The Spin-Off Transaction Playbook

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1.01 INTRODUCTION

This article discusses the compensation and benefit issues associated with a corporate spin-off. A spin-off is a transaction where a corporation, usually a business unit that has been organized as a subsidiary corporation, is transferred out of a larger enterprise. Typically, the transaction is a proportional distribution of the stock of the subsidiary to the parent company shareholders, coincident with the listing of the stock on an exchange with the effect of making the subsidiary an independent, newly listed company.[3] The frequency of spin-offs has been increasing — over 60 corporate spin-offs since the beginning of 2010[4] — not counting divestitures where a business unit is sold to another company, an operating company, or a financial buyer. The spin-off transaction at some companies has been driven by a shareholder activist.

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[3] There are generally three types of corporate spin-offs. The first, a conventional spin-off, is where the parent company distributes all of the stock in the business unit or a subsidiary to the parent company's shareholders. Coincident with the distribution to the shareholders, the shares of the former subsidiary are also registered so that they may be immediately traded on the exchange by the shareholders. The consequence of this type of spin-off is that the parent company and the former subsidiary are separate and independent, publicly-listed companies. The second form of spin-off is sometimes referred to as a "carve out," where the parent company sells up to 20 percent of the shares in its subsidiary in a public offering. In this case, the parent company receives the cash proceeds from the public offering. This sort of transaction allows the parent company to realize some value for its interest in the subsidiary, and also establishes a market value for the subsidiary. Finally, the third type of spin-off is when the parent company distributes the remaining (e.g., 80 percent) interest in the subsidiary for which it had previously sold a minority interest. Alternatively, the parent company could continue to hold a majority interest (e.g., 80 percent) in the subsidiary corporation for an indefinite period.

[4] http://www.stockspinoffs.com/recent-spinoffs/

In the announcement preceding the spin-off, most companies indicate it is for strategic reasons such as differences with the parent company regarding business operations, scope or opportunities. A spin-off may allow a better focus on distinct growth profiles, product categories, supply chain operations, distribution systems, strategic priorities, organizational structures, or operating models. Sometimes, an entity may spin-off a business in order to “unlock” value — meaning that the value of the parent and the subsidiary individually is greater than the value of the two combined. A spin-off may allow sharper allocation of resources and capital deployment, and allow investors to value business units based on particular operational and financial characteristics.

These business strategy reasons almost always impact the talent strategy of the spun-off company, which in turn drives its compensation and benefit strategy. As a result, it is important for the spin-off team to understand the strategic motivation for the spin-off so it can properly design and develop the compensation and benefit structures to support the business. A spin-off presents an opportunity to revisit the employee value proposition as the change in the business model may impact employee perceptions and attitudes toward employment. In addition to strategic issues that are the context for the spin-off, there are many technical issues, such as legal and accounting, surrounding the compensation and benefit aspects of a spin-off transaction.

For purposes of this discussion, we will focus on a tax-free, U.S.-based spin-off effected through a distribution to shareholders and a coincident listing of all shares of the divested business, which we will refer to as SpinCo.[5] We will also refer to the company that effects the spin-off as "ParentCo."

1.02 TIME-BASED EQUITY AWARDS

[1] General

We begin the review of compensation arrangements with time-based equity, such as time-based restricted stock or restricted stock units, and time-based stock options or stock appreciation rights ("SARs"), which vest solely based on continued employment. Prior to the spin-off, these awards are usually in respect of ParentCo stock, not the stock of SpinCo. These awards are subject to a continuing employment or service obligation with ParentCo or a company that is affiliated with ParentCo (such as a wholly-owned subsidiary). This means that if ParentCo does not modify the terms of the compensation award, the spin-off may result in a forfeiture of time-based or service-based restricted equity awards, or the need to exercise vested stock options or SARs, in each case because the employees of SpinCo will be considered to have incurred a "termination of employment" or a "separation of service" from ParentCo. The result is that employees of SpinCo will not realize the benefit of the time-based awards even though the employees may still be employed at the same job (with SpinCo) as before the divestiture.

The same potential for forfeiture also applies to unvested, time-based stock options or SARs. The vesting schedule on these awards is usually subject to a continuing service requirement. Also, with stock options and SARs, a termination of employment triggers

[5] There are instances where the spin-off is effected by the sale to a financial buyer, such as a private equity firm, or the spin-off is effected by selling to a strategic buyer – usually another operating company.

the period during which vested options may be exercised (e.g., during the period of 90 days or one year beginning with the date of the termination of employment). The fact the employee will not be employed by ParentCo and its affiliates after the spin-off means the terms and conditions of the stock option regarding the service obligation and duration of the exercise period will need to be modified for executives of SpinCo to enjoy the benefits of the stock options as originally awarded. The modifications may take the form of an agreement between ParentCo and SpinCo, such as the employee matters agreement which is typical for a divestiture, as to the crediting of service for SpinCo employees or vesting of compensation and benefits.

