M&As and Retaining Key Talent: How Do Your Change-in-Control Plans Stack Up?

A *Compensation Committee Series* Webinar
Presented by NACD and Pearl Meyer

April 1, 2021

Meet the Presenters

Frank Jaehnert (moderator) is an experienced board member serving on the board of several publicly traded companies. Frank currently serves on the board of Itron, Nordson, National Material L.P., and the NACD Chicago Chapter. Frank is an EY Entrepreneur Of The Year 2008 Upper Midwest Award winner, and he has been a regional, national, and world judge and supporter of the US program for many years. He previously served as the CEO for Brady Corporation for over ten years.

Margaret Black is a managing director in Pearl Meyer's Los Angeles office. She is a member of the firm's Technical Services team, and has extensive expertise in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions and IRC Sections 280G, 409A, and 162(m) compliance.

Dan Wetzel is a managing director at Pearl Meyer, based in Los Angeles. He advises clients in executive and board compensation, the development of effective annual and long-term incentive compensation programs, reasonableness of compensation related to IRS assessments and litigation, and compensation plan design during acquisitions and IPOs.

Housekeeping

- Submit a question and receive your answer directly from Pearl Meyer, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.
- Tweet live during the event today with **@NACD** and **@PearlMeyer.**
- Presentation slides are available today at www.pearlmeyer.com/cic-provisions and within the webinar console.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/cic-provisions.

NACD Credentialing Credits

NACD

Your participation in today's webinar earns you credit toward maintaining your NACD credentials.

NACD Board Leadership *Fellowship*

If you're working toward maintaining your NACD *Fellowship*® credential, you will receive **1 skill credit.**

1 Skill

Fellowship Credit

NACD Directorship Certification™

If you're working toward maintaining your NACD Directorship Certification credential, you will receive **1 recertification credit.**

1 CREDIT

DIRECTORSHIP CERTIFICATION

Agenda

- Common CIC designs, plans, and features for the CEO and top executives
- What to do when a CIC is imminent
- How to evaluate your current CIC plans' ability to retain key talent, including assessing potential retention and/or transaction bonus levels and design parameters
- The critical legal and tax issues related to contracts, CIC payouts, and IRC Section 280G exposures

