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A Reasonable Approach to Severance and Change-in-Control Payments

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Watson Wyatt's executive compensation consultants are advising clients to rethink their severance and change-in-control provisions and, when warranted, to bring them into closer alignment with their purpose and shareholder interests. The areas for reconsideration include:

- Full or partial gross-ups triggered by a change-in-control event
- Age, service or formula enhancements for supplemental executive retirement plans (SERPs) triggered by either severance or a change-in-control event
- Full-cash severance payouts rather than those that sunset after a period of service
- Full protections for any termination following a change-in-control event
- Single-trigger equity vesting at a change-in-control event

Current Climate

In the new world of executive compensation disclosures, the public and press seem particularly interested in payments to executives triggered by terminations, change-in-control or other severance events -- what the U.S. Securities and Exchange Commission (SEC) mundanely calls "Other Potential Post-Employment Payments." These disclosures have revealed potentially significant payouts for SERP enhancements, severance payments, accelerated vesting of options and restricted stock, and tax gross-ups. Clever commentators boldly anticipated this would cause many "holy cow" reactions.

Interestingly, the SEC rules do not require companies to disclose the "walk-away" value of these payouts — the total amount the executive would receive on the event date. Rather, companies must disclose only the incremental value to the executive. Thus, the value of pension accruals disclosed elsewhere and the value of previously vested (but unexercised) options are rarely disclosed in one place on the proxy. Diligent readers can do the math themselves, but the total value is not readily apparent.

We advise clients to calculate this walk-away value to help the compensation committee make informed current-year compensation decisions. Companies also may want to consider providing the full walk-away value in the "Other Potential Post-Employment Payments" section of their proxy to give

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shareholders a clearer picture of all compensation.

Even before the SEC rules were proposed, Watson Wyatt's executive compensation practice had been exploring the rationale behind current severance and change-in-control packages. As even a cursory read of the *Disney* and *HP* litigation illustrates, shareholders are aware of how much these provisions cost and generally don't like them. During the 2006 proxy season, in at least 15 different companies, a majority of shareholders supported proposals to either limit executive severance or require shareholder approval for compensation programs.

Institutional investors don't like these provisions either, according to recent surveys by Watson Wyatt[1]:

- 64 percent said change-in-control agreements for top executives are shareholder unfriendly.
- 74 percent said executive severance plans for involuntary terminations are shareholder unfriendly.

Although corporate board members acknowledge the need for these agreements, many believe they should be tempered, according to other recent surveys by Watson Wyatt[2] – 77 percent of directors said severance and change-in-control provisions should be positioned at the market median.

Existing Change-in-Control Compensation Designs

Many plans pay out significant compensation upon a change in control. Payments typically are triggered by either a change in control alone (a single trigger), or a severance or "constructive termination" (good reason termination) after the change in control (a double trigger). The definition of a constructive termination varies widely among companies, and the definition often favors the executive. A few modified single triggers permit executives to walk away for any reason within a specified period of time after a change in control.

Cash severance payments following a change in control usually involve a double trigger, although the modified single trigger is also popular. The CEO typically receives three times salary and bonus, and other proxy-named executives receive two to three times salary and bonus. In contrast, most companies still have single-trigger accelerated vesting on outstanding equity awards.

"Excess golden parachutes" trigger an additional excise tax, which applies to change-in-control payments that exceed 2.99 times the executive's W-2 compensation averaged over the previous five years. However, most large companies provide full gross-up protection to shield executives from out-of-pocket costs. Thanks to the magic of circular tax calculations, in which the gross-up is also a parachute payment that generates further gross-ups, ad infinitum, the gross-up benefit can cost far more than the excise tax (often 250 percent more). Moreover, companies may not deduct excise taxes, further ratcheting up the cost of the benefit.

