Expecting the Unexpected – Preparing Your Change in Control Program for an Unsolicited Takeover Bid

Within the past three years, several technology and life sciences companies have been confronted with what was previously a rarity in these industry sectors – the unsolicited takeover bid. Recent attempts to acquire such large, high profile companies as Yahoo! and Genentech, as well as "successful" acquisitions of several mid-sized firms, including BEA Systems, Hyperion Solutions, and ICOS, are reminders that few businesses are immune to these bids. There is little reason to believe that hostile takeover attempts will stop in the near term given the ongoing volatility in the stock market, which has resulted in the stock of numerous companies trading at historic lows.

In this environment, companies are well-advised to evaluate their existing change in control arrangements to ensure that they are serving their intended purpose. Firms that wait until they are "put into play" to take up this question often find themselves scrambling to respond in a highly-sensitized environment, placing further stress on management and the Board of Directors and creating risk that could threaten the maximization of shareholder value.

The Value of a Formal Process

As experienced executive compensation advisors, we have worked with management, Boards of Directors, and Board compensation committees on change-in-control plans and arrangements in many recent transactions and hostile takeover attempts. From this work, we have developed an efficient process for evaluating existing change in control programs, identifying potential modifications where appropriate, and developing new executive and key employee retention programs, which is summarized in this article. We have found this process an effective means of ensuring that a company's change-of-control program achieves its overarching objective of retaining executives and other key employees during an uncertain period in a manner aligned with shareholder interests.

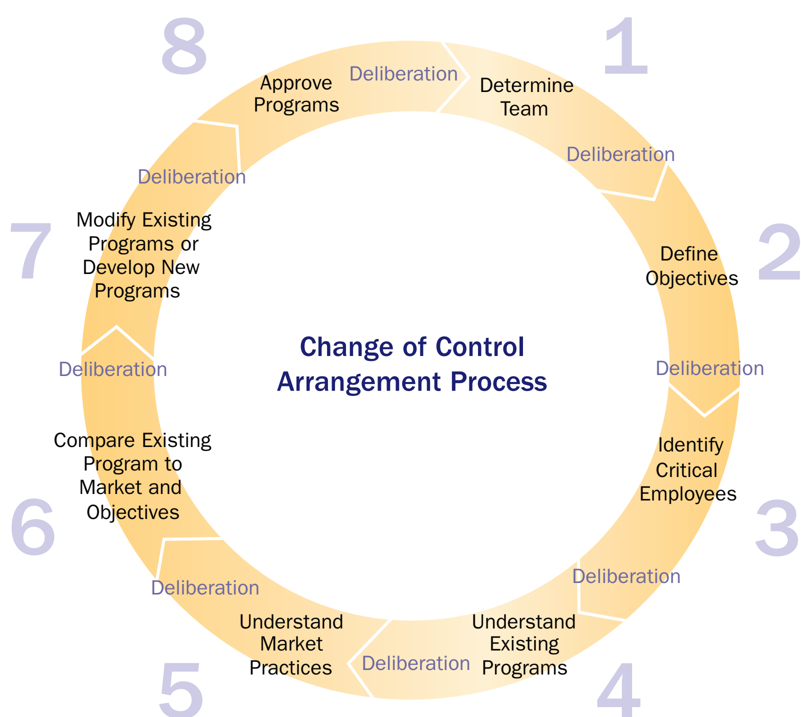
An Effective Process is a Deliberative Process

In our experience, companies should evaluate their compensation-related change in control plans and arrangements well before an offer has been made to allow sufficient time for a thorough, deliberative examination. Such an approach gives management the opportunity to articulate program objectives and develop appropriate strategies for meeting these objectives. Moreover, from a corporate governance standpoint, a deliberative process provides the Board of Directors ample time to digest the alternatives presented, test key assumptions, devise and evaluate alternative scenarios, and, ultimately, make thoughtful, informed decisions.

Trying to accomplish these tasks after an offer has been made can be difficult – and risky. The pace of an acquisition transaction, particularly an unsolicited one, typically does not lend itself to deliberative and thoughtful decision-making. In addition, in today's litigious environment the "process" of reaching a decision matters and, arguably, may be as important as the decision itself. In the case of an unsolicited offer, which may carry hostile undertones, it is critical that any compensation payments and benefits that will be triggered by the transaction be the product of a methodical, informed decision-making process. This will put the company, as well as management and the Board of Directors, in the best position to withstand the inevitable scrutiny of shareholders, employees, and regulators, not to mention plaintiff attorneys and shareholder activists.

