Dealing with Performance-Based Equity Awards upon a Change in Control

Responding to calls for a stronger and more transparent link between pay and performance, technology and life sciences companies have shifted the composition of their long-term incentive programs from largely stock options and restricted stock units to a mix of time-based (options and RSUs) and performance-based (performance shares) equity awards. However, this move is not without its challenges, as performance-based equity awards are inherently more complex than time-based awards. Implementing a performance-based equity plan raises a seemingly endless list of sophisticated and, often, interrelated design issues – such as selecting plan participants, identifying and calibrating appropriate metrics, setting the duration of the performance period, deciding whether to provide threshold and overachievement payouts, and apportioning awards relative to other equity.

In this setting, the disposition of awards in the event of a change in control of the company is often not fully considered and, in some instances, overlooked altogether. Even when considered, it is often just an afterthought, with companies simply applying the same change in control treatment as for time-based awards. Given the relative novelty of performance-based equity awards in the technology sector, it's not surprising that the potential issues that arise for performance-based awards in a change in control setting haven't been fully addressed. Yet, for several reasons, this subject warrants careful attention.

In the first place, given the scalability of most performance-based awards, the dollar amounts at stake may be significantly greater than with a time-based award. In addition, unless the disposition of outstanding awards in the event of a change in control is planned for in advance, the performance-based spirit of the awards may be frustrated, potentially undermining the company's intentions and objectives. Finally, in today's highly-sensitized environment, simply providing for accelerated vesting in the event of a change in control is a "non-starter" for many compensation committees, institutional investors and other executive compensation watchdogs; placing greater importance on developing an appropriate strategy for program continuity when a company's circumstances change.

This article summarizes various approaches for dealing with the possibility of a change in control in a performance-based equity plan. It also identifies the advantages and disadvantages of these approaches, as well as the other considerations that are likely to influence how companies address this issue.

Typical Framework for Change-in-Control Protection

Most long-term equity incentive plans provide for the disposition of time-based awards in the event of a change in control of the company in one of two ways:

- Occasionally, the plan stipulates that upon, following, or in connection with a change in control of the company outstanding and unvested equity awards will immediately vest in full (a "single trigger" arrangement).
- Alternatively, the plan may provide that upon, following, or in connection with a change in control of the company outstanding and unvested equity awards will either be (i) assumed by the acquiring entity (or exchanged for an equivalent substitute award) or (ii) immediately vest in full. Where an award has been assumed (or substituted for) in connection with a change in control, customarily its vesting status will be preserved. Thereafter, upon a

termination of employment by the company "without cause" or by the executive with "good reason" within a prescribed period, the award may vest in full (a "double trigger" arrangement).

These two approaches do not work well with performance-based equity awards. Full acceleration of outstanding awards upon a change in control may create a "windfall" for executives who receive the full value of their awards even though the requisite performance criteria have not been satisfied (and, in the case of poor performance, may not have been capable of being satisfied). Not only is this likely to anger investors, it also may have implications for the transaction (where executive retention is a key consideration) and raise complex tax issues. Assumption (and, thus, preservation) of outstanding awards may not be practical because, depending on the nature of the metrics, it may no longer be possible or appropriate for executives to achieve the specified performance objectives, or such objectives may no longer be measurable, in the reconstituted company.

Further complicating the picture are the potentially divergent interests of a company's executives and its board of directors when it comes to devising a solution to this issue. Not surprisingly, management can be expected to press for full vesting, contending that the occurrence of a change in control during the performance period frustrates their ability to achieve their pre-established performance objectives. Directors, on the other hand, tend to be reluctant to vest an unearned performance-based award, particularly where the performance outcome may be uncertain or unlikely.

Handling Performance-Based Equity Awards

At this point, a "best practice" for handling performance-based equity awards upon a change in control of the company has yet to emerge. However, based on our work with management, Boards of Directors, and board compensation committees on the design of a number of performance-based equity plans, we have seen five general approaches used:

- full acceleration of the vesting of the award,
- pro rata vesting of the award,
- conversion from a performance-based award to one with time-based vesting,
- termination of the award, and
- the exercise of discretionary authority by the Board of Directors or board compensation committee.

FULL ACCELERATION OF VESTING

Under this approach, awards are deemed to vest in full (essentially, all of the performance targets will be deemed to be fully achieved) immediately prior to and, typically, contingent on consummation of the transaction. (This latter condition is critical to ensure that vesting isn't accelerated for transactions that are not consummated.) Essentially, outstanding awards are given "single trigger" treatment.

