Compensation
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Compensation Implications of Mergers and Acquisitions

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Imagine this scenario: Company A acquires Company B. The acquisition is transformational for Company A since Company B's products are complementary, the geographic footprint of the combined company is larger and substantial synergies may be realized after the deal closes. The transaction is not without risk however, since Company A is funding the purchase by issuing several billion dollars of long-term debt, greatly increasing the leverage on the balance sheet.

The due diligence is well underway. The transaction is expected to receive shareholder approval and close shortly. What are the compensation implications? What should Company A's HR staff and Compensation Committee focus on? What are the most important issues at this critical juncture?

Due Diligence

The due diligence process provides an opportunity to develop a high-level understanding of the target company's organization structure, employees and compensation and benefit programs. The purpose is to identify potential liabilities that might crater the deal or require an adjustment to the purchase price. Key areas of focus include developing an understanding of contractual rights, the value of severance plans and change in control agreements, retiree benefits and any unusual plans or practices.

An important aspect of the due diligence process from an HR perspective is to understand the retention hooks that will remain in place following the acquisition. An understanding of retention allows the HR team to estimate the potential cost of additional incentives, equity and severance benefits needed to retain key talent after the transaction closes, as well as to right-size the organization, if appropriate. As part of this review, the HR team commonly prepares a side-by-side comparison of the compensation and benefit programs of the two companies.

New Organization Structure

The impact of the newly acquired business on the acquiring company's organization is an important question to answer early in the process. One fundamental issue is whether the acquired business and associated products and services will be merged into existing business units or managed as a separate, stand-alone business unit.

Retention of key employees with customer relationships, product knowledge and a grasp of business fundamentals is a critical priority for the new organization. In many cases, headcount reductions are likely to be extensive. Identifying potential replacements for critical roles is also very important if retention efforts are unsuccessful.

Retention Incentives

Many organizations reserve a pool to fund merger-related retention incentives. Examples disclosed in public filings related to large acquisitions appear in Table 1. These examples reflect mergers closing between 1/1/2015 and 12/31/2016, with transaction values of $10 billion or more (per Capital IQ).

As these examples illustrate, substantial sums are allocated to retaining employees in large transactions. While there is considerable variation, depending on the specific circumstances of each situation, the approaches to retention incentives that we see most frequently are summarized below:

Participation:	Selective; Offered to key employees
Size of Award:	50% to 100% of regular performance-based annual incentive
Payout Schedule:	1 installment for retention periods of 1 year or less; 2 installments for retentions periods of 12-24 months
Form of Payment:	Cash; Stock is used less frequently
Vesting:	Payment is made if company initiates early termination; Payment is forfeited if employee resigns voluntarily

Proxy advisory firm support for these arrangements has been mixed. ISS recommended "For" the advisory vote on golden parachutes in 11 of 18 cases, while 7 companies received an "Against" recommendation. Despite ISS' recommendations, 15 of 18 companies received majority support for their golden parachute votes, with only 3 companies failing to win shareholder support.

Table 1

Select Examples of Merger-Related Retention Compensation

Merger (Target & Acquirer)	Transaction Value	# of Employees at Target	Merger-Related Retention Compensation	ISS Recommendation / Results for Advisory Vote on Golden Parachute
Allergan & Actavis	$72.9B	10,500	$20M pool for cash retention bonuses to Allergan employees (excluding executive officers)	For / Pass
Cameron Int'l & Schlumberger	$16.6B	23,000	$50M pool for retention bonuses and other awards to Cameron employees and executives	Against / Pass
CareFusion & Becton Dickinson	$13.8B	16,000	$25M pool for cash retention bonuses to CareFusion employees	For / Pass
Charter & Time Warner Cable	$78.7B	56,430	2017 retention equity grants for approx. 1,900 employees totaling $148M • Same value and vesting provisions as annual TWC awards that would have been granted in 2017 • Aggregate value of equity awards could not exceed $225M 2015 supplemental bonus for approx. 14,000 employees to be paid on July 1, 2016 • Equal to 50% of each employee's actual bonus payout under TWC's regular 2015 bonus plan • Aggregate value of supplemental bonuses could not exceed $100M	Against / Pass
Chubb & ACE	$31.6B	10,200	$100M pool for short-term cash and long-term equity retention awards to Chubb employees (excluding CEO)	Against / Fail
Covidien & Medtronic	$48.1B	39,500	$20M pool for cash retention bonuses to Covidien employees (excluding executives) 2 Covidien executives joined Medtronic and received one-time new-hire stock compensation totaling $6.4M • 1 executive also received a $1M cash sign-on	For / Pass
DIRECTV & AT&T	$70.3B	30,925	$190M pool for cash retention bonuses to DTV Employees (excl. CEO and CEO's direct reports)	For / Pass

