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SHAREHOLDER PROPOSALS TO LIMIT SEVERANCE AIM TO IMPROVE GOVERNANCE BUT MAY HAVE UNINTENDED CONSEQUENCES

Amid the significant increase in shareholder proposals at Russell 3000 companies over the past year, the most prevalent executive compensation-related proposal is to limit severance payments. The proposal is substantially similar in each case and typically requests that companies seek shareholder approval for any senior manager's new or renewed pay package that provides for severance or termination payments with an estimated value exceeding 2.99 times the sum of base salary and target bonus. This shareholder proposal has appeared on proxy ballots at 17 Russell 3000 companies over the last year and received significant shareholder support: in five cases it passed, and in the other twelve, 33-49% of shareholders voted "for."

The proposals were written to include the value of cash severance and the value of equity awards where vesting accelerates, which means many companies' existing severance arrangements will exceed the 2.99x threshold, especially for involuntary terminations in connection with a change-in-control (CIC).

Looking ahead, companies may increasingly be compelled to adopt policies to limit executive severance benefits, but doing so could have unintended consequences that may not be in the best interests of shareholders or result in unfair outcomes for covered executives.

Significant Shareholder Support to Limit Severance

The 2022 proxy season saw a significant increase in shareholder proposals at Russell 3000 companies.[1] Of shareholder proposals related to executive compensation, the most prevalent was one advanced by a group of small activist investors requesting companies to seek shareholder approval for any "senior manager's new or renewed pay package that provides for severance or termination payments with an estimated value exceeding 2.99 times" the sum of base salary and target bonus.[2] In the past 12 months (as of September 22, 2022), there have been 17 such shareholder proposals, of which five passed. Passage of these proposals is

[1] According to ISS GovernanceAnalytics database, in 2021, 555 shareholder proposals were on the proxy ballots at Russell 3000 companies; as of 9/25/2022, 693 shareholder proposals have been on Russell 3000 proxy ballots, an increase of 28%.

[2] We interpret the intent of these proposals to cover involuntary terminations of employment without Cause, where "severance" is typically provided. However, one could interpret these proposals to also cover terminations due to death, disability or retirement, which are not addressed in this article.

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non-binding on the company, but shareholders expect engagement and responsiveness when support is strong. Overall, shareholder support for these proposals averaged 45.9%, which is high compared to 33% average support for all shareholder proposals, meaning we are likely to see more of these types of proposals in 2023.

Shareholder Proposals to Limit Severance

(9/22/2021 through 9/22/2022)

		All Proposals	Proposals that Passed	Proposals that Failed
Number of Companies		17	5	12
Level of Shareholder Support	High	67.4%	67.4%	49.2%
	Average	45.9%	56.2%	41.6%
	Low	32.8%	50.1%	32.8%

A Majority of Companies Provide Severance in Excess of the Proposed Threshold

At first glance, these proposals may seem innocuous. Cash severance multiples higher than 3.0x the sum of base salary and target bonus are rare. In fact, most of the companies that received this proposal provide cash severance multiples lower than 3.0x. However, the "severance or termination payments" covered by these proposals also include the value of equity awards where vesting accelerates, which can make the total payments significantly higher than the value of cash severance.

To get a sense for non-CIC and CIC severance benefits among large-cap companies, FW Cook analyzed the most recent proxy statements of the 100 largest U.S.-based, publicly-traded companies in the S&P 500 by market cap. For the CEO and CFO positions, the following table shows the ratio of the proxy-disclosed value of total severance benefits upon an involuntary termination without cause - both independent of a CIC and in connection with a CIC - as of the last day of each company's fiscal year, expressed as a multiple of the sum of base salary and target bonus.[3]

Proxy-Disclosed Total "Potential Payments Upon Termination" as of Fiscal Year-End as a Multiple of Sum of Base Salary and Target Bonus at the 100 Largest S&P 500 Companies by Market Cap

	CEO		CFO	
	Non-CIC	CIC	Non-CIC	CIC
75th Percentile	11.3x	15.7x	5.1x	10.6x
50th Percentile	4.2x	9.4x	2.0x	6.1x
25th Percentile	0.3x	4.4x	0.0x	2.2x
% of Companies with Multiple >2.99x	56%	80%	40%	70%

[3] Where a company did not disclose a target bonus, the average of the prior three years of actual bonus (or shorter period, based on data availability) was used.

A significant number of companies already provide severance benefits that exceed the 2.99x threshold included in the typical shareholder proposal, especially in the case of a CIC-related termination. In practice, the actual value of severance benefits depends on a variety of factors, including when during the year a qualifying termination occurs, the company's then-current stock price, and expected funding for performance awards, among others.

Response from FedEx

Of the five companies where the severance-related proposal passed, FedEx is the only one that has filed a proxy statement disclosing its response. An analysis of FedEx's practices prior to the proposal and their changes in response provides insight into actions other companies might take in similar circumstances.