In addition to a separation of service that could trigger a forfeiture of restricted equity or an early exercise of options and SARs, the spin-off will cause a reduction in the value of the underlying ParentCo equity. This is because SpinCo and ParentCo are no longer a combined or aggregated economic unit. For illustration, on a combined basis ParentCo and SpinCo may have a market value of $1 billion. After the spin transaction, ParentCo equity will be worth $1 billion less the value investors assigned to SpinCo. Thus, ParentCo needs to consider actions that will compensate or keep whole the employees holding ParentCo equity awards that will decline in value as a result of the divestiture. As a consequence, the ParentCo equity awards (1) are replaced with or converted into SpinCo equity having the same pre-spin intrinsic value, (2) are adjusted by the grant of additional shares of ParentCo equity restoring any potentially lost intrinsic value, (3) participate on a proportional basis in the distribution of the SpinCo stock distribution, or (4) participate in some combination of the foregoing. The need for adjustment, replacement, proportional distribution, etc., also applies to restricted or deferred stock units (whether vested or not) where actual shares of stock have not been formally issued and are not outstanding on the closing date of the spin-off.

Because the stock subject to the time-based restricted stock and stock options is that of ParentCo, and because the awards are usually issued under a ParentCo plan, the decisions and actions for making employees whole will be determined initially and primarily by ParentCo.[6]

[2] Strategic Pay Considerations and Time-Based Equity Compensation

The approach to ParentCo equity — conversion, adjustment, proportional distribution, or a combination of the foregoing — should be determined on a strategic basis.

A prime consideration is linking an employee's equity — ParentCo or SpinCo equity — with the company for which the employee will work. For ParentCo employees continuing in employment with ParentCo, it is typical that outstanding ParentCo equity is adjusted to restore any lost value, and continues to be the principal – if not the only equity compensation – awarded to ParentCo employees. That said, there may be reasons for ParentCo employees to receive some SpinCo equity – such as a desire to allow ParentCo employees to share in the economic value created through SpinCo equity, or to help align ParentCo employees with the continuing success of SpinCo.

Although not typical, SpinCo employees may have some continuing interest in ParentCo. Usually, the primary focus of SpinCo employees is building a viable and

[6] It should be noted that the non-employee directors of ParentCo usually hold ParentCo equity compensation that will need to be adjusted, converted or included in a proportional distribution plan.

valuable independent company. The mechanics of these different choices are discussed below.

[a] ParentCo Equity

The adjustment to ParentCo equity is intended to keep the intrinsic value of ParentCo equity compensation awards equal before and after the spin. The adjustment to ParentCo equity compensation depends on its form. For restricted stock (including restricted stock units and deferred stock units), the adjustment is the awarding of additional shares (or units) so that the total intrinsic value of all restricted stock (or units) before and after the divestiture is the same.

Consider a ParentCo employee who holds 100 shares of time-based restricted stock before the spin-off when ParentCo stock is worth $20 per share (i.e., aggregate value of $2,000). Assume SpinCo equity represents 20 percent of the combined, pre-spin market value of ParentCo that is shifted to SpinCo equity at the divestiture. Thus, shares of ParentCo stock will have a market value of only $16 per share following the spin-off. Assuming the ParentCo employee does not receive a proportional distribution of SpinCo equity, the ParentCo employee will need to receive additional shares of ParentCo restricted stock. If the ParentCo award before the divestiture had an aggregate value of $2,000 (i.e., 100 shares at $20 per share), following the divestiture the ParentCo employee will need to hold 125 shares of ParentCo stock (i.e., $2,000 divided by $16 per share). In other words, 25 more shares of ParentCo stock are awarded the employee.

ParentCo stock options will also need to be adjusted. An adjustment of ParentCo stock options is generally accomplished by reducing the exercise price so that the aggregate spread (i.e., the difference between the exercise price and the stock's market value) is equivalent before and after the divestiture, and that the ratio of the exercise price and the stock's market value after the divestiture is no more favorable than the ratio before the divestiture. Maintaining the same ratio will require the issuance of additional ParentCo shares.[7]

Again, consider a ParentCo employee who has 1,000 stock options with an exercise price of $12 per share. Before the divestiture ParentCo shares have a market value of $20 per share (for an aggregate spread of $8,000; i.e., 1,000 shares of stock multiplied by $20 per share, less the $12 per share exercise price). The ratio of the exercise price to the stock's market value is $12 to $20 or .6.

If the exercise price of ParentCo existing stock options is adjusted to $9.60 per share, and the number of ParentCo stock options is increased to 1,250, the aggregate spread of the 1,250 shares is $8,000, and remains the same (i.e., 1,250 shares of stock multiplied by $16 per share, less the $9.60 per share exercise price). The ratio of the exercise price to the market value of the share after the adjustment ($9.60 per share compared to $16 per share (or .6)) is not more favorable than the ratio of the exercise price to the market value of the shares before the adjustment ($12 per share compared to $20 per share (or .6)).

[7] Treasury regulations provide rules for an adjustment for the purpose of maintaining the status of incentive stock options under Code Section 422A (see Treas. Reg. § 1.424-1 et. seg. discussed infra), and for purposes of satisfying the conditions of Section 409A of the Code. (See Treas. Reg. § 1.409A-1(b)(5)(iv)(D).)

For ParentCo equity compensation awards there is also the possibility of a proportional distribution. There may be ParentCo employees who are retiring or terminating employment. For them, it may be more appropriate to allow them to receive the same proportional distribution of SpinCo equity as the public shareholders. In that case, the former ParentCo employees are made whole by the distribution of SpinCo equity. This generally assumes the former ParentCo employees are holding ParentCo shares, and not options (which would need to be adjusted as previously described). From a strategic pay viewpoint, these individuals have terminated employment and are similar to public shareholders. They have a neutral or balanced interest in ParentCo and SpinCo. Therefore, no conversion or effort to provide equity in only ParentCo or SpinCo is necessary.

