ANTICIPATING COMPENSATION ISSUES UPON AN ACQUISITION

Proactively assessing pay programs can smooth a potential transaction.
By Kartik Balaram and Justin Peters

IN A MARKET FUELED by the artificial intelligence (AI) revolution, M&A activity will naturally accelerate as companies acquire or divest companies/business units to unlock operating efficiencies. Whether one is the acquiror or acquiree, directors should be mindful of whether the current executive compensation programs have strategic alignment, promote retention and protect executives in the spirit of maximizing shareholder value. Irrespective of whether preliminary discussions have occurred, companies should proactively assess their programs for competitiveness and reflect on key considerations to manage human capital issues through a possible transaction.

A key item of an executive's compensation arrangement are the Change-in-Control ("CIC") severance provisions, which encompass special benefits received in connection with a CIC of the company, and commonly, following a subsequent termination from the surviving company (known as a "double trigger"). Formal CIC arrangements help attract and retain key talent beyond the transaction by mitigating any concerns over potential job loss. By encouraging neutrality to a transaction, effective severance protections ensure executives are focused on shareholder interests during the diligence process. Additionally, CIC protections provide further protections to shareholders by requiring an executive's execution of a release of claims and compliance with restrictive covenants, such as noncompete and nonsolicit covenants. As a powerful compensation tool, compensation committees should review their CIC severance arrangements against market practice to ensure overall competitiveness.

Beyond establishing CIC protections for executives, directors must consider other key issues, which vary depending on a company's role in the transaction.

Target Company

Beyond the standard cash severance, directors of an acquisition target should also evaluate how outstanding incentive awards may be impacted by an acquisition:

- **Annual Incentives**—Directors should gain clarity on how metrics in the plan are treated should a transaction occur. Consideration of performance levels and where awards may settle following the transaction should be assessed for appropriateness.
- **Long-Term Incentives**—While unvested time-based equity awards generally fully vest upon a qualifying termination following a CIC, the treatment of performance-based equity awards in connection with a CIC raises unique complexities. Specifically, directors should understand whether performance-awards vest in full or pro rata and how performance is determined for purposes of calculating the number of vested performance awards (e.g., based on actual performance or assumed target performance). Insights into how an acquiror's assumption or non-assumption of outstanding equity awards impact award treatment under a transaction should also be considered.

Formal CIC arrangements help attract and retain key talent beyond the transaction by mitigating any concerns over potential job loss.

Acquiring Company

Directors of acquiring companies have the added difficulty of integrating both legacy compensation plans and human capital related programs. To do this effectively, diligence must be placed on the acquired company's culture, legacy programs, and key personnel that will be crucial to the transaction's success.

- **Culture Integration**—Company culture is a key sticking point in any transaction and differences are typically not moderated until after closing. Key components of company culture, such as human capital and ESG-related initiatives, should be reviewed well in advance of transaction completion. Differences and opinions should be openly and collaboratively discussed by both parties.
- **Program Diligence**—Directors should ensure proper diligence on the acquired company is conducted, with a focus on understanding standing compensation and severance practices, current organizational structure and equity award treatment following the transaction. Companies should consider whether there are any deficiencies or contradictory elements in the current programs at the target.
- **Retention Initiatives**—Throughout the integration and diligence process, directors and HR teams may consider retentive initiatives, such as one-time cash or equity awards, for key talent identified at the acquiree. Crucial talent can help with the integration of the target company's units and alleviate some of the uncertainty stirred by a transaction.

There is a tremendous amount of work that goes into a potential transaction and leaning on experts to help navigate these complex issues is a path to success. While many companies strive to develop consistent and effective compensation programs, the uncertainty and variability caused by any potential transaction can upset the current operating state of both acquiror or acquiree companies, and directors should be prepared well in advance. Market resources, such as Meridian's 2023 study of Change in Control Severance Arrangements can guide directors in evaluating their company's current practices that may be impacted by a transaction.

Kartik Balaram is a principal at the executive compensation consulting firm Meridian Compensation Partners. www.meridiancp.com

Justin Peters is a senior consultant at the executive compensation consulting firm Meridian Compensation Partners. www.meridiancp.com

PHOTOS COURTESY OF MERIDIAN