Compensation

'Failure to Assume' May Be A Successful Change-in-Control Practice

By Thomas Ramagnano and Matthew Wolfson

In recent years, increased scrutiny over executive compensation practices by activist shareholders, proxy advisory firms, corporate governance experts, and the media generally has resulted in a number of compensation design changes. One is a shift in the treatment of unvested equity awards in the event of a change in control (CIC). This article highlights an emerging design approach in which unvested equity awards of the acquired company vest immediately upon a CIC *only* if they are not assumed or substituted into shares of the acquiring company—referred to as the "failure to assume" approach.

The treatment of unvested equity upon a CIC has traditionally followed one of two approaches. Under the most prevalent approach, unvested equity would fully accelerate solely upon a CIC, regardless of whether a subsequent termination of employment occurred (i.e., single-trigger vesting). The primary rationale for single-trigger vesting was to promote executives' financial security in the face of an acquisition. As the focus on CIC practices began to intensify, more companies moved to an approach that required both a defined corporate CIC *and* a termination of employment for vesting to accelerate (i.e., double-trigger vesting), principally in reaction to the increased scrutiny described above. However, the practical operation of a double-trigger vesting approach can prove to be problematic, especially for performance share programs.

A failure-to-assume approach is a hybrid of the single- and double-trigger vesting practices. Here, if unvested equity awards *are not* assumed or substituted by the acquiring company, vesting is accelerated immediately upon the CIC as would occur under a single-trigger vesting approach. On the other hand, if unvested equity awards *are* assumed or substituted by an acquiring company, such awards continue to vest and are typically subject to the same or substantially similar terms and conditions as applicable to the awards prior to the CIC. These "assumed" awards would then fully vest upon a subsequent employment termination occurring within a stated period of time following the CIC, typically two years (double-trigger vesting).

While the failure-to-assume approach is a minority practice, Meridian's *2014 Study of Executive Change-in-Control Arrangements* found that its prevalence almost doubled from 2010 to 2013, with approximately 20 percent of companies now using it for stock options and restricted stock/unit awards. The approach is slightly less prevalent (16 percent of companies) for performance shares, although its usage has also almost doubled over the same period. Among large-cap companies, we expect the prevalence of failure-to-assume designs to double again by later this year.

Factors to Consider

In determining whether a failure-to-assume approach may be appropriate, boards and their committees should take the following factors into consideration:

- **Consistent terms and conditions:** Under the failure-to-assume approach, equity awards generally remain subject to the same or substantially similar terms and conditions that were in place when the original grants were made.
- **Retention benefit:** Following a CIC, unvested equity that is assumed by the acquiring company will remain unvested subject to the original vesting period, providing a strong "retention benefit."
- **Proxy advisory firms:** Proxy advisory firms such as Institutional Shareholder Services (ISS) prefer that unvested equity awards not be subject to single-trigger vesting. Furthermore, ISS has indicated that it views the failure-to-assume approach to be consistent with double-trigger vesting under its new Equity Plan Scorecard.
- **Emerging trend:** As noted earlier, the failure-to-assume approach is an emerging trend that we anticipate will continue to increase in prevalence over the next several years.
- **Potential for differing treatment among participants:** Upon a CIC, treatment of unvested equity may differ among employees based on whether they are terminated (fully vest) or remain employed (assumed/substituted).

While this approach may not be a "silver bullet" alternative to the issues surrounding the double-trigger approach, it does offer a balanced approach that should be considered by compensation committees.

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