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Complex Corporate Transactions are on the Rise. What Does this Mean for Compensation and Equity Practices?

Corporate transactions can significantly impact compensation and equity practices. This article shares key considerations and actions to take when faced with resulting challenges.

As the stock market continues to set new highs over the past year, corporations are looking to unlock unappreciated value. This may occur through various channels, including merging with a company to create synergies, spinning off a company to maximize shareholder value or going public via an IPO or a Special Purpose Acquisition Corporation (SPAC). When a firm announces one of these corporate actions, there are a large number of strategic decisions that need to be made and implemented that impact employee compensation and equity practices. These projects break down into four major areas:

- IRC Code Section 280G (Golden Parachutes) considerations
- Ongoing talent retention
- Impact on go-forward equity design
- Post transaction compensation design

Ensuring your firm has access to resources to gain unique knowledge and awareness of its positioning in the marketplace will help with planning and executing when these events occur. This article further details the four key areas listed above, sharing useful questions to consider and advice for tackling even the most complex transactions.

Assessment of Change-in-Control (CIC) Liability

Companies need to assess the total potential cash payouts from CIC contracts and agreements. In addition, they must evaluate the numerous alternatives to best assist the acquirer in retaining talent, while minimizing CIC costs and reducing exposure to excise taxes. On top of first determining the cost of the CIC contracts and agreements and deciding if calculations by participant are necessary, other key so-called golden parachute considerations include:

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- Choosing who is a disqualified individual under IRC 280G and what is the value under IRC 280G. Here are some important points to remember:
  - Officer is determined based on the facts and circumstances of a company, which include authorities, term of employment, nature of duties and title
  - Highly-compensated individuals are the highest 1% of employees (rounded up)
  - Shareholders are entities who own more than 1% of the fair market value of the outstanding shares of a corporation's stock (all classes)
  - In general, IRC Sections 280G and 4999 stipulate that if parachute payments (generally payments that would not have been made in the absence of a CIC) made to a disqualified individual exceed three times that individual's base amount (average 5-year W-2 income), then the individual is required to pay a 20% excise tax on all excess parachute payments and the corporation loses all tax deductions on these excess payments
- Evaluating CIC/280G balances many strategic merger and acquisition goals. This should be conducted as early as possible in order to negotiate with the target company to develop the best business and tax decisions.
- Using a framework for evaluating each form of target equity awards and converting them to acquirer awards, including estimates of the impacts on use of cash, dilution, retention and challenges for outside the U.S. Many times, the tax-free exchange of awards for U.S. tax purposes is not tax-free outside the U.S. This is especially a concern for spin-off or IPO transactions.

Talent Retention

Corporate transactions create uncertainty for executives and employees. Therefore, adopting a retention policy for key target company employees is considered best practice. The policy should address multiple time periods, both transaction-related and go-forward, as well as numerous employee functions. Before implementing, be sure to gain insights on current market practices regarding talent retention and address the following items at your firm:

- Identification of employees eligible for retention awards
- Assessment of existing retention incentives and the potential risks
- Retention strategies relative to both retention bonus and longer-term retention mechanisms
- Development of a retention plan with types of awards and levels of rewards by retention category
- Development of one uniform retention agreement per employee function

Retention programs vary in size, length of time, type of awards, vesting requirements and strategic business goals. Creating the retention plan is only the beginning. Communication and education to key employees is also

critical for the success of the program. By following this framework and producing a sound retention policy, companies can accelerate the synergies expected during a corporate transaction.

Managing the Equity Conversion Process

Whether a merger or spin-off, evaluation of granted equity awards should be completed. How to deal with these awards will impact the deal's success and create opportunities to reward and incentivize participants. Considerations vary by the type of corporate transaction. For example, in a merger, are the awards subject to a single or double trigger vesting provision? Should cash-settled awards be cashed out or converted to equity awards? And finally, how should performance awards be evaluated: at target, actual performance or estimated?

In a spin transaction, there are additional considerations, including how the awards should be converted:

- Spin employee converts 100% to SpinCo awards?
- Parent employees convert 100% to ParentCo awards?
- SpinCo and ParentCo participants receive a combination of both company awards?

Evaluating how the conversion should be executed should balance a combination of peer practices, business goals, post corporate transaction, business growth and employee expectations. Beyond these strategic decisions, managing the conversion process can be a difficult task.

Creating a project plan focused on the impact this has on equity awards is critically important to ensure a successful conversion. This process entails coordination by a number of departments (HR, legal, finance, accounting and payroll), as well as the stock plan administrator, to develop conversion alternatives for the forms of equity and document-specific conversion decisions. Also, all U.S. and non-U.S. tax and accounting rules must be considered.

Post-Combination Executive Compensation Design

Post-corporate transaction executive compensation design includes a careful balance of many goals. After the process is complete, the company profile will have likely changed dramatically. It could be twice as large or half its original size with a new business strategy, shareholder expectations, and growth and earnings goals. This will impact executive compensation design in multiple ways. A beneficial first step is to review past executive pay practices and determine how the transaction will change the program. For example:

- Development of a go-forward executive compensation strategy and program design, including:
    - Competitive data and peer plan design data
    - Comparison of key features of the old equity program with new equity program
    - Criteria for selecting a new peer group and recommended peer companies

- Overview of equity practices and pay positioning outside the U.S.

Next Steps

Corporate transactions are complex and impact all aspects of executive and employee compensation. Whether a merger, IPO, SPAC or spin-off, each action presents unique challenges to manage executive CIC agreements, short- and long-term retention, conversion of legacy equity awards and the design and quantum of future awards, and ongoing executive compensation design.

Our data and expertise in executive and broad-based compensation, share-based evaluation, governance and global presence help us assist clients in the most complex transactions.

If you have questions about this topic and want to speak with one of our experts, please write to rewards-solutions@aon.com.

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