



Change in Control and Severance Compensation

Current Issues and Market Trends

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attorney advertisement

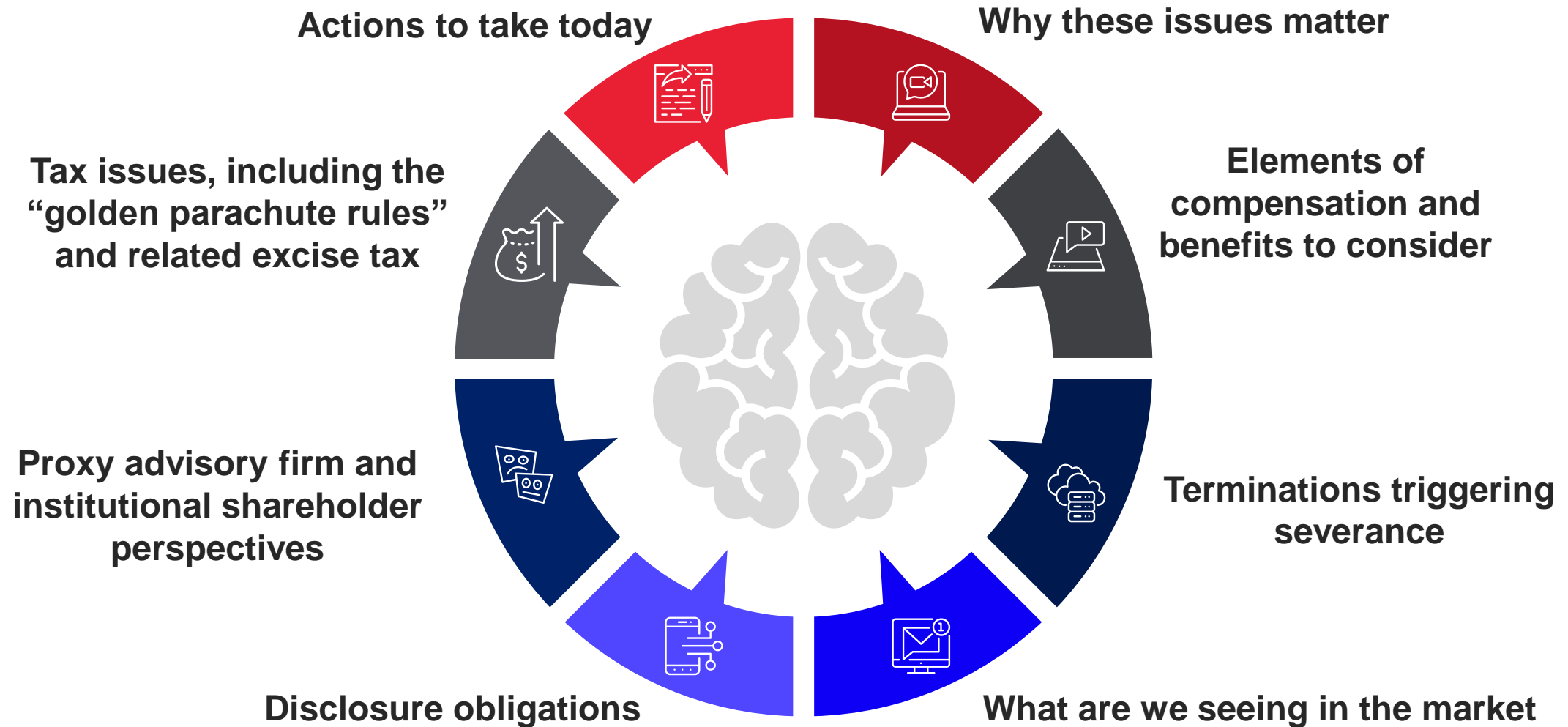
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Overview



Why These Issues Matter

- Record M&A activity in recent years
- Low unemployment rate, so easier for employees to move elsewhere
- Without adequate severance protections, employees may see little downside in proactively searching for new job if the company is seen as being in play
- Distracted, less committed workforce at just the moment when extra efforts are being demanded of employees
- Risk of loss of institutional knowledge that may be needed to ensure smooth negotiation of transaction documents and related schedules