At the time the shareholder proposal to limit severance benefits was advanced in 2021, FedEx's named executive officers (NEOs) had previously entered into Management Retention Agreements (MRAs) that provide certain protections during the two-year period following a CIC. If the NEO is terminated other than for "cause," terminates for disability or death, or if the NEO terminates for "good reason" (each such term as defined in the MRA), then the NEO will receive cash severance equal to 2.0x the sum of base salary and target annual bonus. In addition, FedEx's 2010 and 2019 Omnibus Stock Incentive Plans provided for accelerated vesting of unvested equity upon a CIC (i.e., "single-trigger" equity vesting). FedEx does not have any defined severance benefits for terminations independent of a CIC (other than due to retirement, death or disability).

According to FedEx's proxy filed August 9, 2022, in response to high support (58.4%) for the shareholder proposal to limit severance and lower-than-historical support for its 2021 say-on-pay proposal (76.4%), FedEx conducted an extensive shareholder engagement campaign. In response to investor feedback, FedEx adopted the following policy:

- FedEx agreed not to pay or enter into any new agreement with an executive officer that provides for severance benefits that exceed 2.99x the sum of base salary and target annual incentive, without shareholder approval.
    - Terminations due to death, permanent disability, or in connection with a CIC are excluded. (Note that FedEx's MRAs already limit CIC severance to "the largest amount that would result in none of the MRA payments being subject to any excise tax.[4]")
    - Value of accelerated vesting of equity awards will be calculated according to Internal Revenue Code Section (IRC) 280G.[5]

[4] Under Section 280G of the Internal Revenue Code, if benefits provided to an individual in connection with a CIC are more than 3.0x a "base amount," then the individual is subject to a 20% excise tax and the company loses its tax deduction on amounts in excess of 1.0x the "base amount." The "base amount" is the individual's five-year average W-2 gross income.

[5] For purposes of calculating the value of equity vesting acceleration under 280G, performance-based awards generally count at the full value of what is accelerated, while time-based (i.e., service-vesting) awards count at less than the full value. For time-based awards, the 280G value includes two components: 1) a present value factor, which is the increase in the present value of payments that would otherwise have been made at a later date, and 2) a service factor equal to 1% per full month of vesting acceleration, to recognize the benefit to the individual that continued service is no longer required.

- FedEx amended its shareholder-approved equity incentive plan (the 2019 Omnibus Stock Incentive Plan) to require a cutback of the value of equity vesting acceleration in connection with a CIC to $1 less than 3.0x the IRC 280G “base amount” to avoid excise taxes.

Because FedEx did not have any formal non-CIC severance plans or policies and its MRAs already capped CIC severance benefits, it is unclear whether these changes in response to the shareholder proposal will have a significant impact. However, if other companies take the same approach, it has the potential to substantially reduce executive severance protection, which may not always be in shareholders’ best interests. To better understand this assertion, a review of the purpose of severance benefits is useful.

Purpose of Severance Benefits

In general, severance is intended to be a financial bridge for senior executives when they lose their position due to job elimination or a change in company strategy or leadership. In our experience, some level of severance is almost always provided, even if not pre-arranged, to ensure that terminated executives execute a release from claims and are subject to post-employment restrictive covenants. Adoption of a severance plan or policy establishes a common standard and mitigates the need for individual negotiation as well as the risk of criticism from proxy advisors for providing “after-the-fact” payments to which executives were otherwise not entitled.

Severance protection in connection with a CIC is intended to make executives economically neutral in the face of a potential deal that may be in the best interests of shareholders but result in loss of employment. Such benefits encourage executives’ continued engagement, retention through the end of the transaction, and negotiation for the best deal/highest price. When properly constructed, CIC severance is not intended to be a windfall or form of “transaction bonus” to encourage a deal.

The following are generally accepted “best practices” with respect to CIC severance arrangements:

- Cash severance no higher than 3.0x the sum of base salary and bonus (typically defined as target bonus or an average of two-to-three prior years’ actual bonuses).
    - Over the past several years, cash severance multiples have declined such that 3.0x is now uncommon except for the CEO role. Cash severance multiples for other NEOs are typically 1.0x-to-2.0x.
- “Double-trigger” severance and equity vesting acceleration (i.e., benefits are only provided if: (1) the transaction is completed, and (2) there is an involuntary termination of employment).
    - For equity vesting acceleration, the second trigger may also be that the acquiror chooses not to assume, convert, or replace outstanding awards on an economically equivalent basis.
- Cash severance multiple applied to base salary and annual bonus only (i.e., long-term incentives (LTIs) are not included).
    - Although LTI value is typically a more significant component of the ongoing pay opportunity for senior executives than cash compensation, cash severance does not include an amount to

replace future LTI awards. Instead, there is typically some acceleration of the vesting of prior awards.

  - Vesting acceleration in connection with a CIC-related termination tends to be a combination of a) settlement of "accrued but unpaid" compensation, and b) early payment of future compensation. Consider a performance stock unit award that vests three years from grant, or earlier upon a qualifying CIC-related termination. If there is a CIC-related termination 18 months following grant, the vesting acceleration is partly settlement of the executive's prior 18 months of service (i.e., "accrued but unpaid" compensation), as well as accelerated payment of the remaining 18 months of service that the executive was not given the opportunity to provide.

