How to Deal with Equity

Make sure employees understand the value of their investments.

Holdings
During a Spin-Off

In today's corporate environment, many companies face increasing pressure to deliver strong returns year in and year out. This pressure can be the catalyst for strategic business conversations that lead to acquiring, consolidating, divesting, or spinning off businesses. Executing a spin-off creates an opportunity to unlock company value — value that is based on the belief that the separation of two businesses into stand-alone entities will create more value than a single business can deliver. Some notable and successful spin-offs include PayPal from eBay, Kraft Foods from Mondelez International, and Synchrony Financial from General Electric.

Each restructuring event has a unique set of compensation and benefits challenges from a philosophical standpoint (e.g., defining a new rewards strategy) and a tactical standpoint (e.g., modifying existing incentive awards held by employees).

By Michael Gorski, Semler Brossy

A company intent on spinning off a business may encounter the most complex challenges as it determines how to structure the pre– and post-spin organizations and how to create compensation and benefits programs from scratch for the spin company.

Once the company decides which employees will depart and move with the spin company ("SpinCo") and which will remain with the existing company ("RemainCo"), it quickly needs to decide how they're going to handle employee compensation and benefits programs. While there are many complex issues to address (e.g., how to handle pensions and related liabilities), one of the most pressing questions is related to what happens to the outstanding equity holdings. Base salary, bonus, standard benefits, and other compensation-related aspects (e.g., titling, reporting structure) are generally easier to navigate as they can adopt many RemainCo compensation strategies as needed. The question then becomes how best to manage employee option holdings and unvested stock holdings while ensuring that pay does not become a distraction through the transition.

Translating Outstanding Equity Holdings

Most companies will need to translate outstanding equity holdings for equity participants and can benefit greatly from developing guiding principles for the translation strategy. For example:

- Treat employees fairly and reasonably given the set of circumstances at the time of spin
- Develop transition/translation strategy that is simple and easy to communicate to participants (though not always easy to achieve)
- Align equity treatment and underlying messaging with the business strategy
- Consider the impact the equity treatment approach has on shareholders and outstanding dilution
- Ensure equity plan documents allow for potential planned adjustments
- Limit tax and accounting implications for both the participant and company

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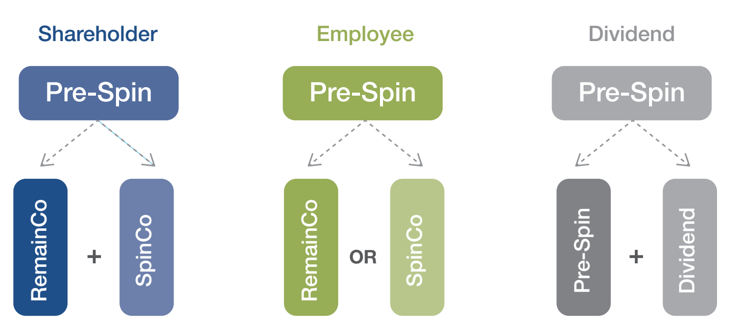
To minimize employee relations concerns, the company should focus on creating a net-neutral outcome for the participant. That is, ensure that the pre-spin intrinsic value (i.e., in-the-money value) of the equity holdings is equal to the post-spin intrinsic value. The following section addresses different approaches to translate equity through the spin event while keeping the participant whole.

Reviewing Equity Translation Approaches

Here are the most common ways companies translate equity through the spin event — these methods generally adhere to the objectives set forth above (see Figure 1 for supporting illustrations). For the shareholder and employee approach, companies will generally look to complete a 1-for-1

Figure 1 | Translation Illustrations



Not all equity for all participants needs to be translated in a single fashion — although that would ease the administrative burden and align with the stated objective of keeping things simple.

spin-off for tax reasons and simplicity. A 1-for-1 spin-off suggests a clean separation of the two businesses; for example, a company with a $20 share price is split into two business, one with a $15 share price and one with a $5 share price.

Shareholder (or Portfolio) Approach

Equity holdings are treated like those of a shareholder at the time of the spin; that is, equity will be translated to both RemainCo equity and SpinCo equity on a one-for-one basis. For option grants, only the exercise prices will be converted as the number of options remain unchanged. Companies may choose this approach to mirror the shareholder experience and provide equal value and opportunity in both post-spin entities.

