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The Changing Face of Change in Control Benefits

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Abstract

As the scrutiny placed on executive compensation increases, so too must companies continue to be diligent in designing and implementing their compensation arrangements. They must be competitive with peers so they can attract and retain their talent but must continue to maximize shareholder value and manage third party perceptions of their pay practices. Companies must be prepared by asking the right questions and being ready to respond to criticism, especially if they engage in poor pay practices as determined by shareholder advisory firms.

Keywords

change in control, executive compensation, gross-up, disclosure

It is almost impossible to open a newspaper or periodical or to surf the Internet without coming across an article related to executive pay. The passage of time has not stifled outrage over executive compensation paid at failing Wall Street institutions during 2008. Instead, executive pay continues to be a hot-button issue. Political activists, shareholder advisory services and the media continue to focus on the compensation of top executives at publicly traded companies.

With the pressure placed on companies by shareholder advisory firms and increasingly burdensome executive compensation disclosures, companies are under the gun now more than ever.

The Board of Directors and the executives whose compensation is publicly disclosed could come under fire. Companies with change of control commitments to terminated executives have to address a series of issues. If 280G excise tax gross-ups are provided as part of the executive compensation package, they could be an even larger target. The Board and executives need to be prepared.

They need to have answers to a myriad of questions. How do our Company's pay practices compare with others in our industry? In our peer group? What is our compensation philosophy? Why? Is our compensation performance based? Do we have poor pay practices as identified by shareholder advisory groups? How will we respond to criticism if we do? Have we considered all of the relevant issues?

Tax Penalties for Certain Payments Contingent on a Change in Control

One of the most controversial pay practices is the 280G excise tax gross-up. The 280G excise tax, aptly named for the Internal Revenue Code (Code) section that provides for it, is an excise tax imposed on an executive that receives a parachute payment on a change in control.

Public companies must quantify and disclose in the proxy the magnitude of termination payments made on a change in control to top executives, whether in the form of severance payments, acceleration of equity awards (e.g., stock options or restricted stock), fringe benefits and/or any "gross-up" payments for excise taxes imposed as a result of Code Section 280G.

> *280G Excise Tax:* A 20% excise tax on excess parachute payments paid to disqualified individuals on a change in control. This excise tax is levied on the executive, not the company. However, the company also loses a tax deduction on excess parachute payments.
> *Change in Control:* A change in control occurs when the ownership of a corporation changes in a certain

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manner. There are specific rules that apply when determining when a change in control occurs that are outside the scope of this article. However, generally, a change in control can occur when there is an acquisition of certain amounts of stock, assets or control of the Board of Directors by another person or entity.
Parachute Payment: A parachute payment is any payment that satisfies the following requirements:

- It is in the nature of compensation for services.
- It is made or will be made to a disqualified individual.
- It is contingent on a change in control.
- It has an aggregate present value in excess of the safe harbor amount (3 times the individual's base amount, which is generally the average of the individual's compensation over the previous 5 years).

Disqualified Individual: A disqualified individual is generally an employee or independent contractor of a corporation who is a shareholder, officer or highly compensated individual.
Excess Parachute Payment: If an individual has an excess parachute payment (a parachute payment in excess of the safe harbor limit), the excess of the parachute payment less the base amount will be subject to the excise tax.

Some companies choose to gross up an executive for this excise tax. If the company pays the excise tax on the executive's behalf, it will be included in the executive's income and subject to federal, state and local taxes. If a company grosses the executive up for taxes, it means the executive will receive, after all applicable taxes, the amount of the excise tax.

Because of the scrutiny placed on executive compensation, increased attention has been specifically placed on payments received by executives in connection with changes in control and the associated "gross-up" payments.

Securities and Exchange Commission Focus on Executive Compensation

Executive Compensation Disclosures

In 2006, the Securities and Exchange Commission (SEC) significantly expanded the disclosure of executive compensation required for public companies. In an expanded Compensation Discussion and Analysis section, the SEC mandates a discussion of the various elements of compensation and a company's compensation philosophy. One of these disclosures requires tables and a narrative detailing termination payments required to be paid to named executive officers on a hypothetical change in control on the last day of the company's tax year.