[b] SpinCo Equity

SpinCo employees may not have any continuing interest in or influence on ParentCo, but are focused solely on SpinCo's economic and financial results. Thus, it is typical that ParentCo equity held by SpinCo employees is replaced or converted to SpinCo equity.

For restricted stock (including restricted stock units and deferred stock units), the process is to calculate the aggregate value of the ParentCo equity compensation prior to the divestiture, then convert that aggregate value to SpinCo equity. Thus, the intrinsic value before and after the divestiture is kept equal.

For example, if a SpinCo employee has 1,000 shares of ParentCo equity worth $20,000 (1,000 shares at $20 per share), and if SpinCo shares are worth $4 per share, the SpinCo employee's 1,000 shares of ParentCo equity would be converted to 5,000 shares of SpinCo equity at the time of the divestiture.

For stock options, a conversion also is typical with the use of the aggregate spread and per share ratio previously illustrated. For example, assume 1,000 ParentCo options with an exercise price of $12 per share and a market value of $20 per share before the divestiture, and $16 per share following the divestiture. Assume SpinCo stock has a market value of $4.00 per share following the divestiture. In order to keep the SpinCo employee whole, the 1,000 ParentCo options should be replaced with an option for 5,000 shares of SpinCo stock with an exercise price of $2.40 per share. This SpinCo option would have the same aggregate value ($8,000) as the replaced ParentCo option, and the ratio of the exercise price to the stock market value before and after the divestiture would be the same (i.e., $12/$20 equals .6; and $2.40/$4.00 equals .6).

[3] Accounting and Taxation Consequences

When reviewing ParentCo's possible choices for dealing with its equity compensation, it is useful to consider the basic accounting and federal income tax rules that apply, and that may influence what ParentCo does with respect to the equity compensation.

An analysis should begin with consideration of ParentCo's equity plan document and related award agreements. These documents control the terms of the time-based equity compensation awards and define a separation from service or termination of employment. These are key in determining if SpinCo employees will forfeit the time-based awards upon divestiture, if there is to be an adjustment or substitution of awards, and what form the adjustment or substitution may take.

Usually, the equity plan document provides a general grant of authority directing ParentCo or a committee (such as a compensation committee) of its board of directors in the event of certain "corporate events" or "equity restructurings" to adjust or modify the ParentCo awards so as to preserve the benefit or value of the awards for affected employees in a way chosen at the discretion of ParentCo or the committee.[8]

The financial accounting rules for equity awards are provided by ASC 718. Generally, under that accounting protocol, the fair value of an equity award granted to common law employees[9] is determined on the grant date and recognized over the service period.[10] If the award is forfeited before the required service period is completed (i.e., the employee has a separation of service before the vesting date), the accounting expense is reversed in the period the forfeiture occurs.[11]

ASC 718 provides that a change to the terms of an award because of an equity restructuring is accounted for as a "modification."[12] The occurrence of a modification requires a comparison of the fair value of the modified award to the fair value of the original award immediately prior to the modification. If the modification causes an

[8] Before deciding the approach to ParentCo equity compensation, the plan document or award agreements will need to be carefully parsed. Due to the relevant accounting rules, these provisions typically anticipate most situations, provide some latitude to the company or committee in structuring a response, and yet be sufficiently binding on the company or committee to obtain favorable accounting treatment. The construct of most equity plans (or award agreements) is influenced by the accounting custom that equity plan documents providing for adjustments to equity awards be definitive (i.e., not discretionary) as to the need for the adjustment. As a consequence, most equity plan documents require the company or compensation committee to make an adjustment in the event of certain corporate events stipulated in the document, but allow the company or the company some discretion in the nature and form of the adjustment

[9] Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 718, Compensation – Stock Compensation (2011). Hereinafter "ASC 718." See 718-10-15-3.

[10] ASC 718-10-30-3; ASC 718-10-30-12; and ASC 718-10-35-2.

[11] ASC 718-10-25-21.

[12] ASC 718-20-35-6. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an equity restructuring or a business combination are modifications for purposes of ASC 718.

increase in fair value, that increase is an additional expense and must be recognized. If the fair values before and after the modifications are the same, no incremental cost is recognized.[13]

If the award is pursuant to a plan document or award agreement that has a mandatory anti-dilution feature intended to maintain the fair value of the award as a result of an equity restructuring, the fact that the feature was part of the plan would result in no incremental compensation cost (i.e., the adjustment was contemplated in the value of the original award before the equity restructuring). If the document allows discretion only to make the adjustment, but it is not required, any incremental compensation increase (perhaps significant) will be recognized as a modification (even if it only makes the pre- and post-spin values equivalent).[14] Similarly, if a plan is amended in contemplation of the equity restructuring, such an amendment itself would be considered a modification. Because the modification was not anticipated in the original award, the resulting changes must be recognized at the time of the modification.

Equity compensation, either as a stock option or restricted stock award, has special rules for federal income tax purposes. A summary of the general, federal tax consequences of equity compensation is in the Appendix. There are particular considerations in respect of a corporate spin-off, which are as follows:

As described previously, strategic pay considerations may result in the conversion of some or all of ParentCo equity into SpinCo equity. Generally, as part of a conversion,

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[13] ASC 718 20-55-2; ASC 718-20-35-3; and ASC 718-20-35-6.

