COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Transformative corporate events and compensation strategy

On March 2–3, 2016, members of the Compensation Committee Leadership Network (CCLN) convened in New York to discuss how compensation committees handle decisions related to significant corporate events, including major transactions and senior executive severance and dismissals. This *ViewPoints* synthesizes those discussions.[1]

Compensation implications of major transactions

A major transaction, such as a merger or an acquisition, can reshape the leadership team of a large corporation. Members discussed how boards can reconcile pay philosophies in ways that motivate the leaders of a new or transformed entity.

Trends in major transactions

Recent years have seen a noticeable uptick in corporate deal making. In 2014, global merger and acquisition activity hit $3.5 trillion, up 47% from 2013, driven largely by 95 deals valued at $5 billion or more.[2] That was followed by a record-breaking 2015, with more than $5 trillion in deals, including 10 valued at more than $50 billion and 69 valued at $10 billion or more.[3] Large transactions have occurred in a range of industries, including pharmaceuticals, food and beverage, oil and gas, telecommunications, chemicals, technology, and insurance.[4] Some professionals expect this robust deal activity to continue in 2016.[5]

CCLN members discussed some of the reasons for this strong transactions market:

- **Scope and scale advantages.** In the low-growth environment that many companies face, deals can enable companies to expand their customer bases or enter different lines of business.[6] One member said, *"If we aren't growing organically, we may look to grow by buying another company."* Another added, *"Once we set our strategic priorities, we look to make acquisitions to speed up our growth in those areas."* A third member said, *"An acquisition might be a good move if you have an asset that is underleveraged and could benefit from the addition of a complementary business."*

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[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] Dan Primack, "2014 Was a Huge Year for M&A and Private Equity," *Fortune,* January 5, 2015.

[3] Wallace Witkowski, "M&A Activity Tops $5 Trillion in Record 2015," *MarketWatch*, December 29, 2015; Dealogic, *Global M&A Review: Full Year 2015* (Dealogic, January 2016).

[4] Witkowski, "M&A Activity Tops $5 trillion in Record 2015."

[5] KPMG, *U.S. Executives on M&A: Full Speed Ahead in 2016* (Chicago: KPMG LLP, 2016), 3; Matt Porzio, "Looking Ahead: M&A Trends in 2016," *Forbes*, January 8, 2016.

[6] KPMG, "U.S. Executives on M&A: Full Speed Ahead in 2016," 16.

- **Available capital.** Deals have become a compelling way for public companies and private equity firms to use surplus cash.[7] In addition, historically low interest rates have made it easier for buyers to finance acquisitions.[8]
- **Tax policy and inversions.** Recent years have seen a boom in corporate inversion transactions in which US-headquartered companies have merged with foreign-parented entities and adopted the nationality of the acquired entity, thus lowering their effective tax rates. For example, last year's largest announced transaction, the proposed $160 billion combination of US-based Pfizer and Ireland-based Allergan, would lower Pfizer's effective tax rate from 25.5% to 17%–18%.[9] For an American company to invert to a new jurisdiction, US law requires the company's shareholders to own less than 80% of the equity in the combined company, and the US Treasury Department recently implemented rules to make it more difficult to circumvent that threshold.[10]
- **Pressure from activist investors.** According to a survey of 94 activist campaigns initiated in 2015, 55 included a push for a major transaction.[11] In some cases, activists encouraged companies to sell divisions or spin off specific business units into separate companies; in others, they pressed companies to make acquisitions or to sell themselves to third parties.[12]

Compensation considerations in different types of transactions

Compensation and personnel decisions are often among the most important considerations in a deal. One member said, *"In many deals, the most valuable asset we are buying is the talent. Boards have to assess what to do to keep key employees."* Members used three scenarios as they considered how compensation comes into play:

- **Major combinations.** In deals where the two parties are similar in size, the resulting entity can be a true combination, with people, assets, and other strategic elements of each of its predecessors. For example, as part of Dow Chemical and DuPont's recently announced plan to merge into a $130 billion company, Dow CEO Andrew Liveris will become executive chair of DowDuPont, while DuPont CEO Edward Breen will serve as chief executive.[13] Members said that when the senior management team of a new entity consists of leaders from both organizations, many if not all executives will have to operate under a new incentive scheme, with new metrics, goals, and thresholds. Members stressed the importance, in these cases, of taking time to establish a compensation philosophy for the new entity. One explained, *"The compensation committee should give itself some flexibility to assess the new management team and its priorities. Changes in size and scope add complexity, and we don't need to get*

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[7] Ibid., 14.

[8] Dana Cimilluca, Dana Mattioli, and Shayndi Raice, "Rising Optimism Fuels Deal Rebound," *Wall Street Journal*, April 8, 2015.