The Rationale Behind Change-in-Control Provisions

Why are change-in-control provisions so prevalent, and what behaviors are they designed to elicit? A review of 2007 proxy statements uncovers similar reasoning among filers (to the extent they provide any

[1] Watson Wyatt surveys of institutional investors (2005 and 2006).
[2] Watson Wyatt surveys of board members (2005 and 2006).

reason at all).

Some cite the need to keep management engaged both before and during an impending deal, or the need for continuity in management after a change in control. Unfortunately, many proxy disclosures don't do justice to the real purpose these provisions serve. For example, consider an auction situation. Many potential buyers are keenly interested in whether the management team will lead the organization through the entire sale and transition, so it is crucial for the team to put its best face forward during the due diligence process. Doing so also benefits shareholders in the form of the higher premium the desired management behavior delivers.

While eliciting the highest price for a potential deal should be the primary goal of change-in-control provisions, it should not be the only goal. Key strategic and operational decisions before an impending sale should be in the best long-term interests of the company, so compensation programs should discourage actions that sacrifice post-transaction performance for a short-term bump in stock value.

Change-in-control arrangements should not create a potential conflict for executives. Executives should not lose by helping to unlock the value of the organization through its sale and should benefit – like shareholders do -- from the deal. Moreover, many executives do not survive the sale and should be able to rely on severance protections to ease their transition to a new job or a well-deserved retirement. However, in serving these goals, companies should not over-compensate executives for actions they would have taken anyway or that create only a short-term benefit.

Another popular, and relevant, argument in favor of generous change-in-control provisions is their role in attracting and retaining top talent. Companies that fail to offer "insurance" against a termination might find it difficult to attract talented executives or to keep those they have from straying. The potential cost of these programs is justified by the benefits -- to shareholders and to the corporation – of stable corporate leadership.

These provisions also have resulted in swifter shareholder value creation, because the payoff from a potential sale can be realized far more quickly. Giving management a long-term stake in the company's efficiency and profitability has virtually eliminated the hostile takeovers so prevalent during the 1980s.

Despite all these benefits, certain widespread change-in-control practices do not support long-term, post-transaction value for shareholders. We are not convinced that change-in-control agreements should furnish unlimited protections throughout the executive's tenure. The following sections discuss option acceleration, excise tax gross-ups, enhanced SERP age and service credits, and other change-in-control payments in terms of current practices and our recommendations.

Option Acceleration

Most public companies provide full acceleration of unvested equity at a change of control. Interestingly, these provisions were first implemented under the old "pooling of interest" accounting rules that imposed negative treatment on plans that permitted discretion in accelerating options during a merger. These mandatory provisions allow executives to share in the value they have unlocked for shareholders by consummating the deal.

While we wholeheartedly agree that the management team should share in the rewards, we do not believe that immediate acceleration accomplishes this goal, because shareholders do not necessarily cash out their holdings on the change-in-control date – many are in it for the long haul. We are wary of provisions that encourage management to dress up the value of the company to maximize its current value, while disregarding the longer-term implications. Similarly, provisions that immediately cash out the in-the-money value of options upon a change in control tend to exacerbate a disconnect from shareholder interests. Finally, immediate acceleration of options means that the buyer must quickly create new compensation programs to keep management engaged after the change in control.

The authors' recommendations: We do not favor a single-trigger acceleration of options at a change in control. Rather, we recommend accelerating options under a double trigger, with the second trigger being: (1) severance, (2) the earlier of severance and one additional year of service or (3) a failure of the acquiring company to assume or replace the awards. We also recommend dispensing with delayed single triggers, which accelerate option vesting for executives who terminate for any reason within a fixed period after a change in control.

Excise Tax Gross-Ups

Most public companies provide a full tax gross-up for excess parachute payments. One rationale for this excise-tax protection is to avoid cooling management's desire to consummate a deal. Without this protection, executives with valuable in-the-money options might simply sit tight until those options vest, rather than closing a deal that would accelerate vesting and incur an expensive tax penalty.