Say on Pay

Beginning with the 2011 proxy season, the SEC required public companies to hold a shareholder vote on executive compensation. Shareholder advisory firms have indicated that they will recommend that institutional shareholders vote against the company's say on pay resolution and/or the reelection of members of the Compensation Committee if "poor pay practices" are present. Although the definition of a poor pay practice continues to evolve, right now it includes providing severance benefits in excess of three times compensation, excessive perquisites and newly implemented excise tax gross-ups for golden parachute payments.

The Executive Change in Control Report

As a result of these increased disclosure requirements, the information available on common change in control practices has significantly increased. Boards of directors and, in particular, Compensation Committees should take a close look at the types of benefits provided and the magnitude of the potential payments.

In an effort to understand pay practices, the Compensation and Benefits Practice of Alvarez & Marsal Taxand, LLC conducted a study of change in control arrangements among the top 200 U.S. publicly traded companies in 2006, 2007, 2009 and 2011.

To compare practices in different industries, the publicly available documents of the 200 largest companies (based on market capitalization) in 10 different industries were reviewed and change in control protections provided to the chief executive officer (CEO) and other named executive officers (Other NEOs) were analyzed. Other named executive officers include the principal financial officer (the chief financial officer) as well as the top three highest paid executives (other than the principal executive officer and the principal financial officer).

The reports can be downloaded from the Alvarez & Marsal Taxand, LLC website:

http://tinyurl.com/6rk8mrk

The reports analyze change in control arrangements in the 20 largest companies in the consumer discretionary, consumer staples, energy, financial services, health care, industrials, information technology, materials, telecommunications and utilities industries.

The documents reviewed included the CEOs' and Other NEOs' employment agreements, as well as the companies' policies, equity plans, annual bonus plans, retirement plans, deferred compensation plans and proxy disclosures.

What the Analysis Revealed

Overall. The average value of change in control benefits provided to CEOs and Other NEOs increased in 2011 by 32%. This is primarily because of the increase in long-term incentive values, which are largely based on the stock price of the company.

Equity-based compensation. More companies are requiring a double trigger to accelerate vesting. Similar to 2009, 85% of companies have at least one equity plan (options, restricted stock, etc.) that uses a single trigger to activate change in control provisions, generally resulting in accelerated vesting. In a single-trigger scenario, only a change of control must occur; the executive need not be terminated. In 2011, 53% of companies have at least one equity plan that uses a double trigger (change of control and termination of employment) compared with 28% in 2009.

Severance benefits. Similar to 2009, most CEOs and Other NEOs are entitled to receive a cash severance payment on termination in connection with a change in control. The most common cash severance multiple for CEOs remained steady at three times compensation (51% in 2011 and 52% in 2009). The prevalence of Other NEOs entitled to a cash severance multiple of three times compensation decreased to 20% in 2011 as compared with 26% in 2009. Fifty-eight percent of Other NEOs in 2011 were entitled to a severance multiple between two and three times compensation compared with 51% in 2009.

Retirement benefits. The percentage of companies that provide at least one executive with an enhancement in retirement benefits decreased to 52% in 2011 compared with 59% in 2009.

Gross-up for 280G excise tax. Forty-nine percent of CEOs and 47% of Other NEOs are entitled to receive "gross-up" payments. Compared with 2009, this is a reduction from 61% and 58%, respectively. Fifty-one percent of companies that currently provide an excise tax gross-up or modified gross-up payment indicated they intend to phase out, or completely eliminate, excise tax gross-up payments in the future.

Quantification of Benefits

One of the main goals behind the SEC executive compensation disclosure rules is transparency. As discussed above, one requirement is for companies to quantify any parachute payments the CEO and Other NEOs would receive on a hypothetical change in control at year-end.

After reviewing the data in the Potential Payments on Termination or Change in Control section, as well as other sections of the executive compensation disclosure, we calculated the average value for certain typical parachute payments.

Total Benefit Values for CEOs

On average, CEOs of the top 200 publically traded companies are entitled to change in control benefits of $30,263,141. This is a significant increase from $22,987,661 in 2009 but still lower than $38,355,523 in 2007, primarily because of the change in long-term incentive values. The value of long-term incentives is largely driven by fluctuations in the stock market. Common benefits in the "other" category include health and welfare benefits continuation, outplacement services, financial/tax planning services, country club dues and life insurance.