[14] ASC 25-55-104, 105 and 106. The language contained in many plans can differ, so legal counsel may need to determine if the operations of such a provision are mandatory. Generally, a provision may not specify how the award will be adjusted, but that an adjustment is required, and that would likely be considered an adequate anti-dilution provision.

the exchange of ParentCo equity for SpinCo equity of an equal value does not result in income tax recognition or a corporate tax deduction.[15]

Thus, when properly structured, neither ParentCo employees nor SpinCo employees will recognize taxable income upon the conversion. For unvested shares, taxable income will be recognized when the shares vest. (See Section 83 and Appendix.) For ParentCo shares that were previously vested and replaced by SpinCo shares, any additional tax recognition (such as the capital gain) will be recognized upon disposition of the SpinCo shares, as federal tax law does not generally view these exchanges of equivalent economic value as tax recognition events.

For ParentCo stock options that are replaced or converted into SpinCo stock options there are specific rules that must be followed in order to avoid an adverse tax consequence. These rules either (1) maintain the status of a stock option under Section 422 of the Internal Revenue Code of 1986, as amended (the "Code") as an "incentive stock option" or "ISO." (See Appendix for additional information regarding ISOs.), or (2) maintain the equity compensation's favorable status under Code Section 409A.

ISOs converted as a result of a divestiture retain their character as ISOs if the following conditions[16] are observed:

1) The conversion or replacement is by reason of a corporate transaction such as a separation (i.e., a change caused by market fluctuation is not adequate);

[15] Rev. Rul. 2002-1; 2002-2 IRB 268 (January 14, 2002).
[16] Treas. Reg. § 1.424-1(a)(3)-(5).

2) The original option must be replaced such that it relates to SpinCo and not ParentCo for employees joining SpinCo; the original option and replacement option cannot both continue;

3) The aggregate spread (i.e., excess of the stock value over the exercise price) after the exchange must not exceed the aggregate spread immediately before the divestiture;

4) On a share-by-share comparison, the ratio of the option price to the fair market value of the shares immediately after the divestiture must not "be more favorable" to the optionee than the ratio of the option price to the fair market value of the stock immediately before the divestiture;

5) The number of shares subject to the new, converted option may be adjusted to compensate for any change in the aggregate spread; and

6) The new option must contain all terms of the old option; no additional benefits.

For the purpose of preserving the status of stock options as not constituting deferred compensation, generally similar rules apply under Section 409A of the Code.[17]

See Appendices B and C for more information regarding the treatment of ParentCo equity in a divestiture.

[1.03] PERFORMANCE-BASED COMPENSATION

[17] Treas. Reg. § 1.409A-1(b)(4)(D).

ParentCo will likely have annual and long-term incentive programs for which there will be one or more performance periods or cycles interrupted by the spin-off. The time between the date the spin-off is announced and the date the spin-off closes may be of a sufficient length that ParentCo will need to continue the incentive plans, allowing some performance periods to conclude, and requiring some performance periods to begin. Spin-off transactions are not certain to close, and ParentCo will want all of its employees, both ParentCo employees and the employees of SpinCo, to be paid competitively and to be motivated to effect optimal results, notwithstanding the pending spin-off transaction. Thus, the consequences of interrupted performance periods under both short-term and long-term incentive plans need to be considered.

[1] Short-Term Incentive Plans

Short-term incentive (STI) plans usually involve variable cash compensation that is based on measured performance over a period of one year or less. The construct of most STI plans is based, at least in part, upon the financial performance of ParentCo for its fiscal year against pre-set financial goals. The plan may also include goals specific to certain business units, as well as individual performance objectives for employees. These STI plans usually have a performance range and a corresponding payout range. For example, the leader of a business unit may have an STI plan opportunity based partially on the financial performance (revenue, profitability, etc.) of his or her specific business (SpinCo), as well as the financial performance of the entire enterprise (ParentCo). Each metric has a range of performance expectations usually involving a minimum level (sometimes call a "threshold") of performance, and a maximum level of performance, with intermediate performance between those two end points. There are also different levels of payment associated with each level of performance.

Most STI plans operate under a shareholder-approved plan document. Shareholder approval is one of several conditions in order for the STI payment to be tax deductible by ParentCo under Section 162(m) of the Code generally in respect of its executive officers named in its proxy statement (NEOs). Other conditions include that the payment be contingent upon meeting pre-established performance goals that are set within the first 90 days of the performance period, and that the performance goals are objective. Compensation that does not meet this condition in respect of NEOs is not performance-based and is not deductible if it exceeds $1 million in a year.

The occurrence of a spin-off in the middle of the performance period may disrupt the determination of the pre-established performance goals. The divestiture removes SpinCo performance from the final, combined results, which may be to such an extent that the goal cannot be obtained. In order to accommodate the pre-established goal requirement to obtain a federal tax deduction, the occurrence of the spin-off is typically addressed in respect of the incentive plan in one of the following ways, although not all of these alternatives are certain to preserve deductability under Section 162(m) of the Code:

[a] Plan Document Adjustments — Most STI plans provide for certain adjustments, the occurrence and amount of which can be objectively determined and quantified. The STI plan document may allow ParentCo to ignore discontinued operations or restructuring effects that occur during the year. If the plan

document anticipates the occurrence of a spin-off and the extent of the adjustment, the plan document may avert the loss of deduction.