But in many such situations, the payoff would be big enough to take the sting — and the disincentive — out of the excise tax. Moreover, the bigger the payoff to executives, the higher the cost of the gross-up (ultimately borne by the buyer), which could adversely affect the purchase price in a bid situation.

A second justification for gross-ups is that they protect "good soldiers" who continue to hold outstanding options, thereby promoting continued alignment with the interests of shareholders. Without the gross-up, the argument goes, more executives would exercise options early and cash out their holdings. This, in turn, would raise the executives' average W-2 compensation, thus making excise taxes less likely (change-in-control payments must exceed 2.99 times five-year average compensation to trigger excise taxes). So, the argument concludes, tax gross-ups encourage the "right" behavior and protect executives from a punitive tax arising from arbitrary limits.

The authors' recommendations: Because of the wide range of circumstances in which tax gross-ups do not affect executive behavior and the cost of the benefit, we generally recommend eliminating full tax gross-ups for new executives and phasing them out of existing agreements. We believe that strong stock ownership guidelines or limitations on the immediate sale of shares following an exercise (except to cover taxes and the strike price) can create a culture of stock ownership and accomplish the same goal.

In some circumstances, a modified gross-up remains appropriate, such as when executives do not reap massive gains due to stock price appreciation. Under these provisions, the company pays the excise tax only if the payments exceed 2.99 times base compensation (i.e., the level at which an excise tax is triggered) by a certain amount or percentage (typically 110 percent). This approach would work for companies using a gross-up to avoid incurring a disproportionate corporate cost when the overall benefit provided to the executive is minimal. Payments below this level would be reduced to just below 2.99 times the base amount. Another modified approach would be to offer a gross-up only for the excise tax paid by the company, rather than a full tax gross-up to offset the executive's total tax exposure.

As noted earlier, to enable the compensation committee to fully evaluate its approach to tax gross-ups, it should be made aware of an executive's full walk-away amount on the date of a change in control.

Enhanced SERP Age and Service Credits

Many SERPs and nonqualified pension plans provide additional age and service credits at a change in control. These enhancements often tie compensation definitions to factors other than the target bonus available for the change-in-control year or the average of prior-year bonus payments. The logic for these protections is that, in many situations, the executive is nearing retirement and could earn a full benefit without the change in control, thus creating a disincentive for him or her to consummate the deal.

This argument holds water in some circumstances but not in others. If an executive holds little unvested equity compensation, a SERP enhancement would eliminate a disincentive to make a deal. However, if there is significant in-the-money value of equity or restricted stock at a change in control, there may be little disincentive to begin with, making the SERP enhancement unnecessary.

The authors' recommendations: If the present value of SERP enhancements after a change in control exceeds the value of the cash severance, we recommend reducing the cash severance payments, with the decrease dependent on the value of the SERP enhancement. We also recommend against basing SERP compensation definitions on inflated compensation definitions (e.g., those that count all W-2 compensation, including options gains) or on future bonus or long-term incentive plan (LTIP) payouts that may never be realized.

Other Change-in-Control Payments

Cash severance is often only one of several payments triggered by a change in control. Option vesting acceleration is a popular and, we think, necessary provision for the reasons articulated earlier.

In a change in control, the in-the-money value of the options provided to the executive can be significant, possibly dwarfing the value of cash severance payments. Although there will always be criticism of equity values realized by executives at a change in control, we have observed that cash severance payments tend to be especially incendiary. Compensation agreements should consider that high equity values at a change of control diminish or even eliminate the need for cash severance. Similarly, supercharged age and service credits under a SERP or nonqualified pension can provide significant value, especially if the compensation is tied to a maximum bonus target. Moreover, companies often provide an array of additional benefits, such as extra post-termination medical coverage, use of the company plane and other perks.