[9] Jim Puzzanghera and Samantha Masunaga, "Pfizer and Allergan's $160-Billion Pharmaceutical Merger Puts New Twist on Tax-Avoiding Inversions," *Los Angeles Times*, November 23, 2015.

[10] Richard Rubin, "U.S. Unveils Rules to Make Corporate Inversions More Difficult," *Wall Street Journal,* November 19, 2015.

[11] Gibson Dunn, *2015 Year-End Activism Update* (Los Angeles: Gibson, Dunn & Crutcher LLP, 2016), 2–4.

[12] Ibid., 2–16.

[13] Jack Kaskey and Simon Casey, "Dupont, Dow Chemical to Combine in Merger of Equals," *Bloomberg*, December 11, 2015.

everything fixed on day one." Another added, *"In a merger, you don't automatically double the pay, but if the combined entity is successful, pay is likely to increase significantly over time."*

- **Strategic acquisitions.** In the majority of mergers, acquisitions, and similar deals, one party is effectively buying the other for some strategic purpose. Members indicated that there are challenges in integrating employees in these cases, especially when the acquiring and target companies differ significantly in size, maturity, geographic location, or compensation philosophy. In particular, members described some of the difficulties that large companies face when acquiring smaller ones. One said, *"There are particular challenges when you buy a start-up, especially granting equity compensation. Big companies cannot compete with a start-up in terms of the potential for equity growth, but we can change our equity plans to provide different kinds of incentives to these new employees."* Another said that acquiring founder-driven companies can be especially tough: *"Normal incentives are misaligned for many entrepreneurs. They usually have a higher risk tolerance than the acquiring organization, and you can't pay them enough to offset these differences."* Members also discussed the broader decision of whether and how to integrate smaller companies into the parent organization. One said, *"When we buy a company with an agile culture, we want the people to go to other jobs in the company and bring that cultural background with them. That is part of the value they bring."* However, one member cautioned, *"An attempt to smash together the cultures of a big company and a small start-up can be a disaster."*
- **"Acqui-hires."** In some cases, the driving force behind a deal is to acquire a company's workforce, rather than its products or services. Members said that these deals are usually done to acquire talent with particular knowledge or expertise, such as computer programmers or engineers, and generally do not result in adding new officers. While a substantial portion of the acquisition price in these deals is often earmarked for employee retention,[14] members noted that in the long run financial considerations are not always enough to satisfy these employees, some of whom have strongly held views about working at large companies. Another member suggested minimizing disruption: *"The trend is to do as much as you can to keep their compensation plans and corporate culture unique and only make changes when necessary. That could include keeping an outpost in a place where they want to be."*

The timeline for personnel decisions

Members discussed the lifecycle of a transaction and the different milestones at which companies and their boards must make decisions about key personnel. These include choices about who will manage the combined entity and how those leaders will be compensated in both the short and longer term.

Pre-agreement considerations

In the early stages of a major transaction, directors consider who would best serve in the very top roles of a merged entity and how these new colleagues would work together, all with the caveat that a deal may not be consummated. While these discussions are occurring, boards must protect against the risks associated with a potential transaction, including employee departures and low productivity. Members emphasized that it is

[14] Danielle Naftulin, "So You're Being Acqui-Hired…" *Cooley GO* (blog).

critical for management's motivations to be aligned with the company's best interests and not with their own job security. This can be particularly challenging when part of an acquirer's diligence is an assessment of the management team. One member said, *"When the CEO is considering a deal, you have to caution them not to talk about their own job or compensation as part of the negotiations."*

Spin-offs and splits

Major transactions are not always about increasing the size of a company. In some cases, boards conclude that disparate business units would be more profitable as independent companies, allowing different management teams to focus on different strategic challenges. Recent examples include Xerox's announcement that it will split into two public companies, Symantec's sale of its data storage and recovery business to private equity investors, and Fiat Chrysler's initial public offering of shares of its Ferrari subsidiary.[15] One member observed, *"There can be benefits to getting rid of business units if there is no strategic rationale for them being part of the portfolio."* Another said, *"Smaller companies are just run better. I don't see many exceptions."*

Boards are presented with different challenges when they reshape a company by divesting some of its assets. Members said that these deals present boards with challenging questions about compensation for the executive team of a firm that has suddenly become smaller. One member explained, *"If you split the company in half, do you cut executive compensation in half too? Do you need to change the peer group? If the company is smaller, then compensation should usually be lower. But management needs to be able to look dispassionately at transactions that could create shareholder value."* Another added, *"It is hard to tell someone who is a phenomenal CEO, who does all the right things, that he or she won't be making as much money because the company's revenue will decrease as a result of the deal."*