[b] Full-year Aggregated and Disaggregated Plans — Under this approach, ParentCo may develop its STI plan as if there would be no spin-off – i.e., set full-year performance goals determined on the basis of aggregated or combined performance, including the performance of all business units (i.e., including SpinCo). This will provide reasonable performance objectives if the spin-off does not occur in the fiscal year.

For the same fiscal year, ParentCo would also develop an STI plan based on full-year performance with ParentCo and SpinCo performance disaggregated (e.g., one plan for ParentCo excluding SpinCo, and a second plan only for SpinCo). When the year is completed, and it is known whether the spin-off occurred, the appropriate STI plan is applied — the aggregated or disaggregated plan (e.g., if the spin occurs, the disaggregated plans are used).

[c] Performance and Payment Proration – If it is not possible or desirable to create separate or disaggregated plans, another approach is to create a full year, aggregated plan, possibly stipulating quarterly performance goals. Then, if the spin-off occurs mid-year, the performance and payment are measured on a pro rata basis for the portion of the performance period that is completed, and new performance goals and related (prorated) payments are set for the remaining portion (i.e., the stub portion) of the performance period. For practical reasons, the proration should occur on the last day of the fiscal quarter preceding the spin-

off so that regularly prepared quarterly reports can be used. Also, the plan document should be carefully reviewed to be certain less-than-annual performance is permitted. There is also the issue of establishing performance measures that are stated on a quarterly basis. Some tax advisors may regard this approach as preserving the tax deductability.

[d] Spin-Off is Ignored — If the relative impact of the spin-off on ParentCo's financial performance is small, i.e., SpinCo is a small portion of ParentCo total results, or the spin-off occurs late in the performance period, ParentCo may elect to simply ignore the fact that the spin-off reduced ParentCo's reported results for the year, and apply the STI plan based on actual, full-year financial performance. This approach is most often used when a spin-off occurs very late in a company's fiscal year, when only a very short period of time in the performance period does not include SpinCo's financial contribution. Here, the tax deduction may depend on whether actual financial results were used.

[e] Discretionary Plan — In circumstances where the spin-off is especially large or disruptive to ParentCo's business, another alternative is to ignore financial performance entirely and make STI payments based on the successful completion of the transaction. For named executive officers, it is unlikely that tax deduction could be preserved, as the goal of the spin-off is not likely to be considered a performance goal[18]. However, for STI plan participants who are not named executive officers, it reinforces the dominant ParentCo goal of making the spin-off occur in a timely fashion.

[18]See Code § 162(m) and Treas. Reg. § 1.162-27.

[2] Long-Term Incentive Plans

Long-term incentive (LTI) compensation is most commonly a variable cash or equity payment, the value of which is based on performance measured over a period greater than one year. For ParentCo employees, LTI plan issues occur in a spin-off with respect to performance cycles that start before the spin-off is announced, and expect to end after the spin-off closes; it is likely that SpinCo performance was included and expected at the outset of the performance period but will not be included in the measurement of financial performance at the end of the cycle.

LTI plans have the same conceptual issues as STI plans — the conditional and uncertain timing of the spin-off is problematic to the setting of pre-established performance goals that meet the conditions for deductibility under federal tax law. Most LTI plans operate under a shareholder-approved plan document. The same tactics for addressing the pre-established goal requirement of federal tax law as apply to the ParentCo STI plan are generally available for the ParentCo LTI plan. (See previous discussion.)

For employees who will join SpinCo, there is the issue of terminating employment under the ParentCo's LTI plan. Once the divestiture occurs, SpinCo employees will have terminated employment with ParentCo, and ParentCo terminated employees usually forfeit LTI awards for which the performance period has not been completed. Therefore, a mid-cycle spin-off could cause SpinCo employees to lose potential compensation under the ParentCo LTI plans. Thus, ParentCo LTI plan documents or the divestiture documents usually to provide for a proportionate payment (prorated for the portion of the cycle worked before the spin-off close) based on actual, truncated performance. It is typical that the settlement of the shares for SpinCo employees is in the form of SpinCo equity with the number of shares based upon the conversion methodology described previously relative to time-based restricted stock.

1.04 RETIREMENT BENEFITS IN THE UNITED STATES

[1] Defined Benefit Pension Plans

Dealing with retirement benefits in a spin-off transaction can be complicated, especially when SpinCo employees participate in a defined benefit pension plan with ParentCo. Defined benefit plans typically promise a retirement benefit after an employee terminates employment, attains a certain age (or a combination of age and service), and is a function of service and compensation earned with the sponsoring employer. Typically, this benefit obligation is partially or fully funded through a trust contributed to by the sponsoring employers, which may include SpinCo.[19]

As the company prepares for the spin-off, a number of decisions must be made regarding which company will be responsible for paying the benefits of the existing plan. There could be multiple plans in which employees of SpinCo participate, for example, salaried employees might participate in a separate plan from hourly employees or union employees.

The cleanest situation is where a pension plan has only current and former employees associated with the SpinCo business. In this case, it is likely that the entire plan, including all assets and liabilities, will be transferred with SpinCo. Where employees of

[19] Special accounting treatment for ParentCo may be necessary if SpinCo employees are covered under defined benefit plans.

both ParentCo and SpinCo participate in a plan, the following questions need to be considered:

Which company has responsibility for the liability associated with accrued benefits of current SpinCo employees, based on benefit service earned to the date of the divestiture? The most straightforward arrangement is for a SpinCo plan to retain the accrued liabilities associated with current employees, especially if SpinCo determines to continue to offer pension benefits after the divestiture. Later, SpinCo could decide to alter or freeze the benefit formula going forward.