Employee (or Concentration) Approach

Equity holdings are translated into one entity's equity; that is, equity will be translated to either (a) RemainCo equity or (b) SpinCo equity depending on where the employee resides. For option grants, both the underlying number of options and exercise prices will be translated, maintaining the existing award leverage. Companies may choose this approach to ensure participants are aligned directly with the success of the go-forward entity. This is the approach most often used by companies in a spin-off situation.

Dividend Approach

A spin-off can also be viewed as making a special large dividend. The nuance here is with option grants as any full value share (e.g., restricted stock) would receive dividend equivalents. For options, the number of awards is not translated and companies can choose to either (1) reduce the exercise price by the dividend amount to preserve the intrinsic value, or (2) keep the same exercise price while providing a distribution (like cash) equal to the dividend value. These two approaches change the underlying award leverage materially, restrict the ability to translate equity into the employee's go-forward entity, and result in potential accounting implications. For these reasons, companies generally prefer either the shareholder or employee approaches. However, companies may prefer this simplistic approach to avoid navigating a potentially complex translation process.

Determining the Right Translation Approach

Selecting a translation, or conversion, approach isn't black and white. Not all equity for all participants need to be translated in a single fashion — although that would ease the administrative burden and align with the stated objective of keeping things simple. The decision should consider the equity plan documentation, as it will be essential to review any related plan/award provisions that may govern how awards need to be treated. Ultimately, the approach used will also need to be something the board of directors supports, especially for the executives.

Subject to the plan provisions and allowable discretion, the company can prescribe certain treatment based on any or all of the factors below:

- The go-forward entity of employee (regardless of vehicle),
- The equity award vehicle,
- The employee role/function to ensure a smooth transition and alignment of business objectives,
- The vesting status of holdings,
- The value of options, or
- Other factors as deemed by the appropriate legal documentation.

From a disclosure perspective, equity treatment is outlined in an Employee Matters Agreement, which must be disclosed and filed with the SEC for public companies. The two examples below help contextualize the above decisions about how equity can be handled.

PayPal and eBay (equity translated by role/function in transition). For all outstanding vehicles, the company generally used the Employee Approach for those individuals staying with eBay or those moving to PayPal but used Shareholder Approach for those executives in charge of ensuring a smooth transition. This strategy likely underscores an objective that employees will have equity only in

Illustrative Calculations for Shareholder and Employee Approach

The graphic below provides an example of how a company can translate pre-spin equity holdings into post-spin equity holdings for both restricted stock units and options using either the Shareholder or Employee Approach.

Assumptions for calculations:

- Pre-spin share price of $20 (and a 1-1 spin)
- Post-spin RemainCo share price of $15 and post-spin SpinCo share price of $5

Restricted Stock Units (RSUs)

Determine pre-spin value of RSUs (e.g., $20,000 in example below) to ensure a match after translation.

Shareholder Approach:

For each share of pre-spin equity held, provide one share of RemainCo and one share of SpinCo (i.e., 1,000 shares in each entity in example below).

Employee Approach:

Multiply the number of units by the ratio of (i) the pre-spin share price to (ii) the post-spin share price ($20 pre-spin/ $15 post-spin for RemainCo; $20 pre-spin/ $5 post-spin for SpinCo).

Stock Options

Determine pre-spin 'intrinsic value' of options (e.g., $37,500 in example below).

Shareholder Approach:

Similar to RSUs, participants will receive the same number of options in both RemainCo and SpinCo; the exercise price will be converted by multiplying the pre-spin exercise price by the ratio of (i) the post-spin share price to (ii) pre-spin share price ($15 post-spin/$20 pre-spin for RemainCo; $5 post-spin/$20 pre-spin for SpinCo).

Employee Approach:

Use the same exercise price conversion as in the Shareholder Approach and the post-spin share price to determine the spread per option ($15.000 less $9.375 for RemainCo employees, $5.000 less $3.125 for SpinCo employees). Then divide the pre-spin intrinsic value by the spread ($37,500 divided by $5.625 for RemainCo employees, $37,500 divided by $1.875) to determine the post-spin number of options.