Elements of Compensation and Benefits to Consider



Performance Awards Deserve Special Consideration

- Wording should be carefully reviewed when these awards are drafted and/or related plan/agreement provisions are structured/amended
 - For example, stating that awards vest “in full” may raise the question of whether this means target, maximum or actual
 - Stating that awards vest at target may not make sense for awards structured without a target concept and may be unfair to employee if performance is on pace to exceed target
- Special attention warranted when:
 - Designing performance awards (consider existing plan/agreement provisions that will apply unless award specified otherwise)
 - Designing/amending equity plans, CIC/severance plans or employment/individual agreements that will apply to already outstanding/future performance awards unless provided otherwise (consider whether to carve out performance awards and instead defer to award agreements)
- Appropriate CIC/severance treatment may vary based on nature of performance metrics, disclosure considerations, proxy advisory firm and institutional investor views, tax considerations, accounting implications

Change in Control Alternatives for Performance Awards

- Accelerate if not assumed (what does it mean to be assumed? do performance measures lend themselves to assumption and post-CIC measurement?)
- Assume + convert to time-based award (at what level? cliff vesting at end of original performance period?)
- Accelerate upon CIC (at what level? target? max? actual? greater of target or actual? adjust performance measures and pro-rate based on portion of performance period that has lapsed?)
- Terminate (only if less than certain percentage of performance period has lapsed or threshold level of performance not met?)
- Board's discretion at time of CIC (but consider whether this places Board in more difficult position at time of CIC; also consider accounting consequences)

Terminations Triggering Severance



Triggering Terminations: Protected Period

- In addition to the economics of the severance arrangements, it is important to consider what types of terminations of employment trigger severance payments and benefits
- Protected period:
 - Generally 12 months following CIC, although sometimes shorter
 - Some terminations during a defined period of time CIC (typically three months) may be included
 - Pre-CIC coverage is less common in broad-based arrangements than in executive arrangements

Triggering Terminations: Definition of Cause

- Qualifying terminations typically encompass terminations by the Company without Cause or by the employee for Good Reason
- The definition of Cause is typically focused on somewhat less by buyers, as it is relatively rare for a termination to be characterized as being for Cause
 - Typical prongs include failure to perform duties, negligence in performance of duties, conviction of a felony, fraud and material breach of a material agreement or policy
 - Companies should be mindful of the fact that for any termination following a CIC, the parties making the decision will likely be buyer employees (or the buyer Board in the case of an executive), such that prongs that could be more easily manipulated (e.g. “insubordination”) may be less appropriate in the CIC severance context.

Triggering Terminations: Definition of Good Reason

- The definition of Good Reason is often focused on more closely by potential buyers
- Typical prongs include a material adverse change in duties or responsibilities, material salary reduction and material relocation
- Broad-based arrangements (below the executive level) sometimes do not contain a concept of Good Reason, or limit it to the latter two prongs
- The first prong is the one of greatest concern to buyers, as the acquisition of a public company, even in a context where the business will be left to run independently, may trigger fact patterns in which executives can claim material diminishment of duties and responsibilities

Triggering Terminations: Other Good Reason Considerations

- Buyers may require that executives sign waivers stating that the changes brought about by the deal do not constitute Good Reason, while preserving the right of the executive to claim Good Reason based on a post-closing change (e.g. a demotion three months later, or a salary reduction or forced relocation six months later)
- Some companies choose to address this issue in the Good Reason definition proactively, carving out from the definition of Good Reason changes that occur solely due to the Company now being a subsidiary or division of an acquiring company

Market Data



Key Considerations for Executive Severance Provisions

- Benefit levels vary by industry, size and stage of company – detailed benchmarking against peer group is a best practice
- Consider whether to structure as a formal executive severance plan document or individual agreements
- Consider participants: typically a tiered structure focused at most senior levels (i.e. CEO and direct reports or executive officers)
- Generally, severance benefits provided for termination in connection with a CIC will often be richer and/or more robust (~70% of life sciences companies and ~60% of tech companies)

Market-Based Executive Severance Provisions

While benefits will vary by industry segment and stage of company, in the broader market for public technology and life sciences industry companies, Radford observes the following typical benefit levels:

Executive Tier	Market-Based Executive Severance Benefits			
	Executive Severance Benefits <u>Absent</u> a CIC		Executive Severance Benefits <u>Following</u> a CIC	
	Life Sciences	Technology	Life Sciences	Technology
CEO	<ul style="list-style-type: none"> 95% provide for cash severance 12-18 months cash continuation 29% include bonus 48% provide for some equity vesting acceleration 	<ul style="list-style-type: none"> 82% provide for cash severance 12 months cash continuation 26% include bonus 40% provide for some equity vesting acceleration 	<ul style="list-style-type: none"> 98% provide for cash severance 18-24 months cash continuation 74% include bonus Double trigger full vesting acceleration 	<ul style="list-style-type: none"> 92% provide for cash severance 12-18 months cash continuation 55% include bonus Double trigger full vesting acceleration
NEOs / Executive Officers	<ul style="list-style-type: none"> 86% provide for cash severance 9-12 months cash continuation 19% include bonus 36% provide for some equity vesting acceleration 	<ul style="list-style-type: none"> 71% provide for cash severance 6-12 months cash continuation 14% include bonus 24% provide for some equity vesting acceleration 	<ul style="list-style-type: none"> 94% provide for cash severance 12-18 months cash continuation 71% include bonus Double trigger full vesting acceleration 	<ul style="list-style-type: none"> 90% provide for cash severance 12 months cash continuation 44% include bonus Double trigger full vesting acceleration

Source: Aon

Key Trends in Employee Severance Policies - Cash

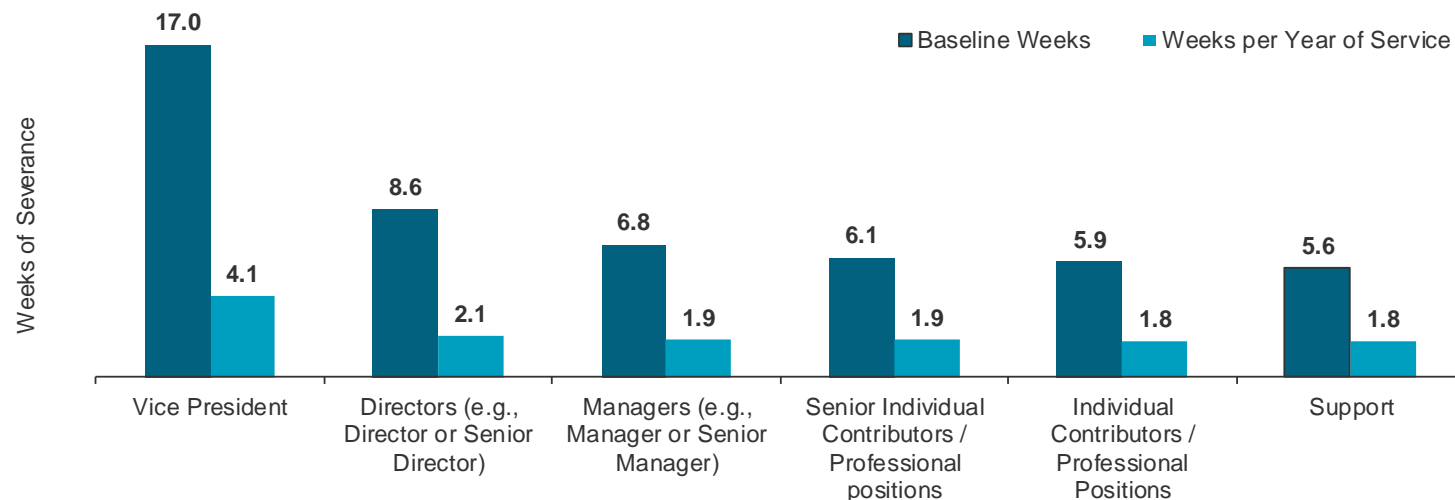
- 75% of technology industry companies report having an employee severance plan, while 57% of life sciences industry companies have one
 - Within life sciences industry companies, VP level employees are more likely to have a severance policy than the levels below
- Companies are split on how they calculate the number of weeks of severance paid:

Severance Plan Structure	Prevalence – Life Sciences	Prevalence – Technology
Rate of severance is tied to the level of the job	19%	10%
Rate of severance is tied to the number of years of service	17%	36%
Minimum rate of severance determined by level with additional pay based on tenure	31%	39%
No severance plan	33%	15%

