Professional Perspective

Executive Compensation & Public Company M&A Transactions

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Executive Compensation & Public Company M&A Transactions

Editor's Note: This article is part of an ongoing series exploring executive compensation considerations in different types of M&A transactions.

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This article provides a high-level overview of the key executive compensation matters that arise in acquiring a publicly traded company. Identifying and appropriately dealing with these matters is critical to the overall success of the transaction. They can be a source of potential liabilities to consider when determining the price that an acquirer will pay for the target company. They also help ensure that key employees of the target are appropriately incentivized through the closing of the transaction and through any post-closing integration period.

Compensation workstreams for an acquirer will vary from one transaction to another but typically include due diligence of the target corporation's compensation arrangements, drafting and negotiation of the compensation-related provisions in the transaction agreement, review and preparation of public disclosure of the transaction and related compensation arrangements, and implementation of new compensation arrangements for key employees of the target company.

Executive compensation practitioners should be engaged at the beginning stages of the transaction and remain in close contact with the broader deal team throughout the transaction. This is critical to ensure these matters achieve optimal outcomes to support the success of the overall transaction and post-closing integration.

Due Diligence

One of the first steps for an acquirer is to conduct a thorough due diligence review of the target company's compensation arrangements. The purchase price in the acquisition of a public company generally is set at the time the transaction agreement is signed without any subsequent adjustments. Therefore, it is imperative to determine all potential items that may impact the purchase price as far in advance as possible so that all potential liabilities can be appropriately factored into the purchase price.

Focus & Scope of Review

In addition to gaining a comprehensive understanding of the target's compensation program, the due diligence review should focus on determining any potential liabilities that may be triggered in connection with the transaction—including a related termination of employment—and identifying any tax, securities, or other legal compliance issues with the target's arrangements. The results of the review often are communicated through a dedicated attorney-client workstream and usually are relayed to the broader deal team through the form of a due diligence report that summarizes the terms of the compensation arrangements and related potential liabilities.

The scope of review generally includes employment agreements, offer letters, and other individual compensation agreements; equity incentive plans and award agreements; cash incentive and severance arrangements; retention, transaction, change in control, and similar types of bonuses; nonqualified deferred compensation arrangements; and perquisite or other enhanced benefit arrangements. In "mergers of equals" and similar transactions, reverse diligence review of the acquirer's arrangements also may be an area of focus.

Obtaining Materials

Copies of many of these arrangements should be publicly available as attachments to the target company's Forms 10-K or 10-Q—and sometimes other filings, including Forms 8-K and S-8. Summaries of the target's executive compensation program also will be described in more detail and, for the prior fiscal year, quantified for the top executive officers included in the target's annual proxy statement. Additional information about the target's stock-based compensation must be included in the notes to the audited financial statements attached to its Form 10-K filing.

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While publicly available materials will help to provide an understanding of certain arrangements, it is important to review other materials that are not included in the target's public filings. These materials typically will be included in an electronic data room made available by the target and generally will include employment agreements and other similar arrangements with individuals below the senior executive level; employee census data; a schedule of outstanding equity awards and key terms; and cash bonus, severance, and non-qualified deferred compensation plans that are not publicly filed.

To ensure that all applicable materials are provided by the target, the acquirer should create a comprehensive due diligence request list that asks the target to provide copies of all relevant materials in the data room or to specifically confirm that the requested materials do not exist. If possible, a follow-up due diligence call with the target's management team and other compensation professionals—including the target's counsel—also may be helpful to gain a deeper understanding of the terms of the arrangements, the target's compensation-setting process in general, and any potential changes that are contemplated.

Transaction Agreement & Disclosure Schedules

The terms and conditions of the transaction are set forth in a transaction agreement, often in the form of a merger agreement, along with a set of accompanying confidential disclosure schedules that includes exceptions to certain representations and additional compensation covenants. The provisions that are most relevant to executive compensation matters generally will include treatment of the target's equity awards, employee benefit representations and warranties, interim operating covenants regarding compensation actions that are restricted between signing and closing as well as exceptions to those restrictions, and post-closing covenants regarding the treatment of compensation arrangements for the target company's employees after the transaction closes.

Representations & Warranties

The transaction agreement will include a set of representations and warranties made by the target on various matters relating to its business, operations, and contractual arrangements, including representations and warranties covering the target's compensation arrangements and outstanding equity awards.