In response to the vagaries of the tax code, companies sometimes convert existing cash severance obligations that would be considered parachute payments into "stay bonuses" or other post-change-in-control compensation. To the extent these payments are considered "reasonable compensation" for services rendered after the change in control, they are no longer considered parachute payments. This ability to convert severance into a stay bonus is sometimes used as additional justification to preserve severance as a retention device, both before and after a change in control.

The authors' recommendations: If the in-the-money value of unvested options or the value of restricted stock upon a change in control exceeds the value of cash severance, compensation committees may want to reduce the severance in proportion to the option gain. As discussed earlier, this cutback would make sense when the severance -- relative to the equity gains -- no longer provides a valuable economic benefit at termination. We are cognizant of the claim that restrictive covenants or noncompete provisions justify cash severance, but we recommend tying such covenants to other change-in-control enhancements (assuming legal counsel determines that such covenants are enforceable).

We believe stay bonuses are appropriate when they are necessary to ensure a smooth transition. Companies that have adopted a double trigger for vesting stock options already have created an incentive to stay.

Finally, due to the unfavorable publicity that tends to accompany these change-in-control provisions, much like executive perks, we recommend against making additional post-employment payments to continue benefits or perks, such as the use of the corporate plane, when the cash payments already provide sufficient compensation.

Severance and Retirement Provisions in Non-Change-in-Control Situations
Market data indicate that typical severance multiples are two to three times base salary and bonus in non-change-in-control circumstances. The definition of bonus varies: It can be an average of prior-year bonuses, a target amount for the year of severance or a combination of the two. For a severance following a change in control, three times base salary and bonus is typical for senior officers.

This protection can last up to three years after the change in control. The general purpose of cash severance is to protect executives from a corporate change of heart during their first few years of employment. Many executives are not willing to change jobs without some insurance against the risk of losing the new job before their long-term equity grants vest. As time passes, the purpose shifts from risk mitigation to ensuring sufficient income to cover the executive's transition to a new job, including the impact of a noncompete agreement that restricts future employment for 12 to 24 months. Thus, the need for a higher severance multiple diminishes over time.

Establishing a diminishing multiple for severance would conflict with "evergreen" provisions in executive contracts. While we leave the issue of whether executive employment agreements are necessary to employment law counsel, we are not aware of any circumstances in which an automatically renewable contract would be in the best interests of the company. It is impossible to forecast the compensation elements and amounts that would be appropriate for a new contract term. This is especially relevant for protection in the form of cash severance, which would make little sense for a long-tenured executive.

Moreover, cash severance should not be an entitlement. While there are valid reasons to provide cash severance in the event of a good-reason termination, too often the definition is drafted broadly enough to essentially give the executive a walk-away right. Many companies need to tighten up their good-reason definitions to ensure that payments are linked to desired corporate behavior.

The authors' recommendations: For cash severance provided in non-change-in-control situations, we advise compensation committees to reconsider providing three times base and bonus for an incoming executive; perhaps ratcheting back the payment to a multiple of two or even one after a few years of service would be more reasonable. If there is an employment agreement, severance protection ideally should be tied to the remaining term of the agreement.

In many cases, continued postretirement vesting under existing schedules keeps retirement-eligible executives focused on long-term stock performance. In contrast, we do not favor option grants made in an executive's final year, while he or she is phasing out of a decision-making role, as a hidden retirement payment. Similarly, we do not advocate option acceleration outside of a change in control for an executive's severance, unless the executive's performance justifies this additional benefit.

Conclusion

To get the most value from change-in-control and severance provisions, compensation committees must carefully balance the cost of providing specific incentives with their likely results. Used properly, change-in-control and severance provisions can elicit behaviors that benefit executives, companies and shareholders, without foregoing fiscal restraint. Boards and compensation committees must think carefully about how and when to implement these provisions. Those that decide to modify existing compensation programs may need to get some complicated legal issues out of the way first. For new hires, however, the slate is clean, and we hope that compensation committees will seriously consider these recommendations for their future executive compensation structures. Shareholders need only to look at their company's proxy to see whether they have.