Merger (Target & Acquirer)	Transaction Value	# of Employees at Target	Merger-Related Retention Compensation	ISS Recommendation / Results for Advisory Vote on Golden Parachute
IMS Health & Quintiles	$13.5B	15,000	Quintiles CEO (Vice Chairman of the surviving entity) received retention awards, payment of which was subject to his continued employment on specified vesting dates: • $7M in RSUs that vest in three quarterly installments • Five quarterly payments of $600K • A retention award and an additional payment with a total value of $6.5M One NEO also received a retention award of $750K in RSUs that vest ratably over three years	For / Pass
Jarden & Newell	$19.0B	40,000	President of Newell Brands, who had previously announced his intention to retire at the end of 2015, received $1.4M in RSUs and $3.0M in PBRSUs to recognize his expanded role following the merger and to promote his retention • These awards replaced LTIP awards that he had declined in 2014 and 2015	Against / Fail
Kraft & Heinz	$55.0B	22,100	Kraft COO received a $4M retention bonus	For / Pass
LinkedIn & Microsoft	$29.3B	10,113	LinkedIn CEO received a retention award of $7M in RSUs, which vest one year after the close of the merger	Against / Pass
Safeway & Albertsons	$12.4B	137,000	Certain key Safeway employees (excluding CEO), received cash retention bonuses ranging from 50-75% of salary • Paid in 2 equal annual installments with automatic acceleration upon a qualifying termination	For / Pass
Starwood & Marriott	$15.8B	188,000	$40M pool for retention awards to Starwood employees Starwood CFO received a retention award of $200K, which vested 60 days after the close of the merger or upon termination without cause or resignation for good reason	For / Pass

Merger (Target & Acquirer)	Transaction Value	# of Employees at Target	Merger-Related Retention Compensation	ISS Recommendation / Results for Advisory Vote on Golden Parachute
Tyco & Johnson Controls	$16.8B	57,000	JCI merger retention program provided for retention awards to be made to executive officers in the form of time-based RSUs, which generally vest after 3 years with automatic acceleration upon a qualifying termination • Two JCI NEOs and one Tyco NEO who were expected to continue as NEOs in the surviving entity received awards totaling $7.4M • Other JCI executives received awards totaling $12.2M Four Tyco executives received cash retention awards with a total value of $2.1M under the Tyco retention and recognition program, which was adopted in connection with the merger	Against / Fail

Sources: Transaction data from S&P Capital IQ; compensation data from target company merger proxy and/or combined company proxy; voting data from ISS

Post-Merger Integration Incentives

Some companies also introduce special incentive plans tied to the capture of synergies post-merger. Six examples appear in Table 2. Post-merger performance can be measured in different ways. After large acquisitions, teams representing all major functions – marketing, sales, supply chain, R&D, HR, etc. – are created. Team members are tasked with achieving integration goals in a timely manner, often requiring significant investments of time and effort. Additional bonuses, either discretionary or performance-based, are frequently provided.

For performance-based incentives, one approach is to measure the specific cost savings realized following the merger. A second approach involves assessing the overall financial performance of the combined company. We believe the second approach is generally more effective since such a program answers fundamental questions: Did the deal achieve the promised ROI? Can we call it a success for shareholders and other stakeholders?