In a transaction involving a publicly traded target company, the representations and warranties generally will not survive the closing of the transaction and generally will not be subject to any post-closing indemnities. As a result, the representations and warranties are used most often as a source of information that can serve as a backstop to the acquirer's due diligence process and typically will require the target to provide the acquirer with a list of all relevant compensation arrangements, information on whether any payments will be triggered under those arrangements in connection with the transaction, and disclosure about any compliance or other legal issues involving the arrangements.

Treatment of Target Equity Awards

If the target company has outstanding equity awards—which almost always will be the case for a publicly held company—the transaction agreement will include covenants providing the treatment of target equity awards at the closing of the transaction. The types of equity awards that may be issued by a target corporation may include stock options, restricted shares, restricted stock units, and performance shares or performance units.

It is essential to analyze the contractual treatment of target equity awards under the applicable equity plan, award agreements, and other applicable arrangements to understand whether certain equity award treatment is required or alternative treatment is permitted without participant consent and to inform negotiation between the parties. Typical treatment can include full or partial accelerated vesting and either cancellation of outstanding awards for cash payments at the closing based on the per-share transaction consideration or the assumption of outstanding awards by the acquirer, as equitably adjusted to preserve the value of the awards.

The treatment of target equity awards that are subject to performance conditions can be particularly tricky. These awards frequently are the subject of negotiation between the parties on how to determine the level of achievement of any performance metrics, particularly for awards that will vest upon closing with a partially completed performance period closing, or when performance will be measured at closing, but the award will be converted into service-vesting acquirer awards.

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In each case, the acquirer should request detailed information about the specific performance conditions and where the performance awards are tracking relative to the applicable metrics to help make an informed decision about the appropriate treatment of the target's performance awards. Where performance will be determined based on actual results measured as of the closing date, the acquirer may seek review and approval rights.

It also must ensure that any contemplated treatment of the target corporation's equity awards does not violate the deferred compensation rules set forth in Section 409A of the Internal Revenue Code (Section 409A). Section 409A issues can be implicated in various situations, most notably involving either the acceleration of vesting and payment of an equity award or the extension of the vesting terms of an equity award. Careful analysis of the contemplated treatment of equity awards is important to avoid any Section 409A violations that can result in severe, and often unexpected, tax penalties for target employees holding equity awards.

Interim Operating Covenants

The transaction agreement and accompanying disclosure schedules generally include a list of compensation-related actions that a target corporation unilaterally can take during the period between the signing of the transaction agreement and the closing of the transaction (the interim period) and a list of actions that can be taken only by the target with the consent of the acquirer. These covenants typically cover the ability to make compensation and benefits increases, grant equity awards, adopt or amend severance arrangements, create employee retention pools or award change in control bonuses, and hire and terminate executives and other employees.

These provisions are often negotiated and can vary widely from one transaction to another. As a general matter, the target will seek to operate its business in the ordinary course during the interim period, including the freedom to make annual salary increases, pay bonuses, and continue to hire and fire employees. An acquirer may seek to have a seat at the table by requiring specific consent for these actions or to otherwise specifically limit the target's actions within certain parameters, such as only allowing salary increases pursuant to normal compensation practices or up to a certain level, and only permitting hiring and termination for non-executive employees.

The ability to adopt retention pools and make new equity award grants during the interim period are often subject to enhanced discussions and negotiations due to the potential costs and impact on the target company's employees.

While the ultimate outcome of the interim operating covenants will be a focus of negotiation and will depend on many factors—including the duration of the interim period, the acquirer's plans for post-closing integration, and the overall leverage between the parties—developing a comprehensive set of specific rules for these actions can be mutually beneficial and will allow the parties to avoid disputes. It also will help the acquirer ensure that the business it ultimately acquires upon closing is not substantially different from the business it agreed to acquire when the transaction agreement was signed.

Post-Closing Covenants

The transaction agreement typically includes covenants requiring an acquirer to maintain compensation and benefits levels for a specified period of time after the transaction closes (the protection period) for employees of the target corporation who remain employed. A standard formulation is, for one year the acquirer would provide those employees the same base salary, a substantially similar target cash bonus opportunity, and other employee benefits that are substantially similar in the aggregate to the employee benefits provided by the target immediately prior to closing the transaction.

Additional provisions may be included, such as requiring the acquirer to provide specified severance benefits upon a qualifying termination or requiring the acquirer to sustain long-term incentive compensation levels.

While such employees generally do not have any direct right to enforce the provisions of these covenants—because the employees are not parties to the transaction agreement and are not provided rights to enforce the agreement as third-party beneficiaries (and the target will no longer exist in a form that will allow the target to enforce the covenants)—these provisions are considered important sources of protection. They set forth the intentions of the acquirer with respect to employee treatment following the closing of the transaction.