Cash Severance: Companies with Baseline + Variable Life Sciences Industry

- Life sciences companies that provide a baseline number of weeks severance plus variable number of weeks severance per year of service offer *an* average baseline weeks of severance that is slightly less compared to companies providing baseline severance only (the gap is even more significant at the VP and Director level)
- In addition to baseline payments, companies are providing one to two weeks of cash severance per year of service, on average, at the Director level and below; VPs receive four weeks of cash severance per year of service, on average

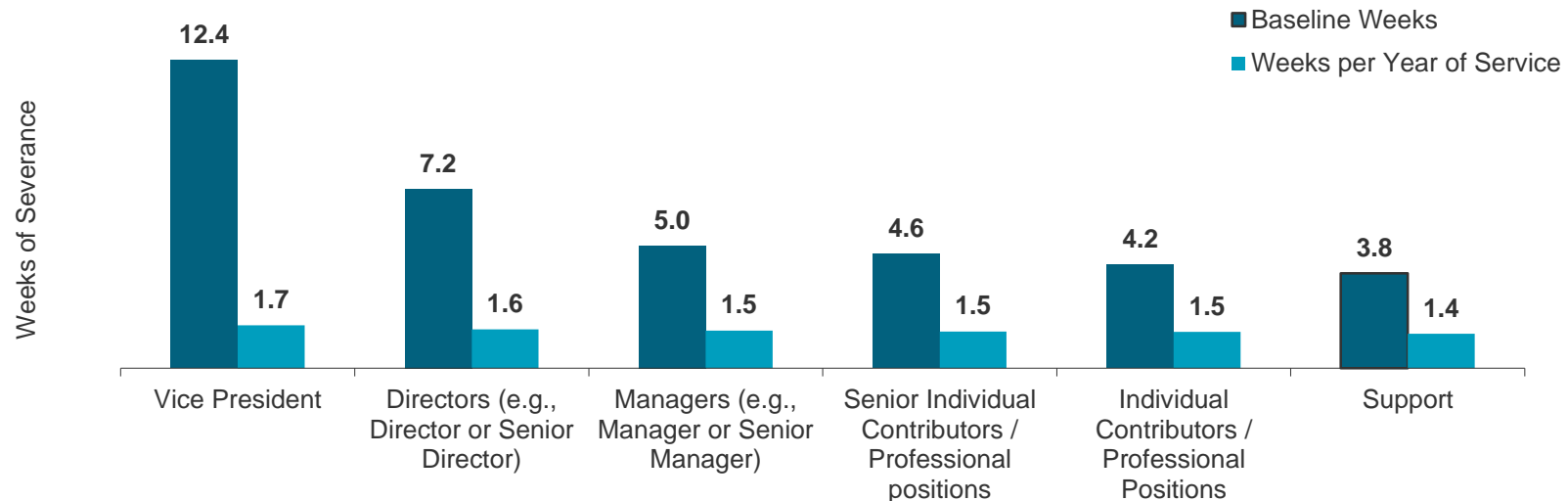
**Average Weeks of Cash Severance by Level:
Companies with Baseline Severance PLUS Variable Severance by Tenure**



Cash Severance: Companies with Baseline + Variable Technology Industry

- The average baseline weeks of severance are slightly less at technology companies that provide a baseline number of weeks severance plus variable number of weeks severance per year of service compared to companies providing baseline severance only (the gap is even more significant for VPs)
- In addition to baseline payments, companies are providing one to two weeks of cash severance per year of service, on average

**Average Weeks of Cash Severance by Level:
Companies with Baseline Severance and Variable Severance by Tenure**



Key Trends in Employee Severance Policies – Cash

- A majority of companies have a maximum cap on the number of weeks of severance provided
 - 61% of technology companies and 53% of life sciences companies
 - Typical caps are 26 or 52 weeks (6 months or 1 year)
- However, few companies require a minimum service requirement before any severance benefit is paid
 - 83% of technology companies and 91% of life sciences companies do not require a minimum employee service
- Most companies calculate severance in a not-for-cause termination plan using base salary only
 - 91% of technology companies and 84% of life sciences companies use base salary only
 - It is more common to find companies including bonus continuation in a termination in connection with a CIC

Key Trends in Employee Severance Policies – Equity

- It is uncommon to provide for any equity vesting acceleration at non-executive employee levels in the event of a not-for-cause termination
- In the event of a CIC, more companies provide for equity treatment with practices split on whether the treatment of equity awards is covered under their equity incentive plan or in a CIC plan
- Double trigger equity vesting is most common, although a small portion of companies still use a single-trigger provision for broad-based employees, most commonly at the VP level