The percentage of the average total value for each type of benefit received by the CEOs of companies in all 10 industries is shown in Figure 1.

The average total values of Change in Control benefits paid to CEOs in 2007, 2009 and 2011 are shown in Figure 2.

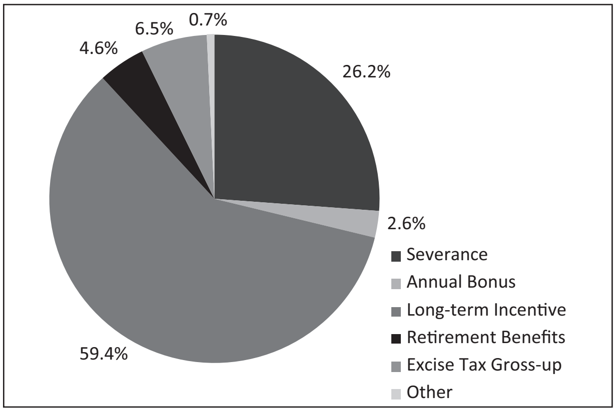

Figure 1. The percentage of the average total value for each type of benefit received by CEOs.

Total Benefit Values for Other NEOs

On average, Other NEOs are entitled to change in control benefits of $10,822,114. This is a significant increase from $7,975,671 in 2009 but still lower than $13,191,635 in 2007 primarily because of the change in long-term incentive values.

The percentage of the average total value for each type of benefit received by the Other NEOs of companies in all 10 industries is shown in Figure 3.

The average total value of Change in Control benefits paid to Other NEOs in 2007, 2009 and 2011 is shown in Figure 4.

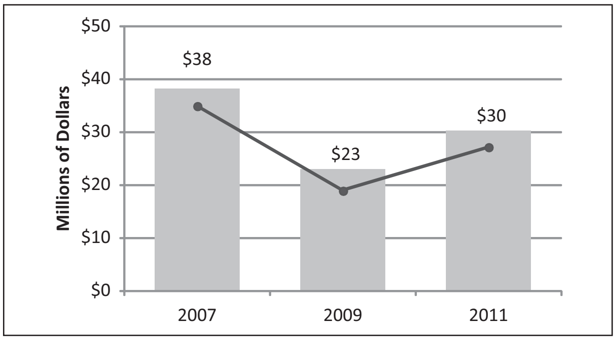

Figure 2. The average total values of change in control benefits paid to CEOs in 2007, 2009 and 2011.

2011 Change in Control Benefit Values for CEOs

	Severance	Annual Bonus	Long-term Incentive	Retirement Benefits	Excise Tax Gross-up	Other	2011 Average Total Benefit	2009 Average Total Benefit	2007 Average Total Benefit
Consumer Discretionary	$8,516,511	$1,683,333	$33,817,834	$191,247	$1,421,182	$398,786	$46,028,894	$24,924,757	$41,323,634
Consumer Staples	7,279,620	1,387,932	15,561,144	917,699	997,770	377,176	26,521,341	23,075,528	33,196,124
Energy	7,887,031	633,479	27,715,068	1,906,902	1,952,831	213,119	40,308,430	34,764,705	54,870,066
Financial Services	6,061,019	662,500	11,197,230	2,084,704	2,281,921	39,254	22,326,628	17,640,937	63,304,908
Healthcare	13,564,987	391,359	15,857,884	518,849	4,990,173	57,324	35,380,576	27,474,558	34,112,916
Industrials	7,029,014	957,305	21,818,691	1,225,370	2,099,348	50,707	33,180,435	31,494,718	40,438,508
Information Technology	3,472,664	834,750	18,154,051	795,151	440,304	97,953	23,794,874	14,459,816	19,793,423
Materials	13,729,924	307,290	15,519,576	4,248,358	2,802,817	87,057	36,695,022	24,444,290	32,689,197
Telecommunications	4,274,296	491,384	10,437,768	23,968	601,975	151,921	15,981,313	9,638,342	29,793,648
Utilities	7,389,035	557,897	9,525,256	2,071,742	2,093,504	776,464	22,413,898	21,958,960	31,115,223
2011 Weighted Average	**$7,920,410**	**$790,723**	**$17,960,450**	**$1,398,399**	**$1,968,182**	**$224,976**	**$30,263,141**	**n/a**	**n/a**
2009 Weighted Average	**$8,147,206**	**$796,688**	**$9,874,297**	**$1,710,842**	**$2,093,842**	**$364,787**	**n/a**	**$22,987,661**	**n/a**
2007 Weighted Average	**$8,351,082**	**$1,115,744**	**$21,357,485**	**$2,773,627**	**$4,415,292**	**$342,293**	**n/a**	**n/a**	**$38,355,523**