Table 2

Select Examples of Post-Merger Incentive Compensation

Merger (Target & Acquirer)	Transaction Value	# of Employees at Target	Post-Merger Incentive Compensation	ISS Recommendation / Result for Say on Pay Vote
Allergan & Actavis	$72.9B	10,500	Members of the senior management team received cash-based "Transformation Incentive Awards": • Target award values: $15M for CEO, $5M for other NEOs • Payouts tied to EPS (65%) and relative TSR (35%) performance • Payouts range from 58.75-200% of target • Earned awards vest 50% following performance period, 50% one year later	Against / Pass
Chubb & ACE	$31.6B	10,200	Certain ACE employees (incl. NEOs) received a supplemental award of PBRS: • Target award values: $4M for CEO, $1M to $2.1M for other NEOs • Same performance criteria/vesting as annual award	For / Pass
Lorillard & Reynolds American	$28.5B	2,900	All full-time employees (excluding the CEO) received one-time "Game Changer" cash incentive awards • Target award values are equal to the lower of the employee's target bonus opportunity and 65% of base salary • Payouts tied to 18-month goals related to the integration of Lorillard	For / Pass
Starwood & Marriott	$15.8B	188,000	All NEOs except for the Executive Chairman received "Business Integration" PSUs • Target award values: $2.5M for CEO, $2M for other NEOs • Payouts tied to three equally weighted measures: management synergies and cost savings, hotel revenue synergies and hotel margin synergies • Payouts range from 50-150% of target	For / Pass
Kraft & Heinz	$55.0B	22,100	Kraft COO received a special incentive bonus with a target value of $10M and a minimum guaranteed value of $7M • Payouts tied to net cost savings (40%), sales growth (40%) and innovation (20%)	For / Pass

Sources: Transaction data from S&P Capital IQ; compensation data from combined company proxy; voting data from ISS

Integrating Compensation Programs

The merger agreement often provides that compensation and benefits will be maintained at existing levels for a defined period, typically one year but sometimes as long as two years. This allows for some time to assess the compensation and benefit programs at the newly acquired business and develop an action plan. In most cases, employees of the acquired company are added into the programs of the acquiring company. But in some cases, it may be appropriate to merge the programs by selecting the best features of each.

Action steps are situational. The specific facts and circumstances of the combined company will dictate the optimal compensation program design decisions. While each company will come to its own conclusions, here are some suggested areas of focus:

1. ***Develop Employee/Executive Roster:*** Assemble a tally of headcounts and compensation levels by business unit, level and geographic location. Understand the population and markets that you are dealing with. Recognize that roadblocks created by different HRIS systems may make this more difficult than expected.

2. ***Address Titling Conventions:*** Determine the extent to which job titles are consistent. Assess whether span of responsibilities associated with different titles (i.e., Manager, Director, Senior Director, etc.) are similar. If inequities exist, develop an action plan to achieve uniformity.

3. ***Develop Integrated Salary Structure(s):*** Depending on current practices, this may involve traditional salary ranges or salary bands. It can be supported by job matching to survey data, or other job evaluation systems. Multiple structures in different geographies may be required. This is a critical step to achieve internal equity, but it also requires time to analyze and implement, as well as input from the HR generalists in the business units.

4. ***Expand Participation in Annual Incentives:*** The place to start is to make a side-by-side comparison of the annual incentive plans of the acquired and acquiring companies. There are a number of fundamental questions to address:

   - Do both companies use performance against budget as the basis for annual incentives?
   - Are the award opportunities consistent at target? At threshold? At maximum?
   - Should award opportunities of newly acquired participants be adjusted or grandfathered?
   - What are the performance metrics? Are they similar or different? What makes sense going forward?
   - How about the performance scales? Are the performance ranges and payout percentages similar?

   Well thought out decisions on each of these points will help create an annual incentive plan that supports business success and creates a bridge between the legacy populations.

5. **Expand Participation in Long-Term Incentives and Equity**: Including newly acquired personnel in the long-term incentive and equity programs requires a similar decision-making process. Since long-term compensation is a significant component of pay at the director level and above at most companies, it is important to size it correctly. Companies should also project the impact of expanded participation on share usage and make sure that the existing plans can fund awards.

   Frequently the acquiring company assumes the equity plan sponsored by the acquired company. The shares in the plan are converted to reflect the equity of the combined company. This provides another source of shares. However, these shares can only be used for employees of the acquired company unless shareholder approval is obtained. Depending on the size of the two plans and the share usage, this may be a worthwhile step to take.

Conclusion

A large acquisition raises a host of compensation and benefit issues. Working through the process of analyzing and integrating compensation programs frequently requires several years. Decisions made after a large acquisition have important implications for talent retention, performance of the combined company and the board of directors' ultimate judgment on whether the transaction was successful. The HR team plays an important role in the process, beginning with due diligence and continuing through the integration process.

CAP consultants have supported many large transactions. Any of our partners would be happy to talk through the implications of an acquisition on incentives and other HR issues.