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Executive Compensation Issues in a Spin-off

▪ By **Melissa Burek** and **Eric Hosken**

Spin-offs have been in the news for several years. Fully 60 spin-off transactions occurred in 2014, followed by another 40 spin-offs in 2015, with 13 involving S&P 500 companies.[1] Spin-off activity continued to be newsworthy in 2016 with major spin-offs completed by Alcoa, Danaher, Emerson Electric, Johnson Controls, and Xerox. Spin-off activity will continue into 2017 with a number of pending transactions including major companies like Ashland, Biogen, Hilton Worldwide, and MetLife. The need to create shareholder value during a period marked by low returns from most asset classes is driving the spin-off activity. In some cases, activist shareholders have pushed companies to create value by breaking businesses into their component parts. When a business undergoes a spin-off, the human resource and executive compensation implications for executives at both the Parent Company (ParentCo) and the Spin-off Company (SpinCo) are very significant.

1 Source: www.spinoffresearch.com

We have advised many companies as they worked through the spin-off process and we want to share some of what we have learned. As a starting point, we have identified four critical work streams for executive compensation in a spin-off:

1. Establishing Transitional Compensation Arrangements (e.g., near-term retention plans)

2. Understanding and/or Modifying Outstanding Compensation Arrangements (e.g., outstanding equity awards, severance and change in control agreements, benefit plans, etc.)

3. Developing Going Forward Compensation Programs for SpinCo, equivalent in many ways to standing up a newly public company in an IPO

4. Modifying Compensation Programs for ParentCo, as necessary to reflect new business focus and business scale

1. Establishing Transitional Compensation Arrangements

After deciding that a portion of the business is going to be spun-off, one of the first compensation decisions that needs to be addressed is how to structure incentive compensation programs for the company in the year of the spin-off. How complex this step is will depend on the timing of the spin-off in the fiscal year and the nature of the company's annual and long-term incentive plans. A general principle is that if the spin-off has already been announced at the time design decisions are being made, SpinCo incentive compensation should be based primarily on SpinCo performance to provide better line-of-sight for SpinCo employees and to facilitate the transition.

Annual Incentive Plans

If the upcoming spin-off is a known event at the time that the annual incentive award is made, the transitional incentive plan can be simplified by ensuring that the annual incentive for SpinCo executives is tied 100% to SpinCo performance for the entire fiscal year. In this case, SpinCo executives will be paid an annual incentive based on SpinCo's performance early in the fiscal year following the spin-off.

In some cases, the annual incentive award may already have been granted prior to the announcement of the spin-off. In such a situation, it is likely that the incentive plan for SpinCo employees will be based on a combination of ParentCo and SpinCo performance up to the time of the spin-off and then on SpinCo performance for the remainder of the year. This may require the company to establish SpinCo specific performance goals for the "stub period" from the completion of the spin-off to the end of the fiscal year. The performance measures for the "stub period" are typically the same performance measures used to assess SpinCo performance for the portion of the fiscal year prior to the completion of the spin-off.

Long-term Incentive Plans

Similar to the short-term incentive, if the company knows that the spin-off is going to take place during the fiscal year, there are design decisions that can help to facilitate transitioning the long-term incentive awards. For any performance-based awards (e.g., performance shares/units/cash), SpinCo employees should be granted awards that are based on multi-year performance objectives for the SpinCo. In some cases, companies will avoid making performance-based awards to SpinCo employees in the year of the transition because of the challenges in maintaining a consistent performance measurement approach before and after the spin-off.

If the spin-off is not a known event at the time that performance awards are made, there may be challenges in converting ParentCo performance awards into SpinCo performance awards at the time of the spin-off. In these cases, some companies will truncate the payout based on the ParentCo performance to date, at spin, and establish SpinCo goals for the remainder of the overall performance period. We will address this issue in greater detail in the next section on the treatment of outstanding awards following the spin-off.