Change in Control benefit values for CEOs by industry.

Excise Tax Protection

Under the "Golden Parachute" provisions under Code Section 280G, a payment to an executive exceeding the "safe harbor" limit results in a 20% excise tax on the executive and a disallowance of the tax deduction to the corporation.

Companies may address this excise tax issue in one of the following ways:

- *Gross-up*: The company pays the executive the full amount of any excise tax imposed. The gross-up payment thereby makes the executive "whole" on an after-tax basis. The gross-up includes applicable federal, state and local taxes resulting from the payment of the excise tax.
- *Modified gross-up*: The company will gross up the executive if the payments exceed the safe harbor limit by a certain amount (e.g., $50,000) or percentage (e.g., 10%). Otherwise, payments are cut back to the safe harbor limit to avoid any excise tax.
- *Cutback*: The company cuts back parachute payments to the safe harbor limit to avoid any excise tax.

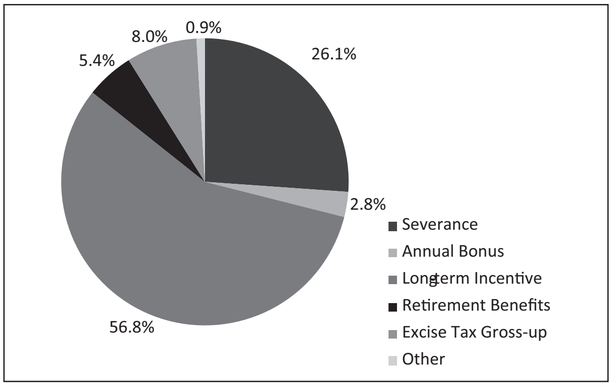

Figure 3. The percentage of the average total value for each type of benefit received by Other NEOs.

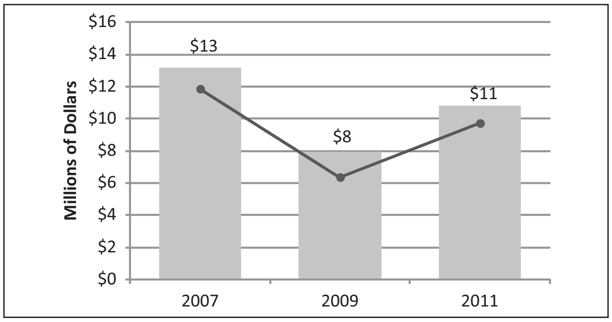

Figure 4. The average total value of Change in Control benefits paid to Other NEOs in 2007, 2009 and 2011.

