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Client Briefing

Unintended Consequences: Severance and Performance-Based Equity Awards

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As the clamor for better corporate governance at U.S. companies continues and activist shareholders push companies to revisit their severance plan designs and equity compensation practices, a note of caution is in order. While more companies embrace lower severance multiples (2x for top executives and 1.5x and less for lower-level executives) and adopt performance-based equity programs (in whole or part), these changes may interact in ways that are not always obvious at first glance.

For example, these trends when coupled with investor concern over gross-ups, could lead a company to also adopt a policy of no gross-ups for its executives. Companies need to be vigilant and fully review the possible consequences of such design changes, and not just leave things to what folks intuitively believe should be "ok" in order to avoid unintended consequences of their compensation design changes.

Example

For example, I just finished up some modeling under Section 280G of the Internal Revenue Code for a company that has adopted a more shareholder-friendly severance policy using the lower multiples mentioned above. The company also has adopted a change to its long-term equity incentive program so that half of the LTI value is delivered by stock options (time-based vesting) and half by performance shares (performance-based vesting) – both have their vesting accelerated upon a change in control. Currently, the company does not have gross-ups for all of its executives (but does have them for several newly-hired executives).

Section 280G Modeling – The Surprising Results

When modeling out the impact of Section 280G on this company's executives, a surprising result occurred. For quite a few of the executives, even though they received only 1.5x their base salary and annual target bonus, they ended up being "over" the Section 280G cap (or "parachute limit") or very close to it. Once an individual executive's severance amount plus other applicable payments contingent upon a change in control exceed the Section 280G cap (generally, 3x the "base amount"), all amounts in excess of the "base amount" (generally, the average of the past 5 years' W-2 income – from Box 1) become subject to a 20% excise tax under Section 4999.

Well, you might think, that is ok. After all, the executives obviously will receive quite a bit in severance (1.5x of base salary plus bonus) so they can afford to give-up some of that in order to come-in under the Section 280G cap. In some cases they could; in others, while they could, it would represent more than half of the cash severance payment they would have to forego; and, for others, even if they gave up their entire cash severance amount, they still would exceed the Section 280G cap and the only way they could come under the cap would be by giving up some of their equity awards.

[1] The Advisor's Blog is on CompensationStandards.com, which can be found at www.CompensationStandards.com

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What caused these results?

The cash severance amount intuitively seems reasonable. Also, the LTI grants were lower than market median and half were delivered as performance shares. So what happened to cause the severance amounts to these executives to come close to or exceed the Section 280G cap? In a nutshell, it was due to the change in their LTI program in which they switched from an all-stock option program to a half stock option, half performance share program. If the company had simply maintained an all stock option program, perhaps only one executive would have exceeded the Section 280G cap (and that was a newly hired executive who was given a 110% alternate cap gross-up – see below for an explanation of "alternative gross-up").

Why Did Switch in LTI program Cause This Result?

The reason is in how the Section 280G regulations handle equity awards based on whether their vesting is strictly time-based or has a performance-based aspect to it. In the former case, time-vested awards only have an incremental amount included in the Section 280G calculation – determined based on the amount of time by which the award's vesting is accelerated. Whereas for performance-based awards, the full amount gets included (full spread for performance-based options and full value of performance shares at deal close).

Consequences

If the company does nothing, then its severance program may not end up producing the results it wants – making the executives indifferent to whether a transaction that is in the best interests of the company and shareholders occurs. If the company goes ahead and grants a standard full gross-up, it likely would be pilloried in the press.

So what to do? Here is where the Board and Compensation Committee need to take ownership and decide what is in the best interests of the company and its shareholders. First off, they should commit to monitoring the potential expense of any solution they implement (preferably on an annual basis as part of their Tally Sheets). Second, they need to balance the objectives of the severance program with shareholder concerns on severance multiples, gross-ups and using performance-based awards. If a company simply adopts all the current practices being proposed without thinking about how they will actually interact, and reviewing the likely consequences of such interaction, it could be in for a surprise.

In the above example, the company adopted lower severance multiples and adopted performance-based equity awards. If it also then blindly adopts the position of some activist shareholders to avoid any gross-ups entirely, the interests of the company and shareholders could actually be hurt, because it could cause the severance plan to fail in its primary purpose.

One possible solution that balances ensuring the goals of the severance program are met with shareholder concern on "excessive compensation" might be to adopt a gross-up provision that only is triggered if the after-tax benefit to an executive exceeds some threshold as compared to the after-tax benefit to the executive with the gross-up applying. Such a provision is generally referred to as an alternate gross-up and a typical threshold is 110% of the after-tax benefit without the gross-up in order for the gross-up provision to be triggered. If the after-tax benefit doesn't exceed such threshold, then the executive's compensation is cut back so that it falls under the Section 280G cap and the executive avoids the 20% excise tax.

The Bottom Line

As companies seek to adopt more progressive corporate governance policies and take actions to re-design their compensation plans and programs, they need to stop and review the practical consequences of their actions to determine the possible impact relative to the underlying purpose for having particular compensation plans and programs. It might be a little extra work, but it helps avoid unwanted surprises and unintended consequences later.

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