Members also discussed the opportunities that spin-offs create. One said, *"If you do a major spin-off, some executives will gain and some will lose. At the new company, you usually have someone who was a division head who is now a CEO."* Another member amplified that point: *"A company that was spun out tends to have an executive group that was underpaid, relative to their new roles. That gives the board an opportunity to rethink things and establish new targets."*

Post-agreement/pre-closing negotiations

Once the terms of a deal have been agreed upon, companies and their boards may face numerous decisions related to combining workforces. Members said they like to identify the employees that are critical to the ongoing success of an acquired entity as early as possible. Companies often create bonus pools for those employees so as to pay retention awards a year or two after the deal closes. One member acknowledged the inherent imperfections of the selection process for such a bonus pool: *"We were overinclusive when*

[15] Dana Mattioli, David Benoit, and Drew Fitzgerald, "Xerox Plans to Split in Two; Carl Icahn to Get Three Board Seats," *Wall Street Journal*, January 28, 2016; Danny Yadron and Chelsey Dulaney, "Symantec to Sell Veritas to Carlyle-Led Investor Group for $8 Billion," *Wall Street Journal*, August 11, 2015; Thomas Ebhardt, "Ferrari Spinoff Generates $4 Billion Windfall for Fiat Chrysler," *Bloomberg*, October 12, 2015.

selecting whom we put in the pool. We wouldn't have put some people into the pool if we knew then what we know now." Members said that it was important for the compensation committee to have detailed conversations with senior executives so that everyone understands how pay will change following the closing. One said, *"As you approach the deal closing, you should discuss the new peer group and the new pay philosophy."*

Post-closing integration

No matter how much planning a company does in advance of a closing, most of the work cannot be completed until the deal is done. Members said that getting the integration right is often more important than coming up with perfect deal terms. It is important, they added, to use integration as an opportunity to consider whether to design a new compensation plan, rather than simply adapting the practices of one of the predecessor companies. One said, *"Especially when there are significant differences in compensation, you need to come up with a plan that fits the new entity."*

It is also important to focus on integrating not just compensation philosophies but also employee cultures. According to one survey, the main cause of mergers failing to meet expectations is clashing cultures: "In a culture clash, the companies' fundamental ways of working are so different and so easily misinterpreted that people feel frustrated and anxious, leading to demoralization and defections."[16] One member said, *"There is a tendency, if you are the acquirer, to force your culture onto the acquiree. A lot of value can be lost that way. Conversations about integrating culture must be taken seriously."*

Executive severance and dismissals

Many of the critical decisions that boards must make about executive hiring and retention relate to severance provisions. Whether a dismissal is part of a change in control or simply the ordinary course of business, CCLN members emphasized the importance of putting thoughtful programs in place that give managers license to make decisions that are in the best interest of the company. Members also discussed how boards approach CEO terminations.

Change-in-control provisions

Change-in-control (CIC) provisions allow for payments to be made to certain key employees in the event of a merger or acquisition that results in a termination or substantial job downgrade. Members discussed the rationale for CIC provisions; one member said, *"Change-in-control provisions are an inducement that is requested in every negotiation. We provide it to get candidates to accept employment."*

In the current environment, where a deal is a possibility for nearly any company, it is important to create provisions that motivate senior executives to consider transactions that will generate value for shareholders, even when such deals could put their jobs at risk. One member said, *"As an investor, I want strong change-in-control provisions in place, because I want management to consider alternatives."* Beyond encouraging managers to consider deals, these provisions also provide employees with a level of comfort that allows them

[16] Dale Stafford and Laura Miles, *Integrating Cultures After a Merger* (Boston: Bain & Company, 2013).

to do their jobs effectively.[17] One member said, *"As a director, my bias has been to be as fair to employees as you can be. It is worth the money to provide key people with peace of mind in a time of uncertainty."*

Members discussed some of the key elements they consider including when creating or amending a CIC program:

- **Double trigger.** This refers to a provision that requires both a change in control and a qualified termination to make an individual eligible for compensation.[18] Members indicated that it has become uncommon to provide CIC benefits absent a qualifying change in employment status. However, in some cases, even absent a termination, the second trigger can be pulled when the acquirer does not assume or provide a substitute for unvested equity awards.[19]
- **Amount of compensation.** The amount of money that an employee is eligible to receive upon the triggering of a CIC provision is ordinarily tied to his or her role at the company. It is common for the CEO to receive three times his or her salary and target bonus, and for other executives to receive some level below that, depending on their roles.[20] Members suggested that it was important to ensure that these provisions calculate severance pay based on target, rather than maximum, bonuses. One member said, *"Paying a maximum bonus as severance is not within the goal of keeping management neutral."*
- **Eligible employees.** Members also debated which executives should receive CIC benefits. One said, *"It should be a very small group. Usually, it doesn't involve the divisional executives; it is for the corporate team because those people are most at risk when control changes."* In some cases, companies winnow the pool of eligible employees in response to pressure from shareholders and other stakeholders.[21] Members also noted that often the employees who would benefit most from severance are the ones who are not eligible to receive any or receive the smallest amounts.
- **Unvested equity.** Members also consider equity awards that remain unvested at the time of a change in control. Most CIC provisions provide for accelerated vesting and some form of prorated payout.[22]