If ParentCo retains the liability for accrued benefits of current SpinCo employees, then the benefits would cease to accrue as of the divestiture, and the employees of SpinCo would effectively be treated as terminated participants of the plan. In this case, SpinCo could decide whether to provide for the accrual of benefits for future years of service and earnings. A common approach would be to define the SpinCo benefit using all service and earnings with ParentCo and SpinCo, offset by the frozen amount retained by ParentCo.

The allocation of plan assets is linked to the allocation of participants' benefits to the respective plans. Once decisions have been made as to which company is responsible for the benefits and the categories of participants determined, then the allocation of plan assets follows the rules set out in Treasury regulations.[20] The asset allocation rules are well-defined, but the process is complicated and involved.

[20] Code § 414(l) and Treas. Reg. § 1.414(l)(1).

The asset allocation rules favor current retirees more than active employees. As a result, one plan may have a better funded position following the split than the other. In this case, some additional cash contributions would be necessary to comply with funding standards.

Pension plans often hold a wide variety of securities for investment in the trust, such as stocks, bonds or other debt instruments, property, or shares of investment funds. Instead of liquidating assets and transferring cash, it may be more efficient to transfer specific securities to the new plan. This process can be used to align the initial investment classes reflected in the plans' trusts with the investment policy for the respective plans/companies. However, if one of the plans is very small, the sponsor may not want to hold individual securities, and investment in diversified mutual funds would be more appropriate. Some turnover of investment securities or funds may be necessary to achieve the precise split of plan assets or to reinvest according to the sponsor's investment policy. One strategy for dealing with the pension plan split is to split the plan(s) in advance of the corporate spin-off.

This strategy allows ParentCo to exert control over the entire split process, streamlining decision-making and execution. It allows for a "trial period" of operation to ensure that both plans are equipped to move forward separately. ParentCo might use this time between the plan split date and the corporate spin date to contribute additional funds to the new plan. Any contributions made prior to the plan split date cannot be directed entirely to one plan or the other, but must be split according to the rules mentioned previously. Then the newly created plan can be transferred to SpinCo in its entirety at the spin date.

The Pension Benefit Guarantee Corporation (PBGC), a corporation established by Congress to insure defined benefit pension plans, would contact ParentCo regarding the corporate transaction if the spinoff is significant. The PBGC is alerted to a plan split through ParentCo's filing of Form 5310-A, "Notice of Plan Merger, Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities." The PBGC is concerned with the financial condition of plan sponsors, the funded status of the defined benefit pension plans, and the ability of plan sponsors to fulfil their benefit promises. As a result of the split, the PBGC could request that ParentCo take certain actions to improve the security of the benefits prior to the spin-off date, such as making additional contributions to the trust or placing assets in escrow for a period of time after the spin-off date, counting considerations (also pertains to retiree medical and retiree life insurance benefits)

[2] Defined Contribution Plans

It is very likely that SpinCo employees participate in a defined contribution plan sponsored by ParentCo. The tax-qualified version of a defined contribution plan is relatively easily to split, as each participant has one or more accounts, and splitting the plan between ParentCo and SpinCo is essentially a task of identifying, aggregating and linking employees and the accounts.

These programs are also typically funded through a trust that is invested in managed assets (e.g., mutual funds). The splitting of any plan will also require the splitting or separation of assets, which may be done easily. There is need for caution, however, to coordinate this with the plan's record-keeper and trustee, to assure a smooth transition and to identify any associated fees. Also, if ParentCo's plan includes a stock fund, the transfer of that fund to SpinCo's defined contribution plan may implicate heightened fiduciary duties under the Employee Retirement Income Security Act of 1974, as amended, ("ERISA") and may create securities law compliance issues (from a registration perspective).

If the ParentCo defined contribution allows investment in ParentCo stock, attention will be required with respect to defined contribution plan participants who will become SpinCo employees. Generally, SpinCo employees will need the ability to cause the portion of their account balances invested in ParentCo stock to be reinvested into other asset classes under the plan as of the date of the divestiture. SpinCo employees are usually not allowed to increase their investment in ParentCo stock after the divestiture.

[1.05] SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN (SERPs) AND NONQUALIFIED DEFERRED COMPENSATION (NQDC) IN THE UNITED STATES

A distinct, yet related, topic is the disposition of SERP and NQDC programs. These are unfunded, future obligations that provide retirement-type benefits to a select group of highly compensated employees upon termination of employment or later, such as at retirement age. Because of their unfunded nature, obligations associated with SERPs or NQDC programs are reasonably easy to transfer to SpinCo at the time of the divestiture – and such a transfer is typically provided in the employee matters agreement that controls the divestiture.

A particular question regarding the division of NQDC and SERP management arises under Section 409A of the Code. The issue is that the spin-off usually constitutes a separation from service (i.e., terminating employment with ParentCo and its affiliates) under the terms of the NQDC or SERP plan, which triggers a payment right that is earlier than desired, and cannot be easily deferred under Section 409A of the Code without significantly changing an employee's plans for payment as originally contemplated. Even if the employee does not want the payment at the time of the spin-off, the fact that the participant is eligible to receive a payment could result in a taxation event on some or all of the plan's benefit. Postponing a payment caused by an unexpected, technical "separation of service" may result in an unintended, early payment.