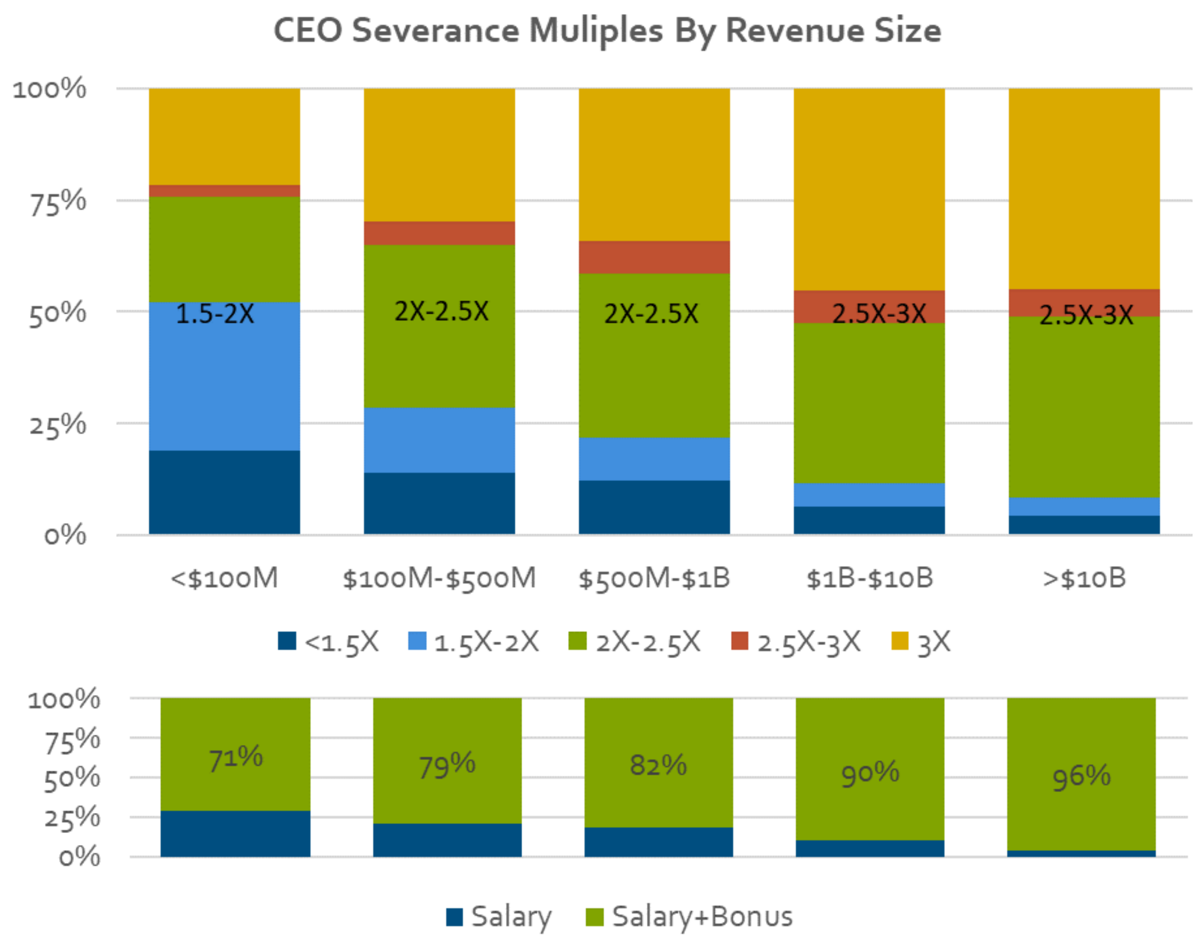
Common CIC Features – Pre-Deal

- Cash Severance – Double Trigger
- Equity Acceleration – 4-1 Double Trigger
  - PSUs generally at target performance but significant variability
- Pro-rata Bonus
- Benefits continuation common (18 – 24 – 36 months)