Special Transition Compensation Programs

Most SpinCo employees are likely to view the spin-off as a positive event. Staff positions (e.g., finance, legal, human resources, etc.) will often have enhanced roles and responsibilities at the new company, given the stand-alone nature of the business. Line positions (e.g., business unit executives and staff) often feel that the spin-off provides them with a greater ability to impact business performance.

On the other hand, announcement of a spin-off creates uncertainty about the future prospects of the business. In addition, the SpinCo is a potential acquisition target, with the business potentially being sold rather than spun-off to shareholders. In many cases, it makes sense to review the severance protection in place for SpinCo staff in advance of announcing the spin-off. If there is a real chance that the business may be sold, enhanced severance protection may be needed to ensure that staff positions do not "jump ship".

There may also be employee retention concerns at the ParentCo. While the spin-off is generally a positive event for SpinCo employees, spin-offs can create concerns for ParentCo employees. For ParentCo employees, a spin-off means working for a smaller company in the future, with a less complex and potentially less interesting job. In addition, the spin-off transaction will create additional work for all corporate staff positions as they set up the newly public company and continue to do their "day job". For select ParentCo employees, a near-term retention bonus or short-term stock retention grant may provide recognition for their additional workload and focused efforts on preparing for a successful transaction, and help to keep them engaged in a stressful working environment. To the extent that certain corporate staff positions will no longer be needed following the spin-off, there may also be a need for enhanced severance for corporate staff.

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2. Understanding and/or Modifying Outstanding Compensation Arrangements

As the company approaches the spin-off, a key compensation issue is how to adjust outstanding compensation arrangements to recognize that one company is breaking up into two companies. Decisions need to be made about what will happen to the company's long-term incentive plans, as well as retirement plans and deferred compensation plans. For purposes of this discussion, we will focus on long-term incentive plans, as it is an area that is particularly critical for executive compensation.

The treatment of outstanding long-term incentives (particularly equity incentives), can be complex following a spin-off. There are several steps that need to be taken to transition awards, including review of the following:

- What provisions are specified in the equity plan and equity award agreements?
- Should the Committee apply discretion to modify the treatment of employees' awards based on the circumstances of the transaction?
- What is the preferred approach for converting ParentCo equity (i.e., ParentCo post-spin and SpinCo equity)?
- What will be the timing of the conversion of equity?

Existing Equity Plan and Award Agreements

The first step in reviewing outstanding equity is to understand the treatment that the company's equity plan and the individual award agreements prescribe for outstanding equity awards. A key issue to understand is what will happen to the awards held by employees of SpinCo. In many cases, the spin-off constitutes a termination of employment and, under ParentCo's plans, unvested awards are forfeited at the spin-off.

It is important to understand the extent to which the prescribed approach impacts the bottom line of both entities. It is also important to work with internal and external counsel to ensure that there is a common understanding of the contractual rights of employees under the equity plan and award agreements.

Another key issue is whether the plan provides for the conversion of outstanding awards in a spin-off transaction. The plan document will likely include a section addressing a change in capital structure and transactions like a spin-off. In most cases, the Committee is required to convert vested awards to preserve value, but is afforded significant latitude in determining the details of the conversion.

Exercise of Compensation Committee Discretion

In our experience, most Compensation Committees do not want SpinCo employees to forfeit outstanding unvested equity as a result of a spin-off transaction. Forfeiture of previously awarded equity could have a serious impact on morale. One way to address this is to accelerate vesting in ParentCo equity or to provide for continued vesting post-spin. Alternatively, if the ParentCo's Compensation Committee does not take action to keep SpinCo's employees whole, then SpinCo's Compensation Committee may need to take action following the spin-off. But it is important to keep in mind that each situation is different. If outstanding awards are underwater, the spin-off may be an opportunity to eliminate overhang on the stock.