Thus, like time-based stock options or restricted stock, awards are deemed to be vested in full, regardless of the actual outcome of the associated performance conditions or the premature termination of the performance period. Where an award is for a fixed number of shares, typically the executive will be entitled to receive that number of shares, although, in some instances, the number of shares received will be pro-rated for the portion of the performance period that has actually elapsed. Where the number of shares to be paid is dependent on the level of performance achieved, typically payout will be made at the target (or, in some instances, the maximum) performance level.

Advantages

- Ensures that executives receive the "benefit of the bargain" with respect to their awards, as they are not penalized for their inability to achieve the performance objectives. This may be particularly reasonable where the anticipated benefits of the transaction outweigh the expected benefits of meeting the specified performance criteria. This result is most likely to be viewed as equitable by executives who will lose their jobs as a result of the transaction.

- Simplifies the calculation and disposition of the target company executives' compensation in connection with the transaction, as it streamlines the disposition of the award (as the transaction may render the original performance objectives moot or incapable of being achieved).
- In the case of continuing executives, eliminates the complexities associated with adjusting awards (and the related performance objectives) to take the transaction into account or, in the event this cannot be done, making replacement awards to offset the foregone compensation opportunity.
- Although acquirer may be willing and able to assume outstanding awards, the nature of the transaction is such that the performance objectives cannot be maintained or replicated.

Disadvantages

- May be perceived by shareholders and others as providing executives with a "windfall" benefit since they will receive compensation that hasn't been earned. This concern will be particularly acute where the payout is at the maximum performance level, takes place under a "single trigger" arrangement, and/or performance prior to the change in control has been poor.
- Mere presence of provision may be viewed by shareholders and others as a waste of corporate assets, or even a quasi-"anti-takeover" device. The major proxy advisory firms are likely to consider the arrangement as a poor compensation practice.
- For purposes of the Internal Revenue Service's "golden parachute" rules, the accelerated vesting of a performance-based equity award typically produces a greater award value than a time-based award.
  - Typically, that occurs because the full value of an accelerated performance-based award is counted to determine whether an "excess parachute payment" has been made, while, in the case of time-based awards, only an incremental amount of the accelerated award's value (tied to the accelerated vesting period) is counted. Thus, there is a greater chance that a full acceleration provision will result in a significant award value triggering the golden parachutes rules and, consequently, increases the possibility of the loss of an income tax deduction to the company and the imposition of an excise tax on executives.

PRO RATA VESTING

Some companies have opted not to terminate the performance period in the event of a change in control, but to continue through to the end of the period, ascertain the company's achievement against the pre-established performance measures, and then pro rate performance-based equity awards for the portion of the performance period that the executives worked prior to the transaction (in the case of a single trigger arrangement) or termination of employment (in the case of a double trigger arrangement). Alternatively, the company may truncate the performance period at the time of the change in control, adjust the performance measures for the shortened period, and then compare performance against the modified measures on an actual or hypothetical basis to determine the payout. Where the company determines the payout on the basis of the hypothetical achievement of the pre-established performance objectives, typically it will assume the target level of achievement.

The nature of the performance measure (or measures) selected for the award will dictate the relative ease or complexity of this calculation. Certain measures (for example, a relative measure, such as total shareholder return compared against an index) will be easier to truncate and compute than other measures (for example, a stock price or financial measure, such as return on equity, that is to be ascertained only at the end of the performance period). Thus, the board compensation committee may find it necessary to assess the likelihood of a corporate transaction during the performance period when selecting an appropriate performance measure or determine an appropriate way to dispose of outstanding awards upon a change in control based on the performance measure being used.

Advantages

- Ensures that executives receive the "benefit of the bargain" with respect to their awards, as they are not penalized for their inability to achieve performance objectives for the entire performance period. This may be particularly reasonable where the anticipated benefits of the transaction outweigh the expected benefits of meeting the specified performance criteria. This result is most likely to be viewed as equitable by executives who will lose their jobs as a result of the transaction.
- Tends to be favored by shareholders and others as the payout (if any) received by executives is tied to their actual service and contributions towards attaining the performance objectives.
- Should enable awards granted to the chief executive officer and three other most highly-compensated executive officers to qualify as "performance-based" compensation for purposes of Section 162(m) and, thus, to be deductible by the company for federal income tax purposes

Disadvantages

- Executives forfeit their right to receive the "benefit of the bargain" with respect to their awards as they will be denied the opportunity to earn the full amount of their target awards.
- Reduced value of the awards in the event of a change in control may act as a disincentive for executives to pursue transactions that are in the best interests of shareholders. (The impact of this disincentive will depend on the potential value of the award relative to each executive's total compensation package.)
- Administration may be burdensome, as company will be required to adjust awards and determine the appropriate payout amounts. The complexity of this process will depend on the precise design of the provision and the extent to which the transaction materially alters the company's business, thereby making it more difficult to measure the executives' performance against the original performance objectives.

