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Severance Benefits in Emerging Biotech Companies

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Severance has been a common topic in compensation committee meetings across the sector. A challenging financing environment coupled with low stock prices has pushed more companies to take actions to preserve cash. This means program prioritization and difficult headcount decisions resulting in restructurings and layoffs. Executives moving between companies have been savvy in trying to negotiate stronger protections to govern compensation outcomes on both ends of the spectrum—either absent a change-in-control ("CIC") or in connection with or following a CIC. In this context, a CIC is most commonly an acquisition of the company after which it is no longer a stand-alone entity—either integrated into a larger organization or operated as a subsidiary of the acquiror. The following is from a recent discussion with Managing Director Matt Molberger, an expert in compensation and governance in the biotech industry.

Q: When and why should companies implement severance protections for executives?

Employment agreements that provide some level of severance protection are now the norm amongst private companies in the industry. Many companies are bringing in talent with large and/or public company experience and this population expects and highly values these protections. It is likely to be a negotiating point at hire. The number of protected executives always depends on the build of the executive team and structure of the organization, but generally applies to C-level members—often a total of three to five individuals. However, there is a wide range of practice in what protections are afforded between companies and sometimes even amongst executives on the same management team.

Q: What are some of the common practices?

At private companies we are most often seeing a single severance amount equal to a number of months (or a multiple such as 0.75x) of salary that applies to any executive termination without cause or by the executive for good reason. The CEO's benefit is typically higher than that for their direct reports. Benefits continuation is typically afforded for an amount of time that aligns with the severance salary continuation amount. One challenge that we encounter is that companies are usually negotiating these benefits with each executive individually at hire. This can result in differing protections across the team, and can be a web that is difficult to untangle upon IPO when the agreements become public and subject to external scrutiny.

Sometimes preferential equity treatment is also afforded as a severance benefit in terminations absent CIC. We see this with founders and CEOs most commonly. Some private companies will provide single-trigger vesting in a CIC scenario, whereby all of the outstanding equity vests upon the CIC itself and does not require termination, but doubletrigger vesting is a better governance practice.

While it is universal for public companies to provide severance and CIC protections to executives, some companies limit these protections to five or six executives (a number that may be slightly higher than private companies), but increasingly we are seeing protections covering a larger executive population, for example including senior vice presidents, which then may total 10 to 12 individuals. Public company benefits tend to be more standardized both across teams internally with a consistent benefit by level and from company-to-company. Providing CIC benefits that are one step up from non-CIC benefits is the prevailing practice. The business case for that is to further align the interests of management with shareholders by keeping an executive objective in the wake of a takeover or sale of the company, and cast aside any perverse incentive for an executive to resist valid offers out of fear of job loss.

Q: What are the main differences in the amount or form of benefits offered for severance in CIC and non-CIC scenarios?

The primary market practice absent a CIC is to provide cash severance solely based on the salary. In these instances, severance is managed through salary continuation, but preferential equity treatment is uncommon. When we do see equity acceleration, it may be a legacy benefit from a pre-IPO agreement or an agreement provided only to the CEO. Full acceleration of unvested equity for anyone is not very common and instead just a portion of outstanding equity would vest, for example what would vest within 12 months of the termination date.

The enhanced severance provided in a CIC scenario is usually a step up in the amount of severance, for example nine months becomes 12 months, and 12 months becomes 18 months. There is also incorporation of a multiple of the target bonus into the calculation. A CEO with an 18-month salary benefit would be afforded 1.5x the sum of the annualized salary and target bonus, and the cash severance is typically paid as a lump sum.

Full equity acceleration upon a termination in connection with a CIC is the potentially more lucrative differentiator vs. non-CIC severance. Usually all unvested awards accelerate if they did not do so upon the transaction itself, either as a negotiated part of the deal terms or pursuant to a single-trigger benefit.

Q: What's the value in having a formalized severance policy versus providing severance under individual employment agreements?

Amongst public companies, we continue to see individual employment agreements—especially for the CEO and other C-level positions. When protections are provided through an employment agreement, they are subject to individual negotiations with each candidate. Companies that are insistent upon ensuring a common set of benefits across internal peers may be complicating the recruitment process by putting forth something to the candidate that seems open to negotiation when the company does not view it that way.

A severance and CIC plan that governs these benefits simplifies the process. Candidates and current employees can be afforded eligibility to participate in the plan and execute a participant agreement to be covered. These plans will stipulate the benefits in each termination scenario by level so that benefits are aligned across internal peers. The key advantages to the company are: (i) standardizing benefits across the team; (ii) simplifying the negotiation process with candidates; and (iii) simplifying future administration. The benefits in the plan may be revisited in the future if the company no longer believes the benefits are market-competitive, or for some other contextual change.

Q: Are there different mechanisms or approaches for providing severance below the executive level?

It is rare for smaller emerging companies to operate programs that guarantee severance benefits below the executive level. Companies may maintain guidelines that they can selectively apply to non-executive performance-related terminations. That tends to be more common than having and communicating a set policy to the entire organization. Guidelines are also used in the event of a reduction in force ("RIF").

In RIF scenarios, many of our clients have elected to fall on the generous side of the severance spectrum. The thinking is twofold: (i) treat people well for having committed to the organization and its mission, and who are being asked to leave through no fault of their own; and (ii) convey to the go-forward team that the company does what is right which can be good for culture and morale post-RIF. Employees are grateful that their impacted peers and friends were treated well. Companies electing a more generous framework for a RIF may be reluctant to adopt the policy as a new go-forward standard for non-executive terminations. Compensation committees and management teams are far less concerned about generosity in a performance-related termination

Q: We've seen an uptick in involuntary terminations over the last two years given the challenging operating environment. Have you seen companies adopt a strictly level-based approach to severance or is tenure also a factor?

There's a split in market practice here. Some companies will simply set a standard number of weeks of salary by level across the organization. Others will incorporate a tenure component, for example, a baseline number of weeks of salary based on an impacted employee's level, plus an extra two weeks of salary for each full year of completed service. These tend to be companies that have been around longer and where the impacted population will include long-tenured employees. They will thank the longer-tenured employees for their service and contributions by including a tenure-based component to enhance the severance package.

Some of the challenged companies are only a few years old so there are very few tenured employees and they will make the opposite determination. In these situations, we often see companies opt for simplicity and only provide level-based benefits. The same may occur in a RIF situation where a last-in-first-out strategy will have the same effect, as it is likely that most would have been hired within the last 12 months.

On a case-by-case basis in RIF scenarios we have seen additional actions taken to provide even greater benefits by way of either targeted accelerated equity vesting and/or the extension of the post-termination option exercise period. It should be noted that neither is common, but depending on the circumstances, this may be a meaningful extra benefit. Accelerated vesting could allow for a next tranche of outstanding equity to vest if the action is taken shortly before a meaningful vesting event. Alternatively, the option exercise window may be extended if the company has a meaningful—and potentially value-creating—milestone within sight.

About the Author

Matt Molberger is a managing director at Pearl Meyer. He consults primarily with companies in the life sciences and technology sectors. Matt works with clients to develop comprehensive executive compensation programs that support long-term business objectives. He specializes in pay benchmarking, incentive plan design, pay-for-performance alignment, security arrangements, and CD&A disclosure. Matt's client experience ranges from pre-IPO planning to supporting Fortune 500 companies throughout the annual compensation cycle.

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