Approaches for Conversion of ParentCo Equity

There are several approaches that are used in practice when addressing how to treat outstanding equity upon a spin-off. The following table provides an overview of the alternative approaches:

Approach	Description
Employee	Employee awards are converted to equity in the company where they are employed. The participants of the equity plan who remain employed by ParentCo retain adjusted ParentCo equity awards. The equity plan participants who are employed by SpinCo receive converted SpinCo equity awards with same terms and conditions
Shareholder	Employees are treated like shareholders. Regardless of where the participant is employed following spin-off, outstanding awards of all equity plan participants are converted into both ParentCo and SpinCo equity at the same conversion ratio as shareholders, with the same terms and conditions as the original awards
Hybrid	A combination of the "Employment" and "Shareholder" approaches based on any of the following: (i) when the equity award was granted, (ii) where the equity holder is employed post-spin, (iii) when the equity award will vest, and/or (iv) the type of equity held at spin-off
Adjustment Only, No Conversion Approach	All employees retain adjusted ParentCo equity with same terms and conditions. Continued employment with SpinCo is treated as employment with ParentCo, for purposes of continued award vesting

While several approaches to conversion are used in practice, the Employee approach is the most consistent with the goal of aligning the executives of the company with the shareholders of the entity they support following the spin-off. Other approaches (e.g., shareholder) may attempt to recognize the efforts of employees, prior to the spin, given that such efforts contribute to the future business success of both entities, post spin. The hybrid approach is sometimes used in situations where there is a significant difference in the growth prospects of the SpinCo or ParentCo. (i.e., ParentCo is expected to have modest price appreciation potential and SpinCo has strong growth prospects). And it is sometimes the case that different treatments may apply to employees within one entity. For example, if the ParentCo hires a senior executive for SpinCo from outside the company, prior to the spin, their awards may convert using the Employee approach if they have minimal service at ParentCo, yet the Shareholder approach may be used for other employees.

For outstanding long-term performance share or unit/cash plans (typically with three-year performance cycles), practice is mixed, and the conversion approach used will depend on the length of time remaining in the outstanding award cycle, the performance measures used, whether a new program is put in place in SpinCo, and the type of SpinCo company structure. In many cases, ParentCo prorates outstanding LTI awards held by employees of SpinCo to reflect their time as an employee of ParentCo. The prorated awards held by SpinCo employees are then paid out based on the original performance criteria at the time payments are made to ongoing employees of ParentCo. Once employees have transferred to SpinCo, the remaining stub periods of each outstanding award may be paid out at the target award amount, or, in cases where the Committee of SpinCo wants to preserve a performance-based focus, they may establish new performance goals based on operational or stock performance of SpinCo. There are challenges associated with setting goals for these 'interim' performance periods, yet many companies will do so.

Retirement Programs. Agreement on the treatment of retirement programs, non-qualified deferred compensation ("NQDC") plans and other benefits is a critical administrative decision. If ParentCo has a defined benefit plan, it must determine whether to transfer assets and liabilities of the pension associated with SpinCo employees to SpinCo. A decision on whether any applicable grandfathering of frozen plans/plan benefits will continue is also required. Non-qualified benefit programs are often only partially funded, or unfunded, and the amounts can be significant. Typically, employee accounts in any NQDC plan of ParentCo are transferred to a SpinCo plan for employees of SpinCo. Alternatively, SpinCo could receive a payout of the NQDC applicable balances. Plan provisions will dictate the course of action. Note that distributions in connection with a spin-off are generally not compliant with Section 409A of IRC, since a spin-off is not a separation of service for employees under 409A.

Health and Welfare Benefits. Generally, SpinCo is responsible for setting up new health and welfare programs and both ParentCo and SpinCo are responsible for claims incurred against the respective plans post-spin. Certain programs such as retiree medical, however, may require a determination of how to allocate liabilities to SpinCo (e.g., for current terminated employees, or just future retirees). Decisions on allocating liabilities related to LTD payments, accrued vacation, COBRA, workers' compensation, etc. may also need to be made depending on the programs of ParentCo.

