

# ClearBridge *CLEARthinking*

Mergers & Acquisitions:  
Key Compensation Considerations



ClearBridge  
Compensation Group

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## Executive Summary

Mergers and acquisitions (“M&A”) present exciting opportunities for growth and transformation. A critical factor in realizing that potential is compensation, which plays a central role in ensuring both a smooth transaction and long-term success. For acquirers (i.e., buyers) and target companies (i.e., those being purchased), navigating key compensation-related decisions thoughtfully can help maximize value and drive a successful deal.

This CLEARthinking article highlights the important compensation-related considerations as companies develop pre-close and post-close M&A compensation strategies, specifically:

### Pre-Close Objectives

- Identify, Incentivize, & Retain Key Talent
- Assess Change-in-Control and Severance Agreements
- Determine Treatment of Outstanding Incentive Plans
- Disclose Transaction-Related Agreements

### Post-Close Objectives

- Review Go-Forward Compensation Philosophy and Peer Group
- Determine Go-Forward Pay Levels
- Develop Go-Forward Incentive Compensation Plans
- Review Compensation Governance Policies

Addressing these objectives during the M&A process is critical to a successful transaction, and requires a clear plan, strong communication, and coordination between all key stakeholders (e.g., Compensation Committees / management of both companies, and outside advisors).

Provided on the following pages is additional detail, key considerations, and market perspectives based on our experience helping clients navigate these challenges.



## **Pre-Close Considerations**

- 1. Identify, Incentivize, & Retain Key Talent**
- 2. Change-in-Control & Severance Agreements**
- 3. Treatment of Outstanding Incentive Plans**
- 4. Disclosure Requirements and Execution**

# Pre-Close Considerations

## I. Identify, Incentivize, and Retain Key Talent

- As part of the M&A process, it is important for both the target and acquiring companies to identify the key talent through the close, and for the post-close company, to take inventory of retention hooks and identify any gaps in the retention and incentive objectives
- If gaps are identified, companies may use certain tools to address concerns, including:
  - Cash retention bonuses tied to deal close (or period beyond deal close)
  - Equity grants with long-term vesting (and/or tied to performance goals / transaction close)
  - Enhanced severance provisions upon a qualifying termination in connection with the deal
  - Post-transaction covenants (e.g., guaranteeing pay levels for one year post-close)

### Market Commentary

Companies will typically approve M&A award pools as a percent of deal size; the pools are typically <1% of deal size, although the percentages are often higher for smaller deals, private companies, or companies undergoing a disposition strategy (i.e., selling individual business units separately). In assessing award structures, companies should determine their objectives and aim to strike a balance between “pay to stay” with “pay for performance”.

## 2. Change-in-Control (“CIC”) & Severance Agreements

Change-in-control and severance agreements can pose significant compensation liabilities for the target and acquiring companies; provided below are key items to evaluate for both companies:

- **Target Company**
  - If transaction constitutes a CIC
  - Existing CIC / severance agreements (e.g., single vs. double trigger acceleration of equity, qualifying termination definitions)
  - Potential cost of compensation obligations
- **Acquirer Company**
  - Costs of cash-severance obligations
  - Severance definitions (e.g., Good Reason) for executives with changing roles / reporting functions
  - Equity treatment for acquired employees (from the perspective of shares being accelerated and need for additional retention grants, if any)

### Don't Overlook Section 280G!

Before a CIC, assess whether IRC Section 280G could apply to any executive. If triggered, it can result in a 20% excise tax to the individual on parachute payments exceeding 1x their 5-year average W-2 earnings. While complex, there are strategies to mitigate or eliminate 280G exposure (e.g., allocating value to non-compete agreements, entering into post-CIC services such as consulting arrangements).

# Pre-Close Considerations

## 3. Treatment of Outstanding Incentive Plans

### Bonus Plans

- *Target Company*: Determine treatment of payouts for inflight bonus (i.e., bonus during year of acquisition), including whether to pay bonuses based on target performance or actual performance (if calculable), as well as any proration to account for shortened performance period (if applicable)
- *Acquiring Company*: Determine if impact of newly acquired business should be reflected in performance results for bonus payouts for year of transaction (if applicable), or adjusted out from actual performance results for either all or a portion of the year

### Unvested Equity

- *Target Company*: Determine treatment of unvested equity per equity incentive plans, award agreements or employee contracts (e.g., single vs. double trigger vesting), as well as treatment of performance awards upon the acquisition (i.e., settle at target vs. actual performance)
- *Acquiring Company*: Assess dilutive impact of assuming any target company equity, as well as impact of target company performance on any unvested performance-based equity (e.g., excluding performance results for all or a portion of outstanding performance periods)

### Market Commentary

For target companies, unvested stock price / total-shareholder return-based performance awards are more likely to be earned based on actual performance at time of close than based on target performance. Practice is more mixed for financial / strategic goals given the complexity of calculating performance results / outcomes for inflight plans.

