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Adjusting the Short-Term Incentive Plan Following a Corporate Transaction

By Jeffrey Keckley and Sam Bricker

Mergers and acquisitions (M&A) activity, from both the purchaser and seller side, has compensation-related implications. For example, an M&A deal may impact the treatment of the corporate-wide annual incentive program. Following a business acquisition, many companies choose to complete the fiscal year with the current plan design and incorporate the newly acquired company into the following year's annual incentive plan. However, this may not be a viable option for companies that divest businesses or change strategic direction following an acquisition. The acquisition or divestiture of a single business unit can render original performance goals inoperative and leave management teams and compensation committees with a challenging question: How should we evaluate our performance for the purposes of determining the annual incentive plan financial results? Below are three options for handling compensation during and just after an M&A deal.

BIFURCATING THE PLAN

When possible, companies may prefer to split the bonus plan into two independent programs, one that applies prior to the transaction and another that applies post-close. This provides the flexibility to recalibrate the plan and make it reflective of the new post-transaction business realities. The approach is both motivational, as it incentivizes participants to focus on new financial measures directly aligned with the go-forward business strategy, and fair, as it locks in financial performance results prior to the transaction. However, this approach is not without inherent challenges. Successful bifurcation of the plan is contingent on management's ability to recalculate current targets for an initial stub period and set achievable performance goals immediately following the transaction. It adds complexity, requiring thoughtful communication to ensure participants understand the design changes. Bifurcating the plan provides an equitable approach, so long as performance measurement and goal setting are realistic endeavors.

MODIFYING EXISTING GOALS

Rather than splitting the plan into two distinct measurement periods, companies may simply reset the full-year financial goals to reflect changes to the business. This approach can be useful when material transactions occur early in the fiscal year. Adjustments to existing goals should consider year-to-date results and current business conditions. Companies may consider modifying goals in a neutral manner, attempting to keep the estimated tracking of performance equivalent pre- and post-modification of the goals. The modification of existing goals ensures plan participants are working toward post-transaction goals without overhauling the existing plan structure. Conversely, it may be difficult to reset goals in a manner on par with year-to-date performance. Depending on the size and scope of the transaction, existing incentive metrics may no longer support the company's strategy; in this case, modifying existing goals may not be the preferred approach. However, if the board desires to include the impact of the transaction without changing the performance metrics or setting entirely new goals, simply modifying the existing goals may be the best course of action.

ADJUSTMENTS OR DISCRETION AT YEAR-END

Companies may consider making no adjustments immediately and evaluating plan achievement holistically upon the conclusion of the performance period. This approach may be particularly compelling for transactions occurring in the latter half of the fiscal year. The approach avoids the rigorous task of additional goal setting and provides the compensation committee with considerable flexibility. Concurrent with flexibility, however, comes a lack of structure and limited communication to participants about post-transaction performance goals. This approach also requires compensation discussion and analysis disclosure on the committee's use of discretion in determining final payouts. Proxy advisory firms are likely to comment on any discretionary bonus plan adjustment, though robust disclosure on the rationale for the adjustment should alleviate investor concerns. For late-in-the-year transactions that do not lend themselves well to immediate goal setting, adjusting performance results at year-end is a viable approach.

Like any compensation committee decision of this magnitude, the unique facts and circumstances surrounding the company and the transaction will drive informed decision-making. The three outlined approaches have their advantages and drawbacks; no approach is perfect. With thoughtful consideration of the three approaches, directors can ensure that annual incentive plans remain fair, consistent, and understandable, even after a significant corporate transaction.

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