CONVERSION TO TIME-BASED AWARD

Some companies provide that their performance-based equity awards will automatically convert to time-based awards upon a change in control. This approach is especially appealing where it is apparent up front that an acquisition will negate a company's ability to measure performance against the awards' pre-established metrics and target levels following the transaction.

Under this approach, outstanding awards would be converted to time-based awards (typically at the target award amount) as of the closing of the transaction. Executives are given service credit for the portion of the performance period that has already elapsed, with the award vesting in full ("cliff" vesting) at the completion of a specified vesting period (for example, two years). As a further refinement, it can be provided that upon a termination of employment by the company "without cause" or by the executive with "good reason" prior to the completion of the vesting period, his or her award vests in full.

Advantages

- Ensures that executives have the opportunity to receive the "benefit of the bargain" with respect to the awards, as they are not penalized for their inability to achieve the performance objectives. This may be particularly reasonable where the anticipated benefits of the transaction outweigh the expected benefits of meeting the specified performance criteria.

- Works well with a "double trigger" arrangement where continuation of the pre-established performance metrics is no longer possible or appropriate.
- More appealing to shareholders than full accelerated vesting and the perceived "windfall" benefit that this approach creates.

Disadvantages

- Reduced value of the awards in the event of a change in control (as a result of risk of subsequent job loss) may act as a disincentive for executives to pursue transactions that are in the best interests of shareholders. (The impact of this disincentive will depend on the potential value of the award relative to each executive's total compensation package, and whether there is vesting acceleration upon a termination without cause or for good reason.)
- Potential perception of unfairness where it is clear that the performance target levels would not have been attained had change in control not occurred.

TERMINATION OF AWARD

Some companies, recognizing the inherent complexities of resolving this issue, have simply elected to cancel in full all outstanding performance-based equity awards in the event of a change of control. Consequently, executives will cease to have any right or entitlement to receive any of the shares of stock covered by the awards and, further, will not be entitled to any payment therefor.

Advantages

- Simplifies the administration of the awards as neither of the parties to the transaction has to concern itself with calculating potential payouts or adjusting the terms or conditions of the award to reflect the transaction.
- Executives do not receive any "windfall" benefit with respect to the awards.

Disadvantages

- Denies executives the "benefit of the bargain" with respect to the awards, potentially affecting their perceived value from the outset.
- Potential loss of the awards in the event of a change in control may act as a disincentive for executives to pursue transactions that are in the best interests of shareholders. (The impact of this disincentive will depend on the potential value of the award relative to each executive's total compensation package.)

Some companies will cancel outstanding awards where less than a specified portion (for example, 40%) of the performance period has elapsed. Where the change of control occurs after this point, typically, pro rata vesting will be applied to the awards.

DISCRETIONARY AUTHORITY

Rather than specify an outcome in advance, some plans give the plan administrator (typically, the board compensation committee) the discretion to decide at the time of the transaction how to dispose of outstanding performance-based equity awards. Thus, the administrator can evaluate all of the relevant facts and circumstances and select the appropriate treatment, which can take the form of one or more of the described approaches.

Advantages

- Allows for full consideration of how much of the performance period has actually elapsed and the actual performance of executives in determining whether a payout is appropriate and greater flexibility in determining the amount of any such payout.
- Ensures that the disposition is consistent with the best interests of executives and shareholders by

giving due consideration to the facts and circumstances that exist at the time of the transaction.