Change in Control Benefit Values for Other NEOs

	Severance	Annual Bonus	Long-term Incentive	Retirement Benefits	Excise Tax Gross-up	Other	2011 Average Total Benefit	2009 Average Total Benefit	2007 Average Total Benefit
Consumer Discretionary	$4,850,761	$457,726	$12,647,799	$40,733	$1,363,966	$148,911	$19,509,897	$10,376,227	$16,649,804
Consumer Staples	2,421,879	539,406	4,736,005	470,423	328,134	150,089	8,645,936	6,653,298	11,853,356
Energy	2,317,169	376,474	7,125,703	786,996	735,635	82,680	11,424,657	11,309,103	13,269,244
Financial Services	3,411,079	421,260	5,775,720	292,556	936,096	21,487	10,858,197	6,074,436	25,458,218
Healthcare	2,804,704	188,325	5,333,258	678,662	1,040,388	59,699	10,105,035	10,491,323	14,442,903
Industrials	1,845,325	446,918	6,999,392	722,655	646,199	281,868	10,942,357	8,228,893	9,152,277
Information Technology	1,826,570	222,716	7,229,696	636,146	372,246	25,062	10,312,436	6,720,017	10,725,572
Materials	4,486,838	100,047	5,163,747	1,195,742	1,581,957	61,424	12,589,754	8,691,287	11,568,100
Telecommunications	1,579,900	161,764	3,620,278	15,799	83,604	46,362	5,507,706	4,217,347	9,087,586
Utilities	2,798,898	126,528	2,660,989	1,016,182	1,557,302	130,003	8,289,903	7,062,790	9,275,447
2011 Weighted Average	**$2,825,947**	**$306,091**	**$6,142,638**	**$584,471**	**$861,446**	**$101,521**	**$10,822,114**	**n/a**	**n/a**
2009 Weighted Average	**$3,054,700**	**$263,563**	**$3,165,153**	**$643,929**	**$743,230**	**$105,097**	**n/a**	**$7,975,671**	**n/a**
2007 Weighted Average	**$3,240,801**	**$387,913**	**$6,786,002**	**$1,203,622**	**$1,426,467**	**$146,830**	**n/a**	**n/a**	**$13,191,635**

Change in Control benefit values for Other NEOs by industry.

- *Valley provision:* The company cuts back parachute payments to the safe harbor limit if it is more financially advantageous to the executive. Otherwise, the company does not adjust the payments, and the executive is responsible for paying the excise tax.
- *None:* Some companies do not address the excise tax; therefore, executives are solely responsible for the excise tax.

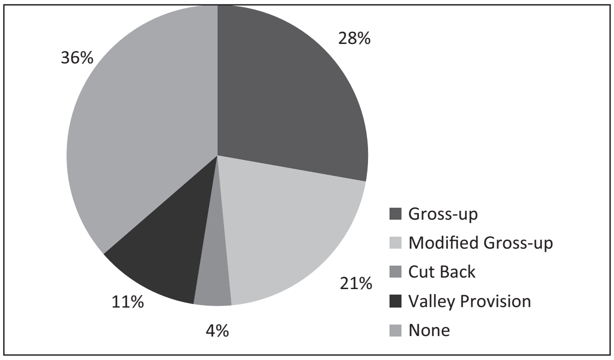

Figure 5. Prevalence of excise tax protection provisions for CEOs in 2011.

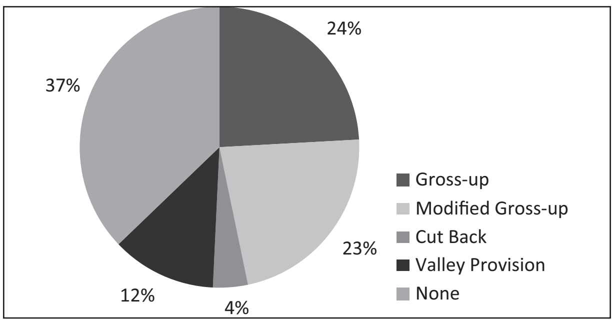

Figure 6. Prevalence of excise tax protection provisions for Other NEOs in 2011.

Excise Tax Protection for CEOs by Industry:	Gross-up	Modified Gross-up	Cut Back	Valley Provision	None
Consumer Discretionary	15%	30%	0%	15%	40%
Consumer Staples	20%	20%	15%	0%	45%
Energy	45%	10%	0%	10%	35%
Financial Services	20%	15%	5%	15%	45%
Healthcare	25%	30%	0%	15%	30%
Industrials	35%	15%	10%	5%	35%
Information Technology	0%	20%	0%	10%	70%
Materials	35%	35%	0%	15%	15%
Telecommunications	35%	5%	5%	25%	30%
Utilities	45%	25%	10%	5%	15%
2011 Average	**28%**	**21%**	**4%**	**11%**	**36%**
2009 Average	**37%**	**24%**	**3%**	**5%**	**31%**
2007 Average	**49%**	**17%**	**2%**	**2%**	**30%**

Excise tax protection for CEOs by industry.

Many companies have chosen to eliminate the use of excise tax gross-ups from executive agreements, which is likely because of pressure from shareholder advisory firms.

The prevalence of excise tax protection provisions for CEOs in 2011 is shown in Figure 5.