Severance and Change in Control ("CIC) Benefits. A spin-off could trigger a CIC depending on the provisions of ParentCo's various plans. While many benefits arising from a CIC are only paid after a "double trigger" (i.e., they are only paid or vested if a termination of employment occurs in connection with the CIC), certain benefits may be accelerated or payments may be triggered immediately. As a result, severance payments could become due to employees transferring to SpinCo. The companies need to determine if any severance obligations apply when employees transfer to SpinCo and who bears the responsibility for such obligations. Note however, that in many transactions, outstanding awards are assumed by SpinCo, in which case, payments would not be accelerated, nor would any benefits be distributed.

3. SpinCo Going Forward Compensation

Developing a going forward compensation program for the SpinCo is a critical process that often evolves over time. While the default approach may initially be to maintain compensation programs similar to those of the parent company, there may be a compelling case to make fundamental changes to the compensation program to address differences between the SpinCo and the Parent. However, depending on the time-frame for completion of the spin-off and the corporate governance structure, the timing of any such changes may be delayed.

Corporate governance of a spin-off can vary and we have seen each of the following approaches used:

- SpinCo Board of Directors is led by ParentCo executives through time of spin-off until ParentCo no longer has majority stake
- SpinCo has Independent Board members appointed prior to spin-off; decisions on compensation for SpinCo may be subject to Parent Company Compensation Committee approval
- ParentCo Compensation Committee reviews and approves programs for SpinCo

Prior to a planned spin-off there is typically a designated subcommittee of the Parent company board that begins planning and making decisions related to the SpinCo's compensation program. A Lead Director may be appointed to oversee this planning process on behalf of the new Board, working with the company's HR or designated SpinCo CEO. Prior to the spin-off, coordinated efforts to recruit new directors, develop a compensation committee charter and a Board calendar, etc. are required.

In a one-stage spin-off, where all shares of the SpinCo are distributed to ParentCo shareholders at the time of the spin-off, the involvement of ParentCo executives and Board members in SpinCo corporate governance will cease at the time of the spin-off. In other cases, where the SpinCo is distributed in stages (e.g., partial IPO to public shareholders followed by a completion of the spin-off or incremental sale of shares in the SpinCo to the public), the parent company Board or parent company executives may continue to serve as Board members of the SpinCo up until the time that the parent company has fully distributed its interest in SpinCo.

When ParentCo Board members or executives are involved in the compensation design, they are more likely to fall back on maintaining a compensation approach that is consistent with that of the parent. They may continue to view the SpinCo as akin to a subsidiary. In these cases, the SpinCo's compensation program may evolve from the timing of the initial spin-off through the year following the parent company fully divesting its interests in the SpinCo.

There may be a compelling case to make fundamental changes to the compensation program for SpinCo to address differences between the SpinCo and the Parent.

Pay Philosophy and Target Pay Levels

For the SpinCo, there is typically pre-planning around the desired compensation philosophy, including a defined market or peer group for pay and performance benchmarking. This peer group should be size and industry specific, reflective of the operating characteristics of SpinCo and may or may not include similar peers to ParentCo's peers.

There is often extensive benchmarking conducted before the spin-off to determine competitive pay levels for executive positions at SpinCo, assuming new position roles/responsibilities as part of a standalone entity (vs. part of a business unit, prior to the spin-off). It is often the case that benchmarking for SpinCo as a standalone entity will support an increase in pay for executive positions. For example, the top finance executive of a subsidiary is a very different role than CFO of a stand-alone public company. Some adjustments to base salaries and bonus opportunities may be made prior to and/or near the spin date, but should be made within the context of an overall compensation framework to the extent possible. The desired pay mix needs to be determined, with the appropriate emphasis on long-term (equity) incentives to ensure equity ownership build up and alignment with shareholders.

