thereby resulting in fewer employee concerns about future career prospects. Strategic buyers may target specific overlapping groups or functional areas for significant employee reductions. At the initial stages, boards may have a vision of likely buyers, but the ultimate program design will need to accommodate a variety of potential scenarios at the outset and adapt as the deal process progresses.

A first step in the process is for the compensation committee to gain a thorough understanding of the current state-of-affairs of the retention hold for all employees and the impact of the potential stock price appreciation on their holdings. Next is to assess how a transaction will be viewed, and how the current plans motivate achievement of the highest shareholder value. From a retention standpoint, identifying the employee groups or individuals most at risk for seeking alternative employment before a deal is completed is a crucial next step. Departures could impact the company's future prospects and deal value.

There are a variety of tools the compensation committee can use during the M&A process, each with their own advantages and limitations. One frequently employed vehicle used by the compensation committee is a retention plan. Our experience is that most companies employ some form of a retention plan in anticipation of a transaction. Owing to the individual characteristics of each deal, these programs vary widely. Frequently they involve cash-based payments which are paid regardless of whether the deal occurs or are paid upon completion of the deal and for some period thereafter. In some cases, they are issued in stock and can vest over a period of several years. The principal advantage of retention programs is

their ability to retain key personnel through the transaction, on a targeted basis, for a targeted time period. This can maximize shareholder value whether or not a transaction proceeds. The disadvantage is that unlike other tools, these plans frequently involve hard costs to either the seller or the buyer, which could negatively impact future results and shareholder value.

To understand how companies are using this incentive, we examined the public disclosures of over 50 companies which provided detail on their retention plans since the advent of say-on-golden-parachutes in 2011. The range of retention pools varied between \$1.5M to \$13M (25th to 75th percentile, with a median of \$6M.) Likewise, participation also varied widely from a few select executives to a large group of employees.

When establishing new programs, the compensation committee should be mindful of the total retention opportunities for the group, including potential severance and equity vesting upon termination or CIC. Also, the committee should be mindful of institutional shareholder and shareholder advisory services concerns and a number of tax, legal, and accounting issues, such as Internal Revenue Code Section 280G which can significantly erode benefits.

About the Author

Dan Wetzel is a managing director at Pearl Meyer. With over 30 years of experience in the field of compensation and benefits, Dan assists clients in the areas of executive and non-employee director compensation and employee pay, focusing on the development of annual and long-term incentive compensation programs to meet clients' strategic objectives. He also provides consultation in the areas of employment contracts and change of control provisions, mergers and acquisitions, expert testimony, reasonableness of compensation, salary administration, performance management, and employee and executive benefits. His client engagements cover a variety of industries and company organizational and developmental stages, including startup/pre-IPO, privately-held, public, subsidiary, foreign-owned, and non-profit organizations.

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