Executive dismissals

In recent years, dismissals have accounted for a shrinking portion of CEO departures; less than 16% of CEO turnover in 2014 was due to dismissal.[23] CCLN members cited improved executive assessments and more open communication and feedback as reasons for the decline in dismissals. One member said, *"Historically, there have been problems when an executive gets great evaluations year after year, then gets hit with the*

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[17] Meridian Compensation Partners, "Change-in-Control Arrangements," *Insights* (blog), December 16, 2015.

[18] Ibid.

[19] Thomas Ramagnano and Matthew Wolfson, "'Failure to Assume' May Be a Successful Change-in-Control Practice," *NACD Directorship*, July/August 2015.

[20] Meridian Compensation Partners, "Change-in-Control Arrangements."

[21] Ibid.

[22] Ibid.

[23] Conference Board, "CEO Dismissals in the US at the Lowest Level in a Decade, the Conference Board Finds," news release, April 14, 2015.

message that he should have been fired two years ago. Boards are getting better at providing evaluative communication on a regular basis."

CCLN members considered appropriate practices for a board that loses confidence in its CEO. They lamented that this process frequently lasts many months. One explained, *"Part of it is reasonable. Typically, after a bad year, we give a CEO the opportunity to make changes. But eventually the question of whether to make a change at the top needs to get on the table."* The decision to change CEOs often crystalizes during executive sessions of the independent directors. One member noted, *"If the independent directors have negative conversations about leadership over a series of meetings, it may be apparent that you need to make a change, even if the board doesn't fully realize that they are unhappy."*

Members emphasized that when a board is deciding whether to terminate a CEO, it is important to have someone on the board take control of the process. This is particularly critical when the board's review is conducted in secret: *"With most dismissals, we have human resources involved and driving the process. That isn't the case with a CEO dismissal. The pieces don't always come together without a strong owner for the process,"* one member explained. Another member suggested involving outside counsel in the process to ensure that the board takes all the proper steps and considers the legal consequences of its action. Counsel may be especially useful when the board is required to negotiate the terms upon which a CEO leaves the company. One member said, *"There are consequences to the language we use. What we say in the press release may be different than what we want to say in the proxy."*

Severance outside of a change in control

Even with executive dismissals on the decline, members said that agreements that provide severance in connection with not-for-cause dismissals can be valuable for executive retention, especially where there is competition for key employees. Ordinarily, these agreements are part of an employment contract and provide compensation when an executive is dismissed without cause; in some cases, they also provide compensation when an executive resigns for good reason.[24] In return for this agreement, companies often agree upon non-disparagement, non-solicitation, and non-compete provisions with these executives.

Some members raised concerns that payments made to an executive upon dismissal are not the best use of shareholder resources. One said, *"We have to be careful. You don't want to overpay the people you are firing, especially if it is a close call on whether the person should be fired for cause."* As a result, some members were unwilling to provide this form of severance, absent extenuating circumstances. Boards do enter into prior severance arrangements, however reluctantly, when a company is trying to attract a senior executive who would be taking a significant risk by joining. One member said that these agreements have implications for people beyond the one receiving the severance: *"Treating the outgoing person fairly is a relief to the person coming in."*

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[24] Meridian Compensation Partners, "2015 Study of Executive Severance Arrangements Not Related to Change In Control," *Insights* (blog), December 16, 2015.

Compensation committees are charged with creating incentives that empower leaders to consider, without bias, all of the options available for maximizing the benefits they deliver to shareholders. CCLN members emphasized that whether or not a company undergoes a transformative event, a company is better off having planned for and considered all of its options.

About this document

Appendix: Contributing members

The following members participated in the meeting:

- John Anderson, Meridian Compensation Partners
- Karen Horn, Eli Lilly
- Bill Kerr, Interpublic Group
- Linda Fayne Levinson, Hertz Global (*CCLN alumna*)
- Laurie Siegel, CenturyLink
- Samme Thompson, American Tower
- Marc Ullman, Meridian Compensation Partners
- John Wulff, Moody's

The following members took part in pre- or post-meeting discussions:

- Mel Lagomasino, The Cola-Cola Company and Avon Products
- Steve Reinemund, Marriott