Source: main data group Severance & CIC provisions: R3000; March 2021

Common CIC Features – Pre Deal

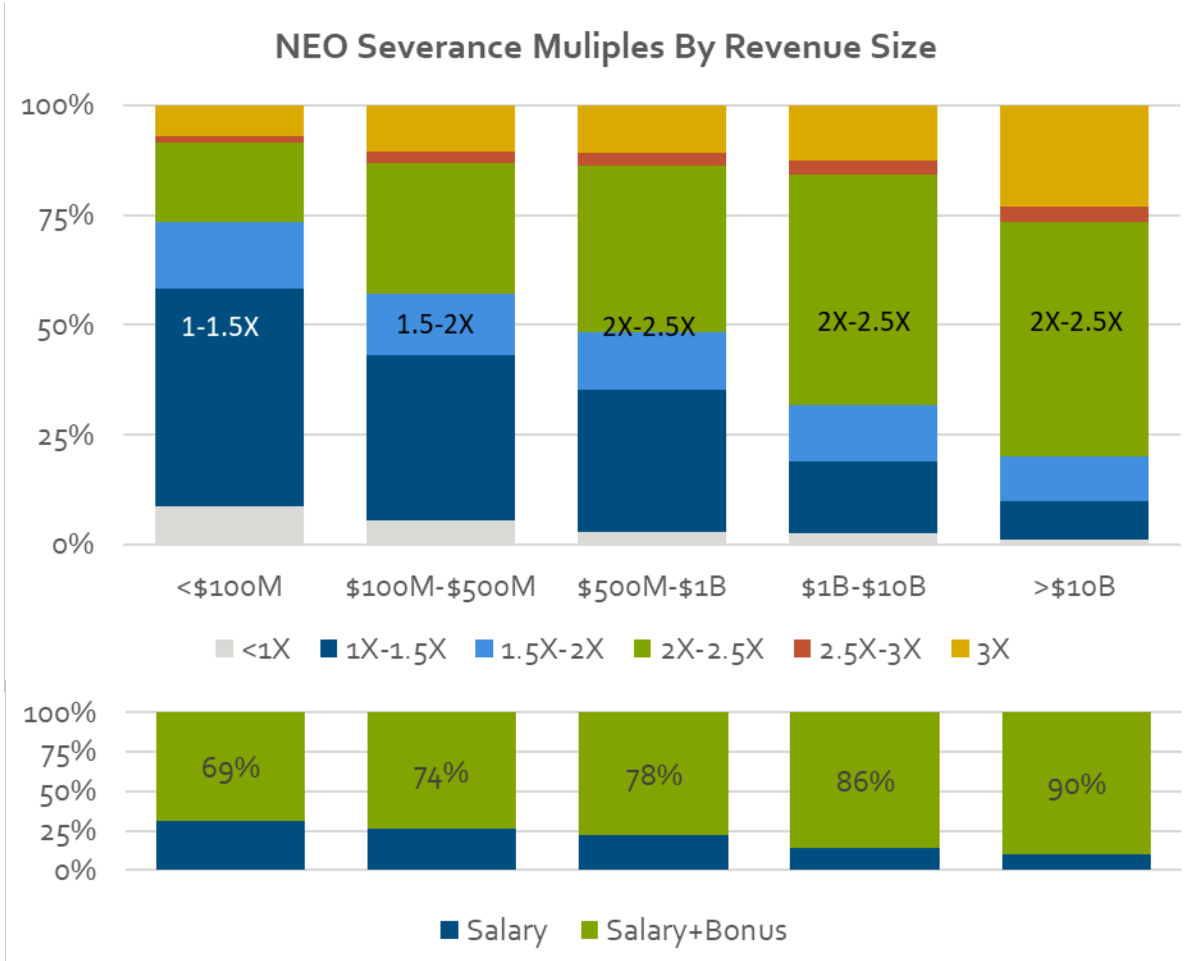
- Cash Severance – Levels



Source: main data group Severance & CIC provisions: R3000

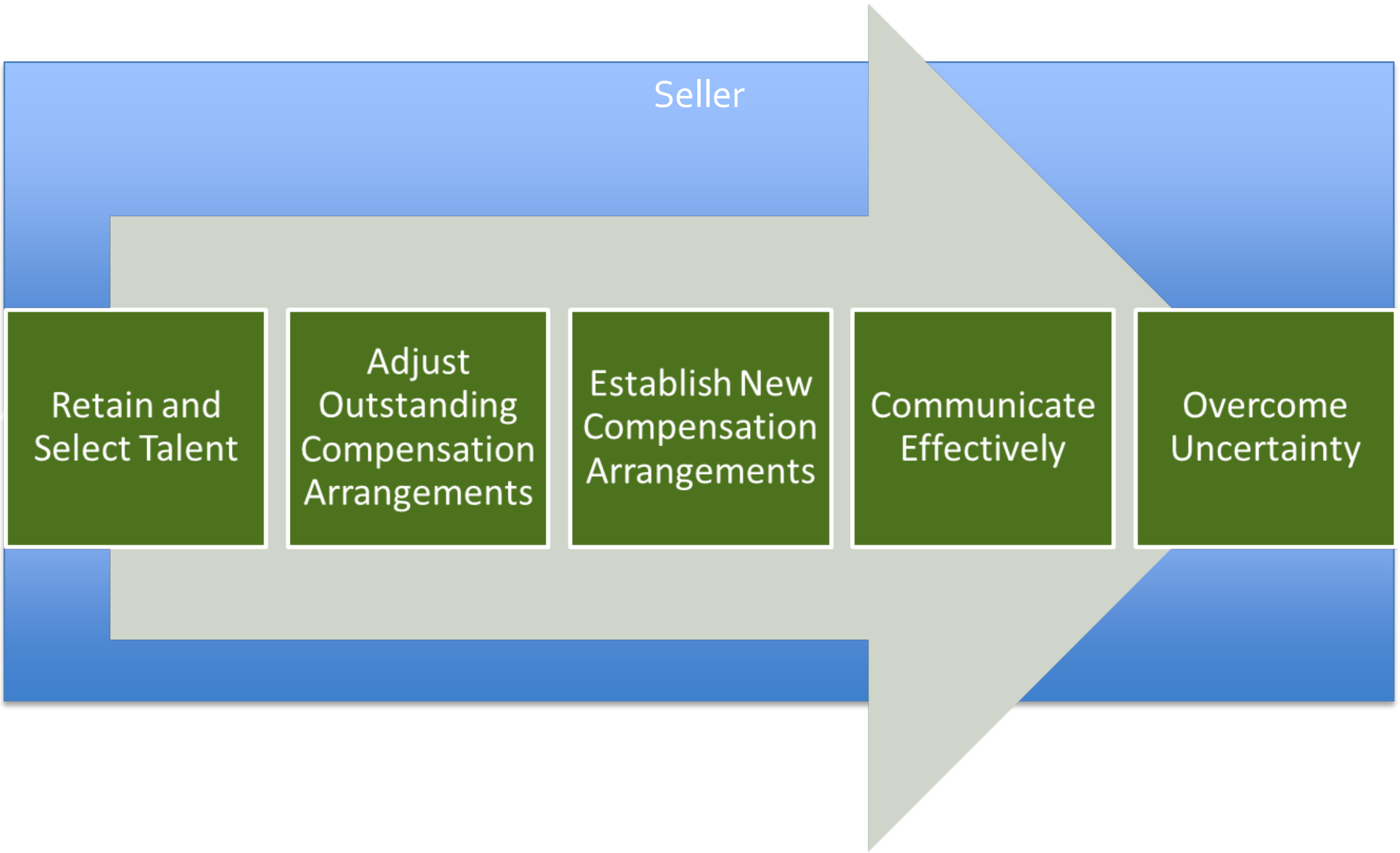
Common CIC Features – Pre-Deal

- Cash Severance – Levels



Source: main data group Severance & CIC provisions: R3000

What to do when a CIC is Imminent



What Tools are Available?

- Change in Control Agreements
- Stock / Options
- Severance
- Retention Bonuses
- Transaction Bonuses
  280G Mitigation