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The length of the protection period and the types of protected items usually are subject to negotiation between the parties. As with interim operating covenants, key considerations include the acquirer's cost of providing the compensation and benefits, the acquirer's plans for post-closing integration of the target company's employees into its broader compensation program, and the need to ensure that an adequate number of employees remain employed through the closing and any post-closing integration period.

Golden Parachute Payments

Target officers and other highly compensated individuals – and sometimes shareholders – can be subject to a 20 percent excise tax on certain compensatory payments made in connection with a change in control transaction under Sections 280G and 4999 of the Internal Revenue Code. An acquirer can lose any corresponding tax deduction. These golden parachute provisions are punitive and designed to dissuade payments and benefits that generally exceed three times the disqualified individual's average five-year annual compensation. (See Checklist - Identifying Golden Parachute Payments to Disqualified Individuals: A Seven-Step Analysis).

In a transaction involving the acquisition of more than 50 percent of the total value or voting power of a public target's stock, a change in control under the golden parachute provisions will be triggered and, unlike a private company transaction, a shareholder vote to avoid the impact of the golden parachute provisions will not be available.

Early in the process, a key workstream is to engage the services of third-party accountants to work with legal counsel in preparing an analysis of all golden parachute provisions, determining whether excise taxes and loss of deductibility may be triggered under those provisions, and structuring the appropriate use of any available mitigation strategies.

These mitigation strategies can include the implementation or valuation of restrictive covenant agreements; gross-up payments, which are disfavored among proxy advisers but are used in certain industries; implementation of post-closing retention payments as reasonable compensation for services in lieu of transaction bonuses or enhanced severance payments; and the accelerated payment of compensation into the calendar year before the closing of the transaction.

It is critical to carefully examine all the target's compensation arrangements as early as possible in the transaction process to determine whether any payments or benefits that may be provided to a disqualified individual could implicate the golden parachute provisions and whether any mitigation tactics can be used to eliminate or otherwise limit their impact.

Post-Closing Compensation Arrangements

In connection with the transaction, an acquirer may want to enter into new compensation arrangements with key employees of the target company. These arrangements are often negotiated and executed before the closing of the transaction, and sometimes even before the transaction agreement is signed, and generally become effective at the closing of the transaction.

These arrangements will help provide comfort to the acquirer that key employees are incentivized to remain employed and focused on the business after closing. They also may be provided as part of the post-closing integration process to harmonize the arrangements of target employees with similarly situated employees of the acquirer.

A review of existing arrangements will be necessary prior to developing any new agreements. This allows for a comparison of terms to ensure that the new agreements are competitive and likely to be acceptable to target employees. It also promotes compliance with Section 409A and identification of any potential issues under the golden parachute provisions.

The development and negotiation of these new arrangements can be a very important process if continuity of the target's management is critical to the success of the transaction and will often need to be conducted in tandem as the broader deal terms are being considered. Enough resources should be allotted to allow this process to occur without otherwise impacting the timing of the overall transaction.

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Public Disclosure of Compensation Arrangements

The target corporation must file various public disclosures regarding the transaction and the payments that may be made to its executive officers and directors in connection with the transaction. These filings include the Form 8-K that will be filed when the transaction is signed by the parties and a much more detailed merger proxy or similar filing filed shortly after the signing.

The merger proxy describes any potential payments to the target's executive officers and directors in connection with the transaction and generally provides the target's stockholders with the ability to cast a non-binding say-on-golden-parachute vote regarding payments to certain executive officers. It describes not only existing arrangements between the target and its executive officers and directors but also any new arrangements that are entered into between the target or acquirer and those individuals in connection with the transaction.

Although less common, if the acquirer is a public company and any of its executive officers or directors will receive any compensation or enhanced benefits in connection with the transaction, those arrangements also may be subject to disclosure in the merger proxy.

The acquirer should keep these public filing requirements in mind throughout the transaction process and consider any potential adverse reaction by stockholders or proxy advisers that may result from the implementation of any new arrangements implemented in connection with the transaction.

Conclusion

Executive compensation matters represent a critical workstream for an acquirer in its acquisition of a publicly traded company and are often a key factor in a successful transaction. These matters commence at the very beginning stages of the transaction with uncovering potential liabilities and compliance issues in the due diligence process. They continue through the negotiation of applicable terms in the transaction agreement and new compensation arrangements for target employees and through the public disclosure of those arrangements in the merger proxy.

Thus, it is important for executive compensation practitioners to be engaged as early as possible in a transaction and to remain in close contact with the client and the broader deal team to ensure that these matters are handled optimally in the context of the overall transaction.

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