## 4. Disclosure Requirements and Execution

- As an agreement is reached on the terms of the proposed transaction, both the target and acquiring companies must prepare for public disclosure of the pending deal
  - Agreements subject to public disclosure include the transaction agreement, Named Executive Officer (“NEO”) employment agreements, CIC / severance plans, equity plans, etc.
- Shareholders of the target and/or acquiring companies may also be required to approve the deal
  - As part of this process, proxy advisory firms may issue voting recommendations
  - Additionally, transaction-related compensation arrangements for NEOs may be subject to a non-binding Say-on-Golden-Parachute vote (similar to a Say-on-Pay vote)



# Post-Close Considerations

1. Compensation Philosophy and Peer Group
2. Go-Forward Pay Levels
3. Incentive Plan Designs
4. Compensation-Governance Policies

# Post-Close Considerations

## 1. Compensation Philosophy and Peer Group

- After the deal is completed, a crucial first step for go-forward compensation committees is to review the compensation philosophy, to ensure compensation program decisions will support achievement of desired business / compensation objectives (e.g., aligning with the go-forward company's strategy)
- In addition, the post-close combined company should reassess and determine if any changes need to be made to the peer group, considering:
  - Company's new size
  - Short- and long-term strategies
  - Any changes in industries the company competes in as a result of the merger
  - Any changes in competitors for talent
- To support the above, the combined company should also finalize employee integration plans, reassess succession plans, and review the compensation committee charter

### Market Commentary

Given revenue and market cap are key factors in developing peer groups (as pay levels closely track with company size), it is important for the post-close compensation committee to assess the go-forward peer group using pro-forma company revenue and the post-close market cap. Typically, most peer groups include companies within ~1/3x to ~3x the company's revenue (and ~1/5x to ~5x market cap), with some flexibility on the specific ranges for direct competitors.

## 2. Go-Forward Pay Levels

- New business strategies or priorities post-close may impact which executives are critical to the company's future and which executives' roles may change (i.e., increase or reduction in roles)
- Pay levels for the go-forward management team are usually reviewed and assessed considering:
  - Go-forward compensation philosophy
  - New / changed roles post-close
  - Internal pay parity among new executive team
  - Experience and/or potential
- In addition, as the go-forward company re-assesses pay levels and makes adjustments to equity grant levels / participation, it will be important to monitor impact on share usage and dilution, including impact on share reserve for future grants

# Post-Close Considerations

## 3. Incentive Plan Designs

- Short- and long-term incentive program designs must also be reassessed to ensure alignment with the combined company's go-forward business strategy, recognizing the historical practices / culture of each legacy company
  - It is important to align performance metrics with the go-forward definition of success over the short- and long-term
  - Performance goals should be rigorous yet achievable (i.e., challenging but not dead-on-arrival) to ensure the continued retention and motivation of employees
- Specific post-close synergy goals may also be incorporated into short-term or long-term compensation plans to ensure the full potential value of the transaction is realized (either as part of the annual program or as a separate additional incentive)

### Market Commentary

While the benefit of having pre-determined performance adjustments for IRS Section 162(m) purposes has been eliminated due to the Tax Cuts and Jobs Act, it is still considered best practice to have compensation committees approve pre-determined adjustments at the beginning of a performance period in order to help provide clarity upfront and potentially avoid difficult discussions at the time of payout.

## 4. Compensation-Governance Policies

- For the post-close company, there are a variety of compensation-related corporate governance items that should be re-assessed, including (but not limited to):
  - Stock ownership guidelines and holding requirements
  - Anti-hedging / pledging policies
  - Clawback policies
- In addition, these policies should be clearly communicated to new employees / executives (i.e., employees of the acquired company), in order to ensure compliance going forward

### Aligning Compensation Plans with Leadership and Culture

Successful post-close integration often hinges on aligning culture and leadership expectations across the organization. Even well-structured pay programs can fall short if employees perceive misalignment in values, communication, or leadership style. Ensuring that incentive structures reinforce shared goals and foster a “one team” mindset is critical to retaining talent and realizing deal value.





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