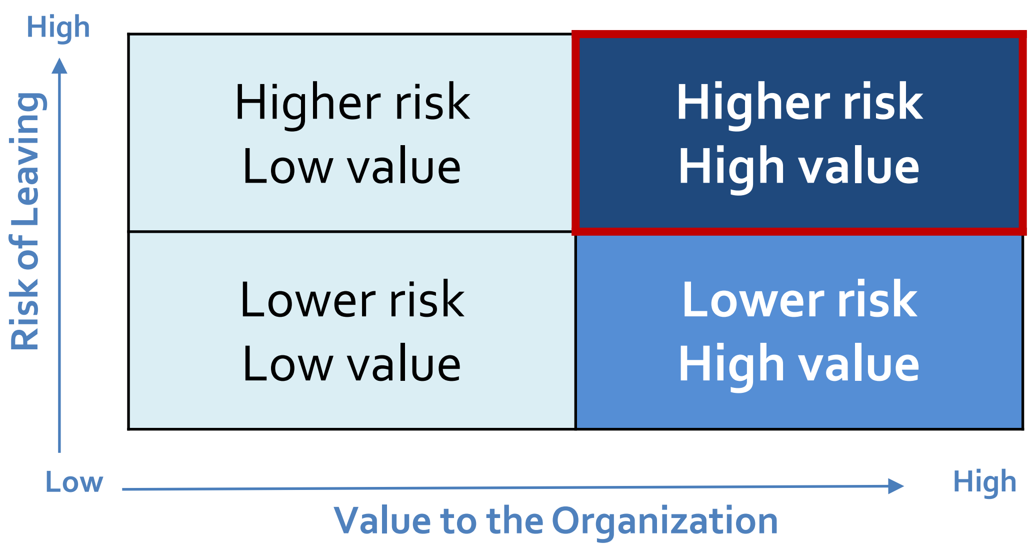
How to Evaluate

Primary reasons for amending or implementing programs

1. **Business Continuity**
   Assure protection during a period of uncertainty

2. **Delivering on Expectations**
   Deliver the business in a form and value expected

3. **Keeping the Right People**
   Motivates staff to stay and do the job required if employment termination appears imminent



How it Plays Out

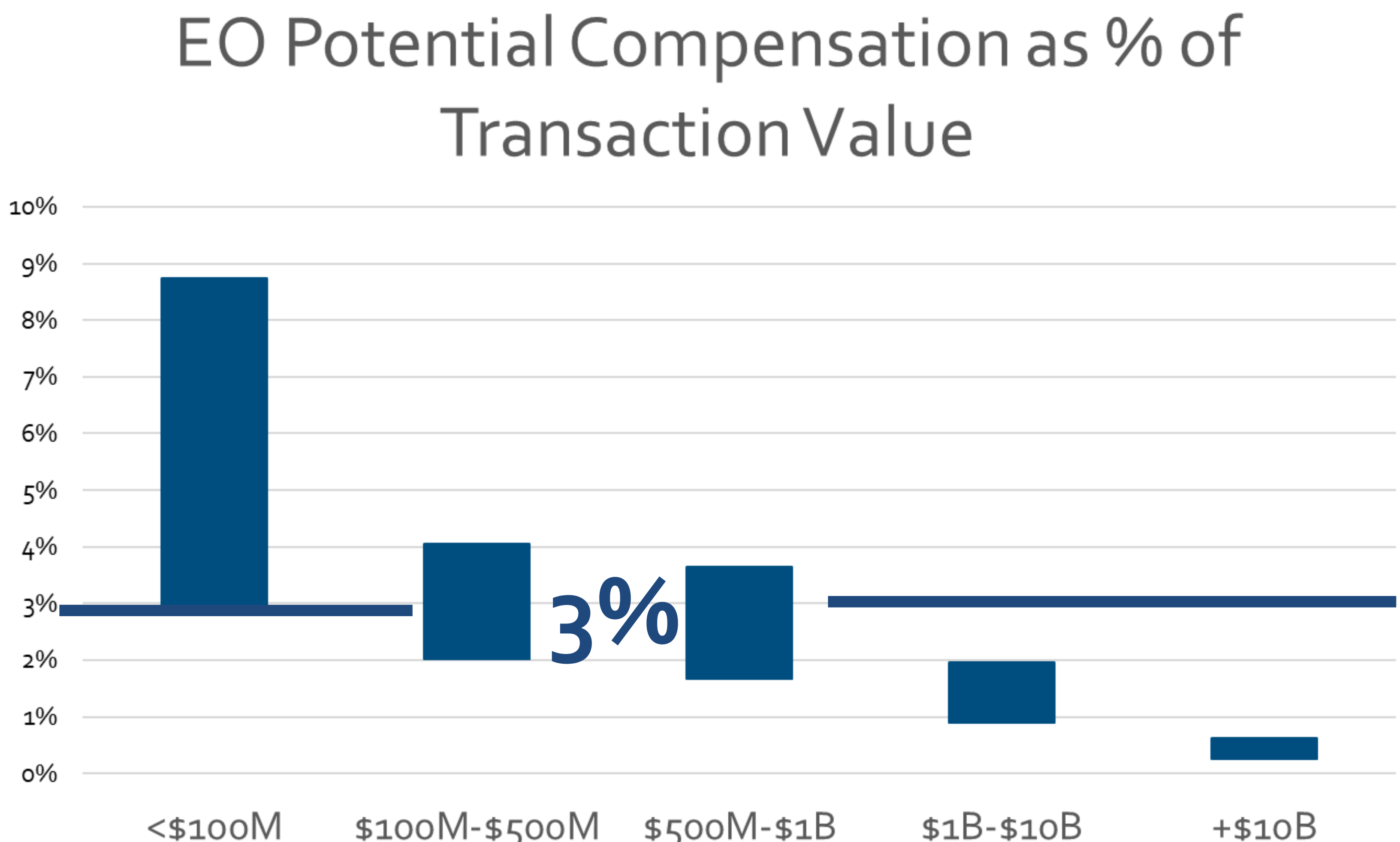
	Agmt	Equity	New Hire	At Risk	Pervcd Risk	Flight Risk	Retain to	Impact	Vehicle
CEO	✓	✓		⛔	⛔	✓	Close	⛔	✓
NEO	✓	⛔	⛔ 280G	⛔	⛔	⛔	6 Mnts	⛔	280G mitigation Retention Equity Retention Bonus Non-Compete
BU A Mgmt	⛔	⛔		⛔	⛔	⛔	12 Mnts	⛔	Retention Bonus Enhanced Severance
BU B Mgmt	⛔	⛔			⛔	✓	6 Mnts	✓	Enhanced Severance
Deal Support	⛔	⛔			⛔		Close	✓	Spot Bonus Enhanced Severance

