Post #80: Industry Consolidation: Compensation Impacts

From Chris Havey, Partner, The Woodlands TX

There have been a few recent announcements of mergers within the industry and more may be coming. As companies may be preparing for potential consolidation, there a handful of compensation items that are likely worth reviewing.

Executive Change in Control (CIC) Provisions

Nearly all public companies have some form of CIC protections built into their compensation plans, whether through cash severance arrangements or vesting of equity. The primary purpose of these provisions is to ensure that executives consider all possible ways to maximize shareholder value, even if it will likely result in their termination. There are a few unique issues associated with the oil & gas industry that should be considered when reviewing these provisions.

CIC Triggers

Several recent oil and gas transactions have been mergers of equals (MOE). However, typical CIC provisions primarily focus on addressing true acquisitions, where the acquired management team is terminated in full. In a MOE, the post-merger management team may be a mix from the two companies, but the definitions of CIC do not always contemplate that possibility. For example, if Company A's shareholders own at least 50% of the combined entity, it might not be a "CIC" for Company A. In this case, a CIC definition that requires Company A's shareholders to own 60% of the combined entity might be more appropriate (combined with double trigger – see below).

Suggested action: review the definitions of CIC in severance and equity plans to understand treatment upon a MOE.

Prorated Bonus for Year of Termination

Companies typically pay a prorated bonus upon a CIC. Sometimes this provision is included in the merger agreement instead of the CIC severance plan/agreement. However, it may be helpful to include payment of a prorated bonus for the year of termination in the CIC severance plan as a minimum guarantee for participants.

Companies also need to determine the level of prorated bonus paid. Practices are generally mixed between target bonus, actual performance to date, and greater of target or actual. In our experience, it is often set at the greater of target or actual performance in actual deals (i.e., in the merger agreement), but the provisions in the severance plan/agreements may be less generous.

Suggestion action: review treatment of bonus in year of termination.

Equity Vesting

Double trigger equity vesting, which requires a second trigger of either termination of employment or failure to assume/convert into equivalent value, has become the standard practice. Single trigger equity vesting was more common 5 years ago but has become more of an outlier practice due in large part to scrutiny from proxy advisors and investors.

The primary risk with single trigger vesting is that the individual keeps their job post-CIC, but all outstanding awards vest, eliminating any retention hook. This risk is even more likely in MOE transactions. Additionally, switching to double trigger vesting of equity may allow companies to adopt a CIC definition that is inclusive of MOE situations (as mentioned above).

Suggested action: review equity vesting provisions.

Treatment of Outstanding LTI Performance Cycles

Companies also need to define how outstanding long-term performance cycles are treated at the time of the CIC. Since performance is usually difficult to continue measuring post-transaction, performance is usually locked in at the transaction. This can be done at target (more likely for financial performance, which is difficult to measure mid-cycle) or actual (more likely for relative TSR performance, which can be measured mid-cycle). The advantage of using actual performance in relative TSR plans is that the management team is rewarded for a good deal, generating greater alignment with shareholders. In an actual deal (i.e., in the merger agreement), a more generous approach can be used (e.g., greater of target or actual, a level above target, etc.). However, actual or target are more typical in ongoing equity award or severance agreements.

Suggested action: review treatment of performance plans upon a CIC.

Broad-Based Severance

Another area to review is broad-based severance. While some companies have broad-based CIC severance plans, they are not generally widespread. However, it may be helpful to consider what would be an appropriate protection level in the instance of a CIC, in advance of a deal being negotiated. Often, the merger agreement would include standards for broad-based severance, so it can be helpful to understand what the company would want in that circumstance. And it can be helpful to communicate the severance plan to the broad-based population at the time of announcement to help mitigate concern about their future with the company.

Suggested action: consider what broad-based severance provisions would be appropriate.

Peer Group Selection

The final area of consideration applies to all industry participants, whether they're involved in M&A activity or not, and that has to do with the reduced number of potential peer companies. Below are a few thoughts for each of the different uses of peers.

Compensation Benchmarking Peers

As the number of potential peers declines, companies may have to expand their compensation peer group to include companies that might look a little different, but which might still be a source for executive talent. For example, E&P companies might have to include potential peers with a different product mix (oil vs. gas), a different asset-base (onshore vs. offshore), etc. Companies may also have to broaden to other ancillary industries. For example, expanding to other parts of the oil and gas sector or companies with other end markets (e.g., oil & gas equipment manufacturers looking at broader manufacturers).

Performance Peers

As the Compensation Benchmarking Peer Group starts to deviate from direct operational peers, it becomes more likely that the Performance Peer Group will need to be different from the Compensation Benchmarking Peer Group. Historically, the oil & gas industry has been more likely than other industries to use the same peer group for both compensation benchmarking and relative performance comparisons. However, that practice has and will likely continue to decline in prevalence. Companies may consider using the constituents of an industry index or using one or multiple indexes as individual peers to fill out an appropriate performance peer group.

Treatment of Acquired Peers

Finally, companies should review relative performance plans to understand how acquired peers are treated. Are they removed at announcement or once the merger closes? Are they removed completely, replaced with another peer, converted to an index, or something else? Please see this blog post with some considerations on this issue.

Suggested action: evaluate current peer groups for compensation benchmarking and relative performance comparisons.

These are a few items you may wish to review in the current environment. When reviewing these items, it is also important to note that disclosing changes to executive CIC provisions in a consolidating environment may send signals about the potential for a deal, so changes should be approached thoughtfully.

Archived copies of previous Energy Insights can be found by going to www.meridiancp.com/insights and selecting Oil & Gas from the dropdown list.

To have your name removed from our Energy Insights email list, please contact ckellner@meridiancp.com.