Change in Control Equity Vesting Triggers by Employee Level

Life Sciences Industry

Survey Question: Please check all employee levels where equity vesting acceleration is provided under your CIC policy and/or your stock incentive plan

“Single Trigger” = Equity vesting accelerates after just a CIC event

“Double Trigger” = Equity vesting accelerates after a CIC event AND a termination

- At the VP level, 22% of companies report equity acceleration upon a single trigger, while 50% of companies accelerate equity vesting upon a double trigger
- At the Director level and below, 13% to 16% of companies report equity acceleration upon a single trigger and between 16% to 19% of companies accelerate equity vesting upon a double trigger

Employee Levels	Yes, Single Trigger	Yes, Double Trigger	Yes, Other	None	Not Applicable/ Not Equity Eligible
Vice Presidents	22%	50%	2%	6%	20%
Directors (e.g., Director or Senior Director)	16%	19%	3%	20%	42%
Managers (e.g., Manager or Senior Manager)	14%	17%	3%	21%	45%
Senior Individual Contributors / Professional Positions	13%	17%	2%	20%	48%
Individual Contributors / Professional Positions	13%	17%	2%	20%	48%
Support	13%	16%	2%	20%	49%

Change in Control Equity Vesting Triggers by Employee Level

Technology Industry

Survey Question: Please check all employee levels where equity vesting acceleration is provided under your CIC policy and/or your stock incentive plan

“Single Trigger” = Equity vesting accelerates after just a CIC event

“Double Trigger” = Equity vesting accelerates after a CIC event AND a termination

- At the VP level, an average of 18% of companies report equity acceleration upon a single trigger, while an average of 24% of companies accelerate vesting upon a double trigger
- At the Director level and below, between 7% to 11% of companies report equity acceleration upon a single trigger, and between 4% to 12% of companies accelerate vesting upon a double trigger

Employee Levels	Yes, Single Trigger	Yes, Double Trigger	Yes, Other	None	Not Applicable/ Not Equity Eligible
Vice Presidents	18%	24%	4%	19%	35%
Directors (e.g., Director or Senior Director)	11%	12%	4%	26%	47%
Managers (e.g., Manager or Senior Manager)	8%	7%	3%	25%	57%
Senior Individual Contributors / Professional Positions	9%	6%	3%	23%	59%
Individual Contributors / Professional Positions	8%	6%	3%	22%	61%
Support	7%	4%	3%	21%	65%

A green rectangular sign with rounded corners and a white border, tilted upwards from left to right. The word "Disclosure" is written in a bold, white, sans-serif font across the sign. The sign is supported by two vertical metal poles. The background is a bright blue sky with scattered white clouds and a sun flare in the top right corner.

Disclosure

Disclosure Obligations

- It is important to be mindful of the disclosure issues associated with severance arrangements so that disclosure does not come as a surprise
- To the extent arrangements cover executive officers, entering into or materially amending a severance arrangement generally triggers the obligation to file an 8-K
- A copy of the arrangement in question is then filed with the next 10-Q (or 10-K, as applicable)
- Named executive officer severance arrangements are described and quantified in the annual proxy in a section on payments due on termination of employment/CIC, and are addressed conceptually in the CD&A

Disclosure Obligations

- There are further disclosure obligations in the context of the merger proxy or tender offer filing relating to the deal
- Interests of executive officers in the transaction must be described, including any potential severance obligations
- In addition, the amounts payable to named executive officers, including severance, must be quantified in a detailed chart and subjected to a “Say on Golden Parachute” vote in connection with the merger
- This vote is advisory only, but there can be sensitivity in the executive population regarding the disclosure and vote

Proxy Advisory Firm Perspectives



Proxy Advisory Firm and Institutional Investor Perspectives Generally

- The following program design features are generally criticized by proxy advisory firms and certain investors:
 - Excise tax gross-up protection
 - Severance multiples $> 2.99 \times$ base + bonus
 - Single-trigger acceleration for cash severance upon a CIC
 - Single-trigger equity acceleration unless awards not assumed by NewCo
 - Modified single-trigger equity acceleration provisions
 - Liberal CIC definitions (see slide 29)
 - Perquisite continuations post CIC termination
 - Additional age/service crediting for retirement plans