Based on a typical employee matters agreement, many divestitures divide or split the NQDC or SERP liabilities between separate ParentCo and SpinCo plans, and cause SpinCo to be the "employer" with respect to its employees. This division of liabilities and the expectation of continuing the original payment election schedule seems anticipated by the preamble to the Section 409A Treasury regulations which includes a comment from the Internal Revenue Service agreeing with a clarification request that a divestiture would generally not result in a termination of employment for an employee of a subsidiary, because the employee is continuing employment with the same employer both before and after the transaction.[21]

Companies that are considering a spin-off should review any legal documents related to SERP or the NQDC to ensure that they have provisions that require participants to not receive a premature or unintended distribution in the event of a separation from service due to a spin-off.

[21] Fed. Reg. Vol. 72, No. 73, p. 19260 (April 17, 2007). Another solution may be a NQDC or SERP plan termination, which can be structured to involve cash-outs over a period of up to two years, and may include vesting conditions (such as continued employment or the satisfaction of post-spin performance goals).

[1.06] HEALTH AND WELFARE PLANS IN THE UNITED STATES

An important and immediate consideration for employees of SpinCo following the divestiture will be coverage under health, medical and other welfare benefit plans such as life insurance, disability protection, sick leave, vacation, etc. Usually these programs do not create considerable business or legal issues. It is often a matter of replicating the coverage provided prior to the divestiture transaction, typically by adopting new plan documents, purchasing insurance, stop-loss coverage, or organizing some other funding arrangement, such as a voluntary employee beneficiary association (VEBA).

The employee matters agreement governing the divestiture should address a number of transitional issues relating to the health and welfare plans, including limitations as to pre-existing conditions, exclusions, and service conditions with respect to participation and coverage requirements, the honoring of deductibles, out-of-pocket maximums, and co-payments incurred. With a spin-off, it is important for the ParentCo's health care administrator to migrate the history of these administrative and cost matters to SpinCo's health care administrator to ensure that the SpinCo employees continue to receive coverage and seamless economic treatment after the spin-off.

Another complication occurs when the size and demographics of SpinCo and the remaining ParentCo employees differ significantly after the transaction. A significant difference may cause the experience rating of each component company to differ from that rating before the transaction, with a negative effect on the premiums that plan members pay for health care coverage. Last, a liability may exist for claims incurred by

SpinCo employees before the transfer from ParentCo to SpinCo but paid after the effective date of the transaction.

A more complicated issue can be retiree medical benefits. If SpinCo retirees are covered for medical benefits there may be issues as to whether SpinCo will have continuing obligation to fund benefits for such individuals, or will SpinCo take the liabilities associated with its retirees with it in the divestiture. If SpinCo does take the liabilities of its retirees with it, there will be a need to consider if there are any assets that have been segregated and what assets should be transferred with the liabilities. Also, the divestiture may create an opportunity for SpinCo to consider any limitations on such benefits. Several companies have been proactive about terminating their retiree medical obligations through seeking a declaratory judgment by which a federal court confirms the termination will not result in ERISA liability, to adversely affected retirees.

[1.07] INTERNATIONAL COMPENSATION AND BENEFIT ISSUES

For companies with global operations, or those that domestically employ non-US citizens through visas, a spin-off provides a unique set of legal and logistical issues that require focus. When employee benefit matters cross international borders, complex employment, securities, and tax issues generally result. Severance liabilities require careful consideration to assure a spin-off does not trigger undesirable reactions from works councils and affected non-U.S. employees. A division of retirement or health plans between ParentCo and SpinCo will require consultation with local counsel within any country in which employees are affected. For U.S. taxpayers who are working abroad as expatriates, Section 409A of the Code continues to be a relevant consideration.

Among the most common international concerns:

Local regulatory authorities may have different tax or accounting considerations related to the decisions that ParentCo makes on incentive plans, equity grants, and pension and welfare obligations at the time of the spin-off.

Similar to defined benefit plans in the United States, special accounting treatment for ParentCo may be necessary if SpinCo employees are covered under defined benefit plans outside of the United States. Also, the decision regarding the transfer of assets from ParentCo to SpinCo applies to defined benefit plans outside of the United States. There are differences, however, as the method and assumptions used in determining the value of assets and liabilities to be transferred is usually subject to separate negotiation. Also, the definition of a defined benefit plan is not always clear. It can be an informal promise, a formal plan with corresponding formal plan document, or a requirement of local legislation, such as a retirement or termination indemnity. In some countries, industry plans exist and require special consideration.

Other benefit plans, such as health, medical and other welfare benefit plans such as life insurance, disability, sick leave, vacation, etc. exist outside of the United States, and their size and complexity vary depending on the country.

Unions, trustees (in the case of pensions), industry groups, and works councils in other countries often need to be consulted relating to the treatment of post-spin compensation and benefit plans at SpinCo. In some cases, a local works council may need to formally approve the terms of the spin-off before employees can be transferred to SpinCo. The spin-off could also trigger a new round of contract negotiations with local unions over key employment issues such as tenure, pay rates and benefits.

If, as a result of the spin-off, there are staff reductions at either ParentCo or SpinCo, consultation (with multiple parties) and severance payments, sometimes substantial, may be required. Rules regarding severance payments can differ substantially between individual (i.e., a few) and collective (i.e., a group) terminations.

