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Enhanced Severance as a Retention Tool in Life Sciences

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Post-employment severance protections are a common feature for executives at most publicly traded companies in the life sciences sector. These agreements are typically focused on senior-level roles only, as a broad-based severance program for all employees could be prohibitively expensive for most companies and are usually not necessary from a talent competition perspective.

However, as companies across the life sciences sector continue to grapple with depressed share prices and the corresponding low retention "hook" for staff, we have seen an uptick in companies inquiring about adding or enhancing severance benefits for non-executive employees. For those who do consider this action, there are some fundamental elements of broad-based severance arrangements and key design features to bear in mind.

The Basics

In the most basic form, severance benefits provide a safety net for employees who are terminated as a result of a company reorganization, position redundancy, or change in business strategy. Even in instances where an employee is not meeting performance standards, it is common for companies to provide modest post-employment benefits that include:

- Salary continuation (typically one to two months as a baseline);
- Benefits continuation (a similar duration of one to two months);
- Outplacement support; and
- Other considerations such as a partial bonus payout, partial equity acceleration, etc.

While this practice is often expected, for at-will employees who do not have an employment agreement or other contractual protections in place, there are no guarantees. Even for companies that have previously provided severance to departing employees in a large-scale headcount reduction, these arrangements typically have a "sunset" provision so that they do not extend indefinitely. While this helps manage costs for employers it may also increase uncertainty for staff members.

When should companies consider this alternative?

Over the last three to four years, there has been a significant uptick in retention-focused compensation programs adopted by bio/pharma companies. These programs often involve ad hoc equity grants, cash retention packages, or some combination of the two. Among companies that have been active since the pandemic, many have already rolled out more than one retention-focused compensation initiative to help stabilize retention and incentives for key staff members. These companies are now in a position where cash and equity reserves have been depleted and continuing to rollout additional compensation programs may not be feasible.

As a result, companies are now exploring more creative strategies to shore up retention and engagement for key staff. While these types of arrangements often fall under the header of "crisis tools," a targeted enhancement to severance arrangements during a time of significant instability may go further than cash and equity instruments. Particularly for smaller companies where mid- and senior-level managers do not have contractual severance but fill mission-critical roles, this approach can provide valuable stabilization. Abrupt departures in even one or two of these roles during a challenging period can create significant upheaval and threaten business continuity.

There are several unique circumstances where a severance-focused retention strategy may be most effective:

- Limited cash reserves and/or a need to preserve cash to extend clinical development initiatives;
- Severe constraints to the equity pool that make off-cycle or upsized equity grants to staff unfeasible;
- A deeply depressed stock price such that even a larger equity award does not significantly enhance perceived retention/upside for key staff;
- A defined window where continuity is absolutely critical with one or more key milestones set to occur within a one- to two-year time horizon; and/or
- There is an identified group of high-performing, mission-critical employees that have little or no severance provisions currently in place.

What are the key design considerations?

Many companies take a simplified approach when rolling out a targeted severance program for non-executive staff. The priority more often than not is to establish a plan that addresses employee concerns in a straightforward and expedited manner. While key components of the plan should be addressed and vetted by senior management, an elaborate design that is difficult for participants to understand may undermine the intent. A thoughtful severance designed to reinforce retention for key staff members should consider the following:

- What is the right scope of the organization to include?
  - Most companies take a targeted approach where five to 10% of non-executive employees (often at the director/sr. director levels) would gain access to a more formalized set of severance provisions that are codified in an agreement providing certainty to the participant. By approaching this in a targeted way, companies avoid ERISA-based guidelines that might significantly increase the administrative burden (and cost).
- What is an appropriate level of severance to provide staff members included in the program?
  - Director/sr. director levels are often eligible for at least two months of salary and benefits continuation. For longer-tenured employees, these severance levels might extend to six months. Specific severance levels will be influenced by the number of participants, the available cash reserves, and what the company's "baseline" level of provisions has been in prior severance events.
- Is a "sunsetting" provision appropriate?
  - A "sunsetting" feature defines an end date when severance protections would lapse. While this may be an appropriate mechanism to manage cost and avoid an undefined term of the severance obligation, if employees included in the initiative have the potential to be long-term value drivers for the company,

removal/elimination of the benefit at some point in the future will likely be viewed as a "takeaway" and could be demotivating to otherwise committed staff members.

- What is the appropriate way to communicate these benefits?
  - Because these programs are often targeted, careful thought should be given when communicating provisions to the employees selected to participate. While there is not a standard model, the most effective communications strategy often involves a personalized memo outlining the basic terms of the plan so that the participant understands the program and feels a sense of exclusivity at having been selected.
- What is the total implied cost of the plan?
  - This is the most circumstance-specific of all the design considerations. Most companies exploring a severance-based retention strategy have to carefully consider the implied cost. In our experience, most companies target a total additional cost that is no more than one to two percent of the total base payroll, and for larger organizations, the total additional cost is often far below this range.

Final Thoughts

The life sciences market continues to deal with challenging headwinds and many companies are running out of alternatives to provide economic incentives to key staff. Despite the softening in the labor market over the last few years as companies have had to downsize and slow hiring, those with top talent and key skillsets continue to have opportunities. While it is not a common practice in the market, a carefully designed severance program may be a useful pressure release valve for companies that have exhausted the more conventional approaches. As is the case with any compensation and total rewards strategy, any plan that is developed should be driven by the company's culture and its broader pay philosophy to ensure it supports long-term human capital goals.

About the Author

Joe McNeal is a managing director in Pearl Meyer's executive compensation consulting practice. Joe advises management teams and compensation committees on a broad range of issues and has deep expertise in the high technology and life sciences sectors. His clients range from early-stage startups to Fortune 500 companies.

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