What is Typical for EOs?

$$\frac{\text{Numerator}}{\text{Denominator}}$$

3% ?

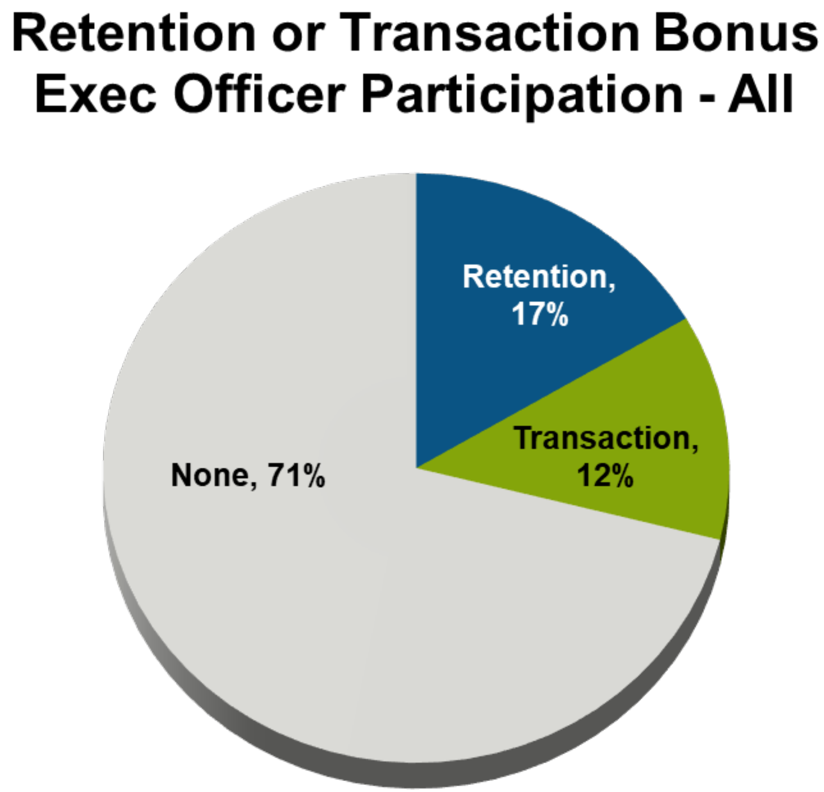
What is Typical for EOs?



Source: main data group 2016-2021 SOGP filings

Retention and Transaction Bonuses

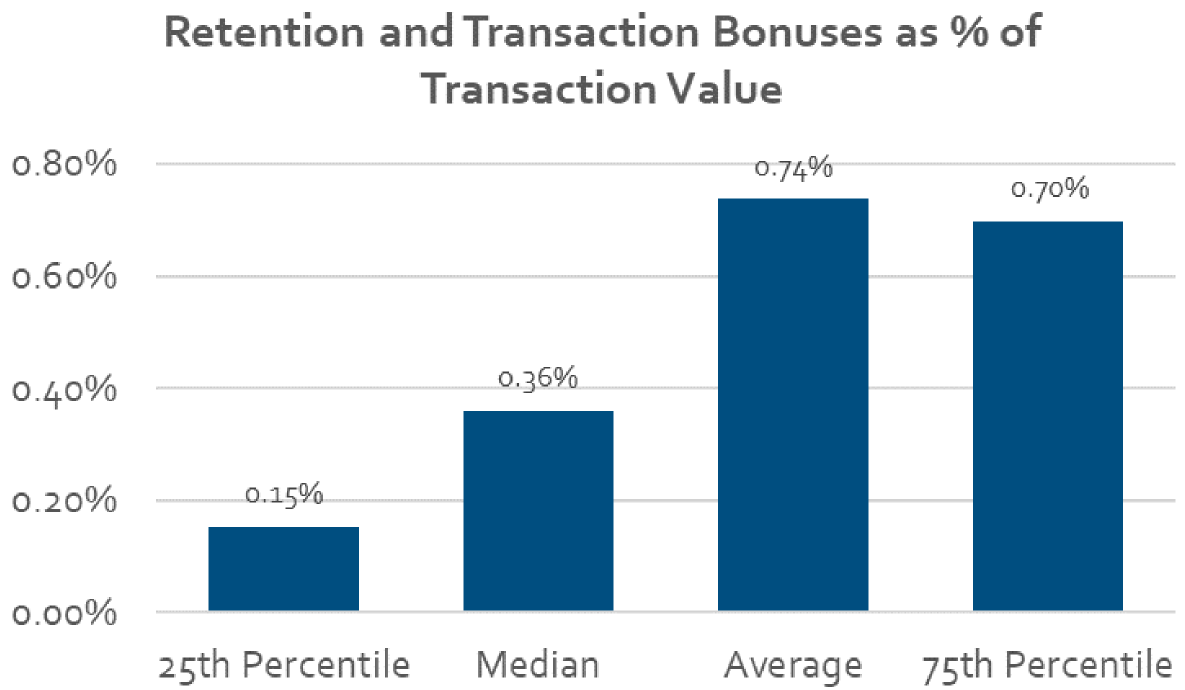
- While retention pools are common, about +30% institute retention/transaction bonuses which include executive officers