Proxy Advisory Firm and Institutional Investor Views Related to Equity Plan Proposals

- **ISS** – starting in 2019, ISS equity plan scorecard model provides points based on the *quality of disclosure* of CIC vesting provisions, rather than based on the actual vesting treatment of awards
 - Disclosure with specificity of CIC vesting treatment for both time- and performance-based awards = **full points**
 - Plan silent on the CIC vesting treatment for *either* type of award = **no points**
 - Plan provides for “merely discretionary vesting” for either type of award = **no points**
- **Glass Lewis** – CIC treatment is not a major part of existing policy; GL notes in “plan features” whether there is single trigger CIC vesting
- **State Street** – single trigger vesting acceleration is one of many factors that when combined could result in vote against an equity plan
- **BlackRock** – encourages companies to use double (not single) trigger provisions

“Liberal” Change in Control Definitions

- **ISS** – a “liberal” definition of CIC will trigger a negative recommendation from ISS for equity plan proposal regardless of how well the plan fares under the rest of the ISS model
 - A definition is considered liberal when it “falls below reasonable standards of what investors may consider to be an actual CIC of the company”
 - Examples include shareholder approval (rather than consummation) of a transaction, a change in less than half of the board, an acquisition of a low percentage of outstanding stock (15% or less), an announcement or commencement of a tender or exchange offer, any other trigger “that could result plan discloses with specificity the CIC vesting treatment for both time- and performance-based awards. If the plan is silent on the CIC vesting treatment for either type of award, or if the plan provides for merely discretionary vesting for either type of award, then no points will be earned for this factor.
- **Fidelity** – will generally oppose equity plan proposals if the plan provides for the acceleration of vesting of equity compensation even though an actual CIC may not occur
- **BlackRock** – may oppose plans that provide for the acceleration of vesting of equity awards even in situations where an actual CIC may not occur

Tax Considerations



Section 409A

- Severance arrangements can raise complex tax issues, and they should be reviewed by counsel to confirm compliance with applicable law
- Section 409A of the Internal Revenue Code imposes an additional 20% in taxes (or an additional 25% for CA residents) on payments that violate its complex rules
- Severance can be structured to be exempt from 409A, or to comply with 409A, but this requires careful drafting and analysis
- Amendments to severance arrangements should also be carefully analyzed to confirm that the change does not violate Section 409A

Sections 280G and 4999

- Pursuant to Sections 280G and 4999 of the Internal Revenue Code, certain payments and benefits triggered by a transaction – or a closely related event (such as severance paid on a termination in connection with the transaction) – can result in an additional 20% in taxes and a corresponding loss of corporate tax deduction
- In connection with a transaction, the Company’s accountants will prepare theoretical “280G calculations” based on conservative assumptions (including the assumption that all executives are terminated the day after the deal)
- The accountants should be provided with copies of all arrangements covering VPs and above and any other individuals who are determined to be covered based on compensation level

Sections 280G and 4999 (cont'd)

- If amounts exceed the 280G threshold (the threshold is, in general terms, 3x the executive's five-year average Box 1 W-2 compensation) then all amounts above **1x** the average compensation could be subject to the tax
 - Double trigger equity acceleration included in severance agreements or equity agreements is often an even bigger potential issue than cash severance payments
- If executives sign new offer letters with new severance provisions in connection with the transaction, it is those new severance payments that would be relevant for purposes of the calculations
- If an executive is subject to the tax, sometimes companies will enter into tax gross-up agreements, despite the negative effect on shareholder advisory firm recommendations regarding the Say on Golden Parachute vote



DO SOMETHING
TODAY THAT
YOUR FUTURE
SELF WILL
THANK YOU
FOR

Actions to Take Today

- Take stock of existing arrangements, including any inconsistencies in treatment across the employee and executive populations, and identify groups and individuals with no current coverage
- Review both levels of benefits and also provisions governing triggering terminations (length of protected period, details of definitions) generally *and compared to market data*
- Consider whether any particular individuals need customized arrangements due to the critical nature of their services in connection with a potential transaction
- Consider how the severance arrangements relate to any retention arrangements and deal bonuses the Company may be considering
- Involve appropriate stakeholders in the conversation (finance, HR, legal, executives) and determine Compensation Committee views
- Involve outside advisors (legal, consulting, accountants)

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