Disadvantages

- Exercise of discretion when a transaction is pending (or even likely) raises fiduciary duty concerns for the Board of Directors, which may find itself in the position of having to balance the compensation expectations of its executives against the interests of shareholders in completing the transaction on the most favorable terms to them. In addition, the accelerated vesting may become a negotiation point with the acquirer, so that the decision has less to do with the performance of the executives than the negotiation position of the company in the acquisition discussions.
- Uncertainty as to the disposition of the awards in the event of a change in control may act as a disincentive for executives to pursue transactions that are in the best interests of shareholders. (The impact of this disincentive will depend on the potential value of the award relative to each executive's total compensation package.)
- Under a recent Internal Revenue Service ruling, the mere presence of this discretion may preclude an award granted to a company's chief executive officer or one of its three other most highly-compensated executive officers from qualifying as "performance-based" compensation for purposes of Section 162(m)'s $1 million deduction cap and, thus, the award may not be deductible by the company for federal income tax purposes.
- May be difficult for the plan administrator to unilaterally exercise its discretion to accelerate the vesting of outstanding awards at the time of the transaction. In fact, the treatment of these awards may become an issue that is subject to the negotiation of the parties as part of the pending transaction.

Other Considerations

The challenge in structuring the treatment of a performance-based equity award in the event of a change in control may be compounded by a myriad of related issues.

- **Design Complexities**. Devising an appropriate disposition strategy will be complicated by the complexity of an award's design. While many awards are relatively simple, providing for the payment of a fixed or formula-based number of shares at the end of a multi-year performance period depending on the absolute or relative level of performance against a single pre-established metric, other awards contain multiple performance measures spanning one or more years (for example, an annual revenue metric and a multi-year total shareholder return metric). In determining how to treat the award in the event of a change in control during the performance period, several factors will need to be weighed, including the likely outcome under each approach (for example, full vesting, pro rata vesting, or termination), the likely point during the performance period that a transaction could occur, and the company's likely performance against the award's various performance metrics. It may be necessary to model a series of possible outcomes under different scenarios before selecting an appropriate approach.
- **Vesting Complexities**. Where performance-based equity awards are accompanied by a time-based vesting schedule [for example, following the determination of the number of shares earned during the specified performance period, the recipient must satisfy a specified time-based vesting period (for example, two years) after the end of the performance period to receive the shares. Typically, the treatment upon a change in control differs in the case of awards that are not yet earned (that is, the change in control occurs during the performance period) and awards that

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are earned but have not yet vested (that is, they are subject to single or double trigger treatment in the same manner as other equity awards).

- **Shareholder Views**. While the design of performance-based equity awards has not yet received the full attention of institutional shareholders and the proxy advisory firms, investor policies on severance arrangements offer clues as to how they are likely to evaluate these awards. Not surprisingly, investors have taken the view that severance payments should be reasonable and not overly generous. Typically, this translates into policies providing for severance payment multiples no greater than twice (or three times) base salary and the use of pro rata target or average historical payout levels for bonuses. Payouts that assume maximum performance achievement are viewed as wholly unwarranted. In addition, single trigger arrangements are likely to be objectionable regardless of how they are structured. In most cases, the presence of these features will be considered a "poor" pay practice and may trigger other consequences (such as a "withhold" vote for board compensation committee members or an "against" vote for an equity compensation plan).
- **Income Tax Implications**. The Internal Revenue Service has taken the position that remuneration will not qualify for the exception from Section 162(m)'s $1 million deduction cap for "performance-based compensation" where it could be paid (without regard to the outcome of the performance goals) on an executive officer's termination of employment by the company without cause or by the executive for good reason. In addition, the mere presence of such a provision in an award agreement will disqualify the remuneration from being considered "performance-based compensation," even if the provision never became operative. Consequently, performance-based equity awards granted to a company's senior executives who are subject to Section 162(m) that provide for accelerated vesting (or, for that matter, anything in excess of pro rata payment based on actual satisfaction of pre-established objective performance goals) in connection with a termination of employment following a change in control (a "double trigger" arrangement) may not qualify as "performance-based compensation" for purposes of Section 162(m) and, thus, will be subject to the $1 million deduction cap.
- **Proxy Disclosure**. As part of the disclosure of their executive compensation programs in their annual proxy statements, public companies will need to consider describing the potential treatment of outstanding performance-based equity awards in the event of a change in control in their Compensation Discussions and Analyses if material to an investor's understanding of these awards. In addition, depending on the approach selected, a company may need to estimate the potential amount payable to each of its named executive officers from these awards upon a change in control as part of its Potential Payments Upon Termination or Change in Control disclosure.

Need additional assistance?

Compensia has had significant experience advising technology and life sciences companies on designing performance-based equity plans and addressing the disposition of performance-based equity awards in the event of a change in control. If you have any questions on implementing a performance-based equity plan or analyzing or drafting change-in-control provisions, please feel free to contact us. ■

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