Source: main data group 2016-2021 SOGP filings

Retention and Transaction Bonuses (cont'd)

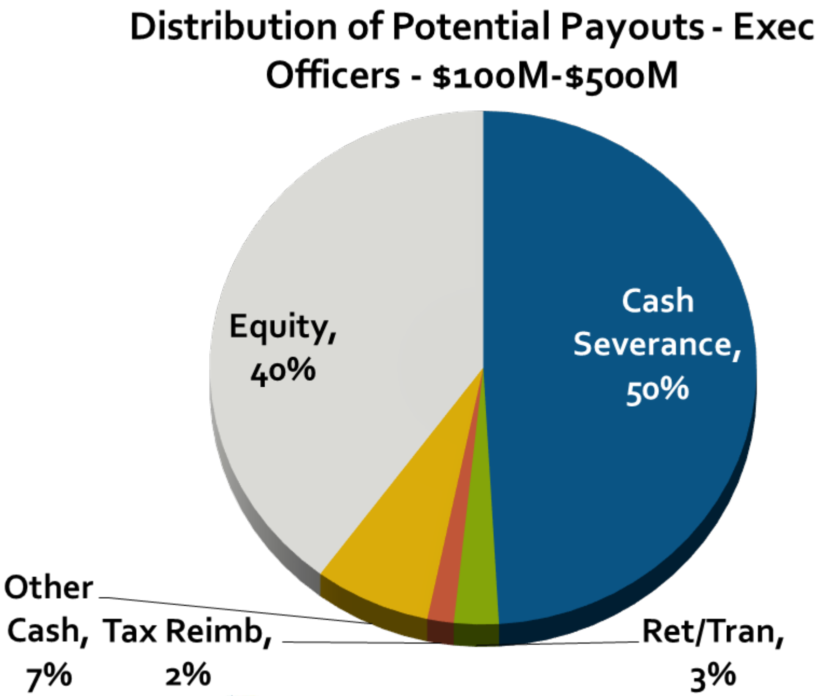
- Retention Bonuses are more common (2-1) and generally higher value than transaction pools

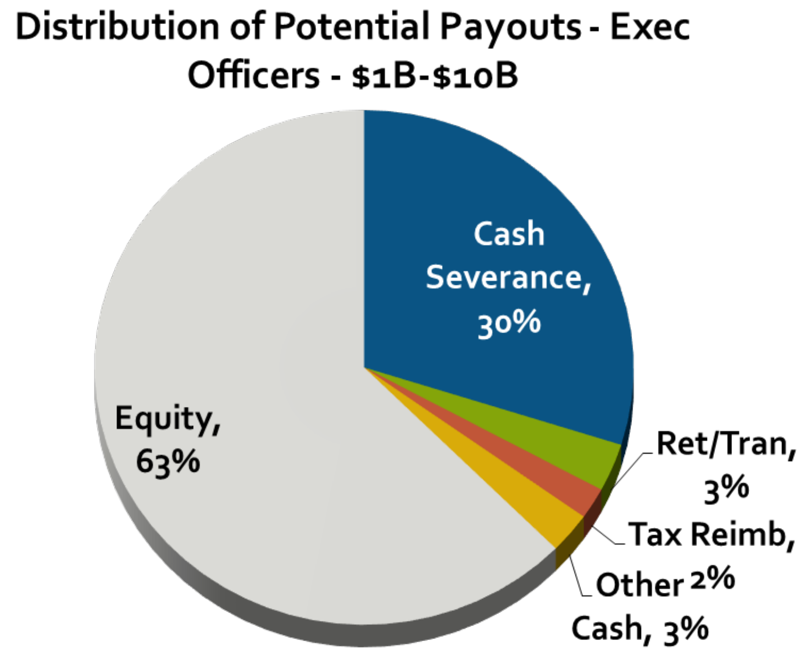


Source: main data group 2016-2021 SOGP filings

Total Potential CIC Payments By Transaction Size

- Severance is primary vehicle among smaller transactions while equity is the primary vehicle among larger transactions