- No excise tax gross-up.
  - Typical practice is for companies to provide "best net-after-tax" benefits. This means that if an individual is subject to excise taxes, benefits will be reduced if the individual would be better off on a net-after-tax basis. Otherwise, the individual will receive full severance benefits, but be responsible for paying their own taxes (including any excise taxes).

Reducing Severance Benefits as a Multiple of Target Cash Compensation

There are various approaches to reducing severance benefits as a multiple of target cash compensation, some of which are similar to mitigating exposure to IRC 280G excise taxes. Many of these strategies run counter to core executive compensation objectives such as aligning pay with performance and attracting and retaining key talent. This list below is illustrative and intended to ensure a full understanding of the potential impact of shareholder proposals to cap severance at 2.99x target cash compensation and is not a recommended "next step" in considering design concepts.

Approach to Reduce Severance Benefits as a Multiple of Target Cash Compensation	However, this approach…
Increase the "denominator" by upweighting base salary and target bonus in lieu of LTI • 2.99x a larger target cash compensation value allows for larger potential severance benefits	× Reduces proportion of pay tied to long-term performance × Reduces pay-for-performance alignment if base salary is increased × Increases cost of cash severance, which is usually a multiple of cash compensation
Shorten vesting periods for LTI awards • Less unvested LTI upon a termination event reduces the amount that might be accelerated	× Reduces retention strength × Makes LTI less "long-term"

Approach to Reduce Severance Benefits as a Multiple of Target Cash Compensation	However, this approach…
Use "single-trigger" equity vesting, with unvested equity accelerating upon a CIC regardless of whether the employee is terminated • Because equity vests upon the CIC irrespective of employment status, the associated value may not be considered a severance payment	✖ Potentially eliminates retention "glue" for employees that a buyer might want to keep, requiring the buyer to grant new awards, which directly reduces consideration provided to selling shareholders ✖ Considered an extremely problematic pay practice; adopting "single-trigger" vesting acceleration could result in an automatic "against" say-on-pay vote recommendations from proxy advisors
Value equity vesting acceleration under 280G rules (i.e., the approach adopted by FedEx) and/or reduce the portion of LTI that is performance-based • Under 280G rules, the value that is considered a CIC benefit is higher for performance-based equity than for time-based equity	✖ Reduces pay-for-performance alignment
To ensure that equity award vesting acceleration is not considered as part of severance, loosen retirement eligibility standards and make associated provisions (which often include enhanced vesting) more generous • Because retirement-eligible executives typically receive enhanced LTI vesting whether termination of employment was voluntary or involuntary without cause, the associated value might be attributable to retirement-eligibility and not considered a severance payment	✖ Could unintentionally create retention problems if the more generous retirement provisions encourage high performing executives to leave prematurely

Of course, the shareholder proposals only limit severance benefits that are not shareholder-approved. Companies subject to this limit could seek shareholder-approval to pay higher severance amounts. However, if a majority of shareholders supported the proposal to limit severance, a standalone proposal to provide a higher level of severance may not pass. In the context of a CIC, this type of "after-the-fact" severance approval may not provide executives the necessary peace-of-mind to pursue transactions in the first place if doing so might negatively impact them from an economic perspective.

Implications of Shareholder Proposals to Limit Severance

If proposals to limit severance continue to gain traction with shareholders, companies may be compelled to adopt conforming policies[6]. However, doing so could have unintended consequences, including the potential adoption of compensation structures that run counter to traditional "best practices" principles. Perhaps most importantly, limiting severance could hinder the effectiveness of CIC severance policies that are intended to align executive's interests with those of shareholders in the context of deal negotiation. At the extreme, without appropriate CIC severance protection, executives may be perversely encouraged to delay or derail a transaction that may be good for shareholders but result in loss of employment and forfeiture of outstanding equity compensation accumulated over multiple years of employment. We also note that in the context of talent attraction and retention, this type of limitation creates an uneven playing field for public companies versus privately held and PE-backed companies that are not subject to such restrictions. It also handicaps widely held public companies versus controlled companies who can "push through" shareholder approval.

In summary, while efforts to reduce the cost of severance may be well-intentioned, such proposals could have negative implications that outweigh the benefits.

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General questions about this summary can be addressed to the following individuals:

Cimi Silverberg at 312-894-0073 or by email at cimi.silverberg@fwcook.com
Dan Ryterband at 212-299-3715 or by email at daniel.ryterband@fwcook.com
Noah Kaplan at 415-659-0212 or by e-mail at noah.kaplan@fwcook.com

Copies of this summary and other published materials are available on our website at www.fwcook.com.

[6] Three companies preemptively adopted or re-affirmed policies to limit cash severance only; these actions did not cause the shareholder proposal to be withdrawn, nor did they drive materially lower support (one still passed and the other two received 39% and 43% support).