Expecting the Unexpected – Preparing Your Change in Control Program for an Unsolicited Takeover Bid (continued)

Evaluating Change in Control Benefits – the Process



Evaluating Change in Control Benefits – the Process

1. **Determine the Team to Assist the Compensation Committee in Evaluating the Company's Change in Control Proposal**
   - Management should form the team to develop proposal
     - Usually driven by Human Resources, Legal, and/or Finance function
     - Generally assisted by the company's outside legal counsel
   - Select independent advisers to the Compensation Committee
     - It is important that the Committee have access to objective, independent advice
     - Advisers should consist of compensation consultant and, possibly, independent legal counsel
     - Advisers should have direct access to the Committee and, if necessary, be able to meet with the Committee without management present
     - Advisers should work on behalf of the Committee as part of the team formed by management

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2. **Define the Program Objectives to be Achieved (which may include):**
    - Ensure that, in the event of a potential transaction, the interests of management are aligned with the interests of the company's shareholders
    - Preserve the ongoing value of the company by retaining executives and other key employees
    - Provide certainty during an uncertain period
    - Align with market
    - Make-up for lagging realized compensation gains

3. **Identify the Employees to be Covered by Change of Control and Retention Arrangements**
    - How deep within the company should the protection run?
    - Who are the key individuals needed to complete a transaction, but who may be in danger of losing their jobs after the transaction?
    - Who are the key individuals essential to the company's' ongoing success?

4. **Understand the Nature of Existing Equity Plans and the Severance and Change in Control Arrangements Currently in Place**
    - Who is covered?
    - What benefits are provided?
    - What conditions are required for payment ("single trigger," "double trigger," etc.)?
    - What are the "hidden costs" (for example, the value of any potential foregone income tax deductions in case of an excise tax liability)?

5. **Understand Market Practices**
    - Define the appropriate peer group of comparable companies
    - Collect market information on the change in control practices, retention arrangements, and broad-based arrangements (equity acceleration, severance, etc.) of those companies
        - Understand where used and why
        - Determine the specific provisions of these arrangements (severance multiples, triggers, benefits, etc.)
        - Assess aggregate cost of peer company arrangements as a percentage of the potential value of the transaction
    - Understand "best practices" for change in control arrangements; identify where best practice differs from market practice, and determine whether this distinction is important

6. **Compare the Existing Program to Market/ Best Practices and Program Objectives**
    - Identify any gaps or issues with the terms of the company's current program compared to market/best practice standards
    - Review individual value delivered and aggregate value or cost of the current program against industry benchmarks
    - Identify and quantify any issues with the company's current program against the program objectives

7. **Modify the Existing Program and Develop New Programs Accordingly**
    - Develop (or modify) program parameters to address any limitations in the current program, which may include:
        - Change in control arrangements and/or enhancements thereto
        - Retention bonus program (cash and/or stock)

    - Other (for example, transaction or transition bonuses or awards)
- Review individual value delivered and aggregate costs of the revised program against industry benchmarks
- Highlight areas of potential sensitivity so that the company can be prepared to address

8. **Approve the Program**
    - Process should be evolutionary rather than an event. The Compensation Committee should be meeting throughout the process to review information and provide input
    - Final approval should be sought only after multiple meetings to allow time for questions and due consideration

A Suggested Timeline for Compensation Committee Action

Meeting 1: Assemble team, including selection of independent advisers to assist in the process; determine program objectives, employees covered, and parameters for determination of peer group

Meeting 2: Present preliminary market findings and preliminary program outline; receive Compensation Committee feedback and direction on potential changes and/or modifications to the company's existing program

Meeting 3: Present specific recommendations with opportunity for questions and fine-tuning

Meeting 4: Seek final approval of modified and/or new program

Need Additional Assistance?

Compensia has had significant experience advising technology and life sciences companies on compensation-related change in control issues. We have helped many companies assess their existing change in control programs in anticipation of a potential transaction. In addition, we have been actively involved in advising companies that find themselves the recipients of an unsolicited offer.

If you have any questions on change-in-control plans and arrangements or the evaluation process outlined above, please feel free to contact us. ■

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About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

San Francisco

770 Tamalpais Drive
Suite 207
Corte Madera, CA 94925
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Michael Benkowitz
mbenkowitz@compensia.com
415.462.2996

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Anna-Lisa Espinoza
alespinoza@compensia.com
858.509.1179

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309