Illustrative Translation Calculation
Based on assumptions above

	Restricted Stock Units			**Stock Options**		
	Current Holdings	(a) Shareholder Approach	(b) Employee Approach	*Current Holdings*	(a) Shareholder Approach	(b) Employee Approach
Pre-Spin Shares Held	*1,000*	--	--	*5,000*	--	--
Pre-Spin Value of Holdings	*$20,000*	--	--	*$37,500*	--	--
Pre-Spin Exercise Price	--	--	--	*$12.50*	--	--
RemainCo Employee						
Post-Spin RemainCo Shares	--	1,000	1,333	--	5,000	6,667
Post-Spin RemainCo Value	--	$15,000	$20,000	--	$28,125	$37,500
Post-Spin Exercise Price	--	--	--	--	$9.375	$9.375
Post-Spin SpinCo Shares	--	1,000	--	--	5,000	--
Post-Spin SpinCo Value	--	$5,000	--	--	$9,375	--
Post-Spin Exercise Price	--	--	--	--	$3.125	--
SpinCo Employee						
Post-Spin RemainCo Shares	--	1,000	--	--	5,000	--
Post-Spin RemainCo Value	--	$15,000	--	--	$28,125	--
Post-Spin Exercise Price	--	--	--	--	$9.375	--
Post-Spin SpinCo Shares	--	1,000	4,000	--	5,000	20,000
Post-Spin SpinCo Value	--	$5,000	$20,000	--	$9,375	$37,500
Post-Spin Exercise Price	--	--	--	--	$3.125	$3.125

their go-forward business, indicating a distinct delineation between the two businesses. Only senior executives would maintain equity in both businesses focusing on key strategic actions for the transition and longer-term outcomes.

Kraft Foods and Mondelez International (equity translated by vehicle). For outstanding options, stock appreciation rights (SARs), restricted shares and deferred stock units, the company generally used the Shareholder Approach; for performance shares they used the Employee Approach. The strategy here suggests supporting a more collaborative behavior allowing for potential equity benefits should either entity thrive in the post-spin environment (i.e., employees post spin generally hold both Kraft and Mondelez equity). Treating performance shares under the Employee Approach aligns directly with each company's ability to measure performance post-spin.

Translating Performance-Based Equity Incentives

An additional nuance with the translation process involves performance-based equity and what determinations (if any) can and should be made about the vesting status of the awards at the time of the spin. The potential decisions include converting at target or actual performance. In almost all cases, the resulting performance-based equity will translate (at the preferred approach) to time-based equity subject to the original service-based vesting conditions (unless other award agreement and legal document dictates otherwise).

The preferred performance assessment approach will mostly lean on the company's ability to measure performance at the time of the spin.

- **For absolute measures,** the performance assessment may be more challenging, particularly in cyclical businesses or where companies are undergoing significant transformations. In these absolute cases, actual performance assessments can consider how the company has been trending (e.g., looking at performance against the last monthly budget), though it will probably be easier to determine the awards are earned at target for administration and communication purposes.
- **For relative measures,** particularly relative Total Shareholder Return measures or other market-based measures, companies will have an opportunity to use actual performance using the spin-off date market value. Relative financial measures may be too difficult to assess and score given the ability to consistently calculate performance mid-cycle against the comparator group (in these cases, translation at target is the better path).

Understanding Other Considerations

With any major business restructuring, other compensation and benefits issues arise, and companies may encounter some of the following during a spin-off.

- Recalibrating pay opportunities for the post-spin entities to ensure that cash compensation is competitive with other similarly sized standalone public companies. In some cases, special pay actions for both the RemainCo executives (e.g., retention awards) and SpinCo executives (e.g., staking awards) may be required, but considered should be what other adjustments are contemplated as part of the compensation philosophy and objectives.
- Addressing the treatment of outstanding equity held by terminated employees (e.g., continued exercisability post-termination for a period of time). Generally, the company may select an Employee Approach for translating the RemainCo equity based on the rationale that the individual departed prior to the spin, so equity holdings should be preserved in the RemainCo entity through the spin, keeping the participant net-neutral.
- Making communication a vital part of the process. In our experience, spin events are challenging to navigate and cause a level of uncertainty for the broader population where experience and understanding of compensation and benefits programs are limited. The company should anticipate numerous questions and develop FAQs and presentations for participants to understand the impact of the spin transaction and exactly what is happening to the different compensation programs in which they participate. It is also important that the CEOs of RemainCo and SpinCo are front and center in employee communications and demonstrating ownership of decisions being made.

Final Thoughts

Translating and converting equity holdings upon a spin-off can turn into a complex and confusing process, particularly when employees already struggle to understand the 'value' of their equity holdings. The key is developing a conversion approach that aligns with the organizational transition strategy, ensuring that both entities can thrive as standalone businesses. ws

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