The prevalence of excise tax protection provisions for Other NEOs in 2011 is shown in Figure 6.

The decline in the prevalence of excise tax gross-up protection for CEOs and Other NEOs from 2007 through 2011 is shown in Figure 7.

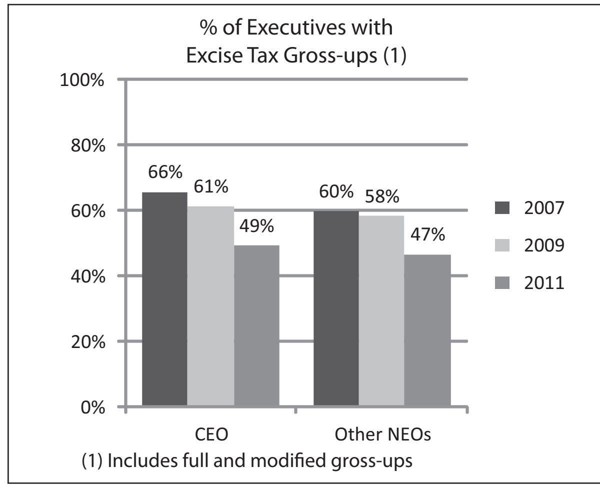

Figure 7. The decline in the prevalence of excise tax gross-up protection for CEOs and Other NEOs for 2007, 2009 and 2011.

Gross-up	Modified Gross-up	Cut Back	Valley Provision	None	Excise Tax Protection for Other NEOs by Industry:
10%	30%	0%	15%	45%	Consumer Discretionary
10%	25%	15%	5%	45%	Consumer Staples
50%	5%	0%	5%	40%	Energy
10%	15%	5%	15%	55%	Financial Services
25%	40%	5%	5%	25%	Healthcare
30%	15%	10%	10%	35%	Industrials
0%	25%	0%	10%	65%	Information Technology
40%	35%	0%	15%	10%	Materials
25%	5%	0%	30%	40%	Telecommunications
45%	30%	5%	10%	10%	Utilities
24%	**23%**	**4%**	**12%**	**37%**	**2011 Average**
33%	**25%**	**4%**	**7%**	**31%**	**2009 Average**
44%	**16%**	**2%**	**3%**	**35%**	**2007 Average**

Excise tax protection for Other NEOs by industry.

How Companies Should Use These Results

Excise tax gross-up alternatives. Companies may not be aware of the different ways in which excise tax protection can be structured for its executives. Even if a company is not inclined to offer a 280G gross-up, or has decided it does not want to fight the gross-up battle with the shareholder advisory firms, there are still strategies that can be employed to minimize the exposure to the executive without costing the company.

Benchmarking. Benchmarking existing plans against other companies' plans will help validate existing benefits or expose opportunities to adjust change in control arrangements. Boards of directors and Compensation Committees are sensitive to the perception that they provide excessive change in control benefits relative to their peers or offer benefits that conflict with maximizing shareholder value.

There may also be strategic reasons a Compensation Committee would benchmark compensation arrangements. The original purpose of termination protection was to ensure that executives evaluate every opportunity, including an acquisition, to maximize shareholder value, not just how such an event would affect their personal circumstances. By addressing change in control provisions in executive compensation packages, boards and shareholders can be assured that executives will approach the intricacies of negotiation without the distraction of personal considerations.

Additionally, Compensation Committees use parachute payment arrangements as a tool to attract qualified candidates to executive positions and to reward top performers for the successful results of their strategies.

Conclusion

In response to pressure from shareholder advisory firms and others, the way Compensation Committees structure executive compensation arrangements, particularly termination protection, is changing. The value of a company's stock, as reflective of a company's performance, continues to drive the value of change in control benefits. Some companies, in response to pressure from the shareholder advisory groups, have completely eliminated excise tax gross-ups but may not realize that executives and the company can be protected in other ways.

As the scrutiny placed on executive compensation increases, so too must companies continue to be diligent in designing and implementing their compensation arrangements. They must be competitive with peers so they can attract and retain their talent but must continue to maximize shareholder value and manage third-party perceptions of their pay practices. It is a tightrope that companies must walk and will have to continue to maneuver for the foreseeable future.

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Bios

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