Annual Incentive Program

As with any company, the ongoing bonus program is designed so that funding is based on an appropriate mix of corporate, business unit and/or individual performance. The mix depends on the company's emphasis on line of sight unit results or overall corporate team results. Performance metrics, whether top line, bottom line, or return based, should appropriately support the company's strategy. Some investors may initially focus on EBIT/EBITDA or cash flow, yet ultimately determine that a balanced mix of metrics is desirable.

It is worth noting that for both short and long-term incentives, based on the tax code rules (IRC Sec. 162(m), the "performance based compensation" tax exemption for select executive officers), if a company gets an annual and long-term incentive plan approved prior to the Spin by the ParentCo board, and discloses such plan documents in any S1 filing, the company is exempt from IRC Section 162(m) rules for one year. Reapproval of such plan(s) by SpinCo shareholders is required prior to Sec. 162(m) transition relief expiring, and is also required under applicable stock exchange rules. Most companies, however, will still construct their plans to conform with "performance based compensation" rules and best in class industry/market practices.

Long-term Incentives

Key objectives of the Long-term Incentive ("LTI") program for the SpinCo are to build executive/ employee stock ownership and to create excitement, engagement and alignment with shareholder value creation.

An important first step is to determine an overall equity pool to reserve for equity grants at the SpinCo, i.e., the amount of public stock outstanding that will be shared with employees as part of the compensation program. (This amount is generally under 10% of CSO, once initial IPO, has occurred and/or upon completion of the full spin; industry norms should dictate). At the initial IPO, or at full spin-off, it is common to grant a front loaded equity award to 'jump start' employee ownership in the new company. Some companies make a broad-based award to employees deeper in the organization, or beyond the executive group. Stock options and restricted stock are used for this type of grant, yet use of options (vs. full value awards) should be balanced with participation, share usage and cost considerations.

The core LTI framework for SpinCo should be designed to accomplish multiple objectives. Emphasis on equity programs helps to build shareholder alignment. Stock-based performance programs are strongly recommended. Not only do they reflect prevalent practice, but they are viewed favorably by large shareholders. Performance-based equity will also serve as a tool for the new leadership team to promote a focus on specific longer term performance results.

Like any LTI program, balance is important. While some specific industries may use more restricted stock than others (e.g., energy companies), most restricted stock is granted at lower levels in the organization, or for special retention/recognition grants. As a new entity, any new design presents an opportunity to assess long term performance goals related to business strategy and those being communicated to the marketplace. Such goals should likely be incorporated into the LTI program.

Vesting, form of payout and termination provisions are also important. The spin-off event is an opportunity for the new company to re-evaluate ParentCo practices. For example, SpinCo may choose to implement somewhat more stringent award termination provisions to support longer term employment of employees. To further align with best practice, companies should include CIC provisions that provide for outstanding award vesting only upon both completion of a CIC and termination of employment for good reason (i.e., a "double trigger").

Severance provisions should be established as part of a formal severance (CIC/non-CIC) program or through severance agreements, or less common, as part of an employment agreement. These programs should be implemented after careful consideration of potential costs and benefits to the participant and to the company. Recognize that severance benefits are a sensitive issue for many investors. Tax gross-ups for any 280(g) CIC tax liabilities are no longer common and should not be included. Non-compete and non-solicitation provisions should be put in place for the new entity, as standalone policies or as part of LTI award agreements.

Governance Practices

Certain good governance practices that are commonly in place should be implemented, as they are in the best interests of SpinCo and shareholders and have come to be expected.

Stock Ownership guidelines are now very mainstream and expected by shareholders. They should apply to the newly formed executive group. In SpinCo, it may take some time to ramp up ownership in SpinCo stock, particularly if outstanding ParentCo equity awards were converted at spin using the shareholder approach. Keep in mind there should be a phase-in period before executives are held accountable and a 'soft' penalty my make sense, to help facilitate ownership, such as a required holding of 50% of net shares (vested or settled), until the guideline is met.

