Executive Compensation

Change-in-Control Benefits Can Incentivize Valuable Transactions, Protect Executives

By Ryan C. Harvey and Jessica Page

As the global economy remains strong, the pace of mergers and acquisitions will remain robust. As such, this is a good time for compensation committees to review change-in-control (CIC) protections, including arrangements for severance, payments, and other special benefits that may be tied to displacement caused by mergers, hostile takeovers, or asset liquidation.

While much attention is often given to the large size of some CIC payments to executives, there is a strong underlying governance rationale for CIC protections that align the interests of executives with shareholders. The primary rationale is to provide sufficient employment and income protection so that top executives will consider, and even seek out, corporate transactions that are in the best interest of shareholders, regardless of whether those transactions jeopardize their own employment. Effective CIC benefits are an important tool for committees seeking to encourage value-driving merger activity. These benefits should meet key design objectives, pass an external test of fairness, and avoid windfalls upon executive departures. Directors should consider the following concepts when designing CIC severance protections for executives.

■ **Participation**. Participation is typically limited to executives directly involved in the identification, negotiation, and execution of a transaction. The CEO and direct reports should be protected because they are most likely to be heavily involved in negotiating a transaction that will trigger a CIC. Occasionally there is a need to provide CIC protection below this level if certain executives are critical to implementing and successfully completing a CIC transaction. The need for CIC protections greater than general severance benefits at this level of executive is often more retentive than strategic because they are not directly involved in deciding if a deal is pursued.

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■ **Benefit levels**. Severance benefits have contracted over the past several years, primarily due to external governance pressures. Currently, executives typically receive a range of one to three times base salary plus target bonus. This range is referred to as a severance multiple. While a CEO severance multiple of three times his or her salary plus target bonus (e.g., target cash compensation) was nearly a universal norm 10 years ago, many companies have reduced the CEO severance multiple to provide from two to two and one-half times target cash compensation. Continued health and welfare benefits usually align with the severance period, and outplacement is often provided up to a certain dollar value.

■ **Excise tax**. The trend of excise tax gross-ups continues to slope steeply downward. These provisions have become a minority practice and are negatively viewed by shareholder advisory groups. They have been replaced with "best net benefit" treatment, which provides an executive with the higher payment between full severance benefits (after the executive pays their own excise tax) and the highest amount that will not trigger an excise tax liability.

■ **Other retention tools**. Severance plans can be a retention tool when used strategically. Before extending benefits to executives beyond those with merger decision power, consider the treatment of outstanding incentives. There is often an opportunity to leverage existing arrangements before increasing costs for new, enhanced CIC severance benefits.

These four topics encompass the majority of CIC severance benefit reviews. The primary objective of any CIC arrangement is to deter a senior executive from placing concern about keeping his or her job above the opportunity to close a corporate transaction that is beneficial to shareholders. CIC protection can become a critical element to ensure that shareholders receive sufficient value from a transaction resulting in a change in company control.

Ryan C. Harvey is a partner in Meridian Compensation Partners' executive and director compensation practice. Jessica Page is a senior consultant for executive pay practices at the firm.