Source: main data group 2016-2021 SOGP filings

280G and M&A – The Uninvited Guest

- CIC provisions exist to protect executives in the event of a transaction – they ensure focus and support even when a job loss post-closing may be likely

- If golden parachute liabilities under Internal Revenue Code (IRC) Section 280G and 4999 are triggered, anticipated CIC benefits can be significantly eroded

- Typical plan provisions include:

	Best After-Tax	Scaleback	Silent	Gross-Up
CEO	52%	7%	35%	6%
NEO	47%	7%	42%	4%

Source: main data group Severance & CIC provisions: R3000

Common 280G Mitigation Actions

Prevalence Discussing 280G Mitigation – 15%

- Increase Base Amounts:
  - Acceleration of annual bonuses, unvested time vested restricted stock or performance-shares, provided not subject to IRC Section 409A
- Allocate Value to Non-competition Provisions (Post-CIC Reasonable Compensation)
  - Illustration provided in the Appendix
- Apply Other Post-CIC Reasonable Compensation Positions (as available)
  - When executives work for some period post-closing, CIC payments can be evaluated for post-CIC reasonable compensation

Source: main data group 2016-2021 SOGP filings

Common 280G Mitigation Actions (cont'd)

- Reduce Excise Taxes by Applying Pre-CIC Reasonable Compensation (as available)
  - Illustration provided in the Appendix

- 280G Excise Tax Gross-Ups (Minority Practice)

Prevalence New 280G Gross Up in Transactions <5%

- No rationale for implementation cited in most disclosures
- Some have cited retention concerns or view that tax consequences were overly punitive when considering shareholder value delivered in deal
- To reign in costs, a few companies put limits on the $ amount of gross-ups provided or limited the benefit to just the "hardest hit" executive(s)
- New Gross-Ups typically result in failed Say-on-Golden-Parachute (SOGP) Vote

Source: main data group 2016-2021 SOGP filings

280G and M&A – A Word to the Wise

- Review CIC plans and payouts regularly to identify issues
- Avoid “back-of-the-envelope” 280G calculations
- Consider including “best efforts” language in CIC provisions, to improve cooperation amongst parties
    - For example, add contractual language that the company must cooperate in good faith with any valuations or determinations of reasonable compensation before or after the CIC

Key Takeaways - M&A Related Board Topics

Committee Activity	Timing
	During CIC
Severance Assessment/ Program Design	Begin prior to deal announcement
Retention/Transaction Bonus Planning	Begin prior to deal announcement
CIC Payment/280G Quantifications and Review	From deal negotiation through transaction close
Say-on-Golden-Parachute (SOGP) Disclosures	Required for transaction proxy materials
Year-End CIC/Transaction Pay Planning	Prior to year-end Evaluate planning actions to reduce IRC Section 280G excise tax exposures

Questions

Don’t Miss Our Next Webinar

Join NACD and Pearl Meyer for our next Compensation Series webinar on May 27, 2021 at 2:00 PM (ET)

“Human Capital Management Disclosure: Lessons Learned”

Register Today

Archives of earlier webinars in this series are available at www.nacdonline.org/webinars or www.pearlmeyer.com/knowledge-share

NACD Credentialing Information

Interested in NACD director credentials?

NACD DIRECTORSHIP CERTIFICATION

Certification.NACDonline.org

Certification@NACDonline.org

NACD Fellowship
The Gold Standard Director Credential

NACDonline.org/Fellowship

NACDFellowship@NACDonline.org

Pearl Meyer

NACD

Thank You

Appendix

Overview of IRC Sections 280G and 4999

- IRC Section 280G limits a company's tax deduction for certain payments made to executives as a result of a CIC
  - Generally, if the **present value** of CIC payments to an executive exceed his or her "safe harbor", payments in excess of the "base amount" are nondeductible to the corporation
- Base Amount
  - The average of the executive's last five years' taxable income from the company (typically Box 1, W-2 wage income) prior to the CIC
    - For executives hired during the time frame, wages are averaged over the number of years employed with wages in the hire on year annualized
- Safe Harbor – three times the Base Amount less $1

Box 1 W-2 Wages	→	Base Amount (5 year Average W-2)	→	Safe Harbor = 3 X Base Amount - $1
2020 $1,000,000 2019 $1,000,000 2018 $1,000,000 2017 $1,000,000 2016 $1,000,000		$1,000,000		$2,999,9999

Overview of IRC Sections 280G and 4999 (cont'd)

- Further, the executive is subject to a 20% excise tax on the excess under IRC Section 4999
  - **These excess amounts are termed "excess parachute payments" in the IRC**