A Clawback Policy for any awards that were based on results impacted by an accounting restatement is a matter of good governance. A majority of companies today have one, with the ability for discretionary recoupment in the case of fraud or earnings restatement. Note that potential Dodd-Frank rules may mandate a "no fault" policy if finalized.

An Anti-Hedging Policy should be in place that prohibits executives from entering into any hedging transactions related to the company's stock or trading any instrument related to the future price of the stock.

If Dodd-Frank rules are finalized as currently expected, companies may need to modify these provisions to comply with final rules, but on their own merit, these provisions should be put in place as a baseline.

Directors Compensation. The outside directors' compensation program of SpinCo should ultimately reflect appropriate market norms for companies of similar size and industry, in terms of the amount of pay provided, the cash/equity mix, and overall structure of board and committee service pay. The design should consider the duties required of directors, as well as the company's executive compensation philosophy. Initially however, the structure of SpinCo's program will often resemble the ParentCo program.

The directors equity plan, if separate, follows the same rules as executive equity plans. The ParentCo board typically approves the SpinCo plan prior to the spin-off. Shareholders of SpinCo must reapprove the plan prior to IRC Sec. 162(m) transition relief running out, and also to comply with stock exchange listing requirements.

If any directors work on SpinCo activities prior to the spin-off, special equity compensation may be awarded, or pro-rated. If board leadership includes a non-executive chair or lead director, compensation will need to reflect the expected role, responsibilities and time commitment expected at that time.

4. Modification to ParentCo Compensation Programs Post-Spin

After the spin transaction, it is a good time for the remaining ParentCo to review its own compensation programs to ensure that they reflect the company's new size and business focus. While not inclusive, the following program components may require review and/or potential modification:

Compensation Philosophy and Competitive Market. The company should assess who the appropriate peer companies are in terms of size, business mix, customers, geographic footprint, domestic vs international business, etc. It may be that the company maintains a market median pay philosophy, but that market position means something different now. If the company's size is significantly smaller than before, pay levels will need to be monitored for alignment with the newly defined market over time.

Annual Incentive Program. The company's annual incentive plan, in particular, may need revision so that the performance metrics reflect key drivers of the remaining entity and adjustments to the plan should reflect the new adjustments to the plan should reflect the new organization structure as it relates to any Business Unit or Division performance components. If the remaining business has slower growth prospects and lower margins, for example, the performance metrics may need to be redefined and the weightings reallocated. It may also be the case that there is more of a role for strategic goals as ParentCo also embarks on a new business strategy.

Long-term Incentive Plans. The company should reassess the role of various LTI vehicles at ParentCo. For example, in a low growth business, stock options are not the most effective long term incentive and the company may be better served by increasing the role of a three year LTIP. Conversely, the company may want to instill renewed enthusiasm around the ParentCo's long term stock performance and growth potential. It may be an appropriate time to emphasize the role of equity. It is also a good time to reassess equity award participation as it relates to overall cost and/or share utilization, both domestically and internationally.

From a more technical standpoint, the Parent should review its current equity plans and share reserve, in light of the recapitalization. A spin-off event itself may not necessarily require revisions to plan documents, but it is an appropriate time to review documents to ensure that appropriate terms and provisions are included. It is also a good time to review compliance with IRC Section 162(m) and 409A.

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The compensation related programs and provisions that need to be addressed and acted upon in a spin-off are comprehensive. It is important to the ongoing entities that both ParentCo and SpinCo business objectives are supported by appropriate pay design. At the same time, employee perspectives need to be considered as these transactions can present uncertainty. Planning should begin well in advance of any potential or planned transaction. A cross-functional team from HR, legal, finance and possibly outside advisors, should oversee the necessary action steps. This report can be used to help guide the process and compensation decisions that an organization will need to consider in a spin-off.

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Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.