A	B Base Amount X 3 - $1	C = A – B	D = A – Base Amount Base Amount = $1M	E = D X 20%
CIC Payments	Safe Harbor	CIC Payments less Safe Harbor	Excess Parachute Payments	Excise Taxes
$6,000,000	$2,999,999	$3,000,001	$5,000,000	$1,000,000
$2,500,000	$2,999,999	<0	None	None

Overview of IRC Sections 280G and 4999 (cont'd)

- There are various approaches commonly used in employment contracts to handle the implications of IRC Section 280G. These include:
  - Gross-up for Excise Taxes
    - Allows a company to pay an executive's excise taxes along with any associated income tax and additional excise taxes on the gross-up payments. Given the negative attention received from the press, shareholders, and shareholder advisory groups, this provision is usually found in **legacy CIC agreements** rather than newly implemented agreements
      - Full Gross-up – covers all excise taxes and any income and excise taxes. Intended to leave the executive whole for any excise taxes imposed
      - Efficient Gross-up – if parachute payments are more than a specified percentage or amount over the safe harbor, a gross-up is provided, if not, the excess is scaled back to the safe harbor

- Scaleback to Safe Harbor
  - Provides for a reduction of parachute payments to the Safe Harbor if an executive's parachute payments exceed the 2.99 times limit, no matter how far over the limitation the executive is

- Best After-Tax Provision
  - Provides for a reduction of the parachute payments to the Safe Harbor in the event that the executive is left **better off on an after-tax basis** by doing so. If not, the executive will receive all of the parachute payments and pay the associated excise taxes

- No 280G Clause
  - If there is no specific language covering the treatment of payments under IRC Section 280G, the executive will receive all of the parachute payments and pay the associated excise taxes

Overview of IRC Sections 280G and 4999 (cont'd)

- Illustration: Best After-Tax Provision
  - Total CIC Payments = $6,000,000
  - No Pre- or Post-CIC Reasonable Compensation Applied
  - Base Amount = $1,000,000
  - Safe Harbor = $2,999,999

	CIC Gross Unreduced Payments	CIC Gross Reduced Payments
Total CIC Payments	$6,000,000	$6,000,000
Scaleback to Safe Harbor ($2,999,999)	n/a	($3,000,001)
Total Payments	$6,000,000	$2,999,999
Excess Parachute Payments	$5,000,000	$0
Excise Taxes (20%)	($1,000,000)	$0
Income Taxes (40%)	($2,400,000)	($1,200,000)
Net After-Tax Benefit	$2,600,000	$1,799,999
Additional Benefit if Payments are Not Reduced	**$800,000**	

Overview of IRC Sections 280G and 4999 (cont'd)

- Post-CIC Reasonable Compensation illustration: allocating value to non-competition provisions
  - CIC Severance = $4,000,000
  - Value of two-year non-competition restrictions = $2,000,000
  - Base Amount = $1,000,000
  - Safe Harbor = $2,999,999

		CIC Payments (W/O Non-compete)	CIC Payments (W/Non-compete)
CIC Severance Payment	[1]	$4,000,000	$4,000,000
Allocation to Non-competition Restrictions	[2]	n/a	$2,000,000
Total CIC Payments	[3]= [1]-[2]	$4,000,000	$2,000,000
Base Amount	[4]	$1,000,000	$1,000,000
Safe Harbor	[5] = [4] x 3 - $1	$2,999,999	$2,999,999
Excess Parachute Payments	[6]= If [3] is > [5], then [3]-[4]	$3,000,000	$0
Excise Taxes (20%)	[6]=[5] X 20%	($600,000)	$0
Income Taxes (40%)	[7]=[4] x 40%	($1,600,000)	($1,600,000)
Net After-Tax Benefit	[8]=[1]+[6]+[7]	$1,800,000	$2,400,000
Additional Benefit to Executive		**$600,000**	

Overview of IRC Sections 280G and 4999 (cont'd)

- Pre-CIC Reasonable Compensation illustration: treating a bonus as pre-CIC reasonable compensation
  - CIC Bonus = $4,000,000
  - Pre-CIC Reasonable Compensation = $2,000,000
  - Base Amount = $1,000,000
  - Safe Harbor = $2,999,999

		W/O Pre-CIC Reasonable Compensation	W/ Pre-CIC Reasonable Compensation
CIC Bonus	[1]	$4,000,000	$4,000,000
Base Amount	[2]	$1,000,000	$1,000,000
Initial Excess Parachute Payments	[3]=[1]-[2]	$3,000,000	$3,000,000
Pre-CIC Reasonable Compensation	[4]	$0	$2,000,000
Reasonable Compensation in Excess of Base Amount	[5]=[4]-[2]	$0	$1,000,000
Final Excess Parachute Payments	[6]=[3]-[5]	$3,000,000	$2,000,000
Excise Taxes (20%)	[7]=[6]x20%	($600,000)	($400,000)
Income Taxes (40%)	[8]=[1]x40%	($1,600,000)	($1,600,000)
Net After-Tax Benefit	[9]=[1]+[7]+[8]	$1,800,000	$2,000,000
Additional Benefit to Executive		**$200,000**	