For SpinCo employees working in the US on a work visa that is sponsored by ParentCo, the visa may need to be renewed with SpinCo as the employer. However, since this may take some time to effect transaction and annual visa supplies may be limited, the SpinCo employee may need to remain a legal employee of ParentCo until the visa can be transferred.

SECTION 1.08 RETENTION

Having the right people in place in SpinCo — at the time of the transaction and through the early months and years following — is crucial for success. To maintain leadership continuity and ensure that SpinCo has the right mix of knowledge and specialized skills across all critical functions, it is important for the spin-off team to design an effective retention strategy.

Retaining key talent in a spin-off has its challenges. Taking advantage of employees' fears and uncertainty, competitors often use the opportunity to raid ParentCo and

SpinCo of their most valuable talent, which makes the risk of losing high performers great. There's also considerable risk that employees who haven't been with SpinCo for long — and whose financial and emotional ties to the organization are weak — will leave for what appears to be a more certain future in a company experiencing less fundamental change.

The main contributing factor to talent flight during a spin-off is employee uncertainty. Though many employees are excited about SpinCo, there's widespread speculation about a range of transaction-related issues. All of this uncertainty weakens the employee value proposition and creates doubt about SpinCo as an employer. Employees have questions about SpinCo's mission and strategy, culture, financial strength, structure and leadership, employee value proposition, resources to support employees and much more. Overall, employees want to know how their lives will change because of the spin-off, and not all answers may be known at the time of the spin-off, even if ParentCo and SpinCo are focused and diligent in trying to communicate the details of the spin-off. The strain can exacerbate any pre-existing workplace dissatisfaction, destroy employee good will created previously by SpinCo and Parent Co, reduce employees' motivation and lead them to disengage.

[1] Retention Strategy

To address these issues head-on, prevent key talent from leaving and keep engagement levels high, the spin-off team should develop a clear retention strategy and implement it consistently before, during and after the transaction.

The retention strategy is governed by a set of guiding principles for retaining the talent SpinCo will need to succeed. It should be tied to the divestiture goals and SpinCo's business strategy. Though there's no single formula for successful talent retention in spin-offs, most effective retention strategies share common objectives. The over-arching goal is to help ParentCo select, retain and engage the talent that SpinCo will need to operate and thrive as a stand-alone entity. To do that, the strategy should include tactics for promoting workforce stability, helping employees manage the stress of making the transition, ensuring leadership continuity, building employees' trust in SpinCo's leaders and making the best use of SpinCo's resources. When executed effectively, such retention programs help to preserve SpinCo's value and ensure the transaction meets its business goals.

Most effective retention strategies include a combination of tactics that appeal not only to employees' financial needs, but to their emotional and career needs. Towers Watson's 2012 Global M&A Retention Survey, which surveyed nearly 180 acquiring organizations in more than 19 countries, found that companies most successful at retaining employees are considerably more likely than others to focus on tactics that support relationship building, such as personal outreach by leaders and managers. See exhibit. In addition to promoting selected employees who are targeted for positions in SpinCo, leaders can use monetary incentives (retention bonuses), as well as relationship-building activities that create emotional connections to SpinCo among employees targeted for retention.

Prevalence of acquirers' retention tactics

[Insert Chart 1]

Retention bonuses can help the spin-off team retain employees who will be critical to SpinCo's business operations, ensure management continuity through the transaction, and minimize employee distraction by providing financial security during the period of uncertainty. Relationship-building activities can include assigning retention targets to integration task forces, to strengthen their bonds to SpinCo; providing targeted employees with development assignments; having senior leaders reach out to targets personally, and including them in mentoring programs; and allowing retention of employees who are perceived to be retention risks to attend conferences and be recognized at high-profile internal and external events. All such activities help to create and strengthen employees' emotional connections with SpinCo.

[2] What, When, How

It's helpful for the organization to segment its workforce and develop a tailored retention program for each segment. For each, the first step is to identify the roles, functions and skills that are most important to SpinCo's success. The team outlines the mix of people and skills that SpinCo will need, including senior managers, technical experts and other individual contributors.

The team then examines its workforce in light of SpinCo's business plans and opportunities. Leaders assess how critical each employee is to the transaction, to making SpinCo operational and to SpinCo's business plan. Retention strategists consider not only how crucial each worker is to SpinCo, but also each target's flight risk and the potential impact of their flight, including the resources that would be required to replace the employee.

The spin-off team should identify retention targets as early in the process as possible — ideally, during the due diligence phase of the spin-off. Once the spin-off team has finalized a list of potential SpinCo employees, leaders make decisions about the retention program's design. A primary consideration is whether to use formal retention agreements and retention bonuses.

Retention bonuses are typically lump-sum cash payments or shares given at the end of an agreed-upon retention period. While the length of retention agreements varies across organizations, survey participants indicated that most agreements cover a period of one to three years.

[Insert Chart 2]

When such bonuses are used to secure employees' commitment to SpinCo, it's important to offer amounts that will be effective and facilitate attainment of SpinCo's strategic objectives.

Bonus amounts, which may vary among workforce segments, should be attractive enough to keep employees engaged without imposing an undue financial burden on SpinCo. Leaders must also decide whether to tie bonuses to an individual employees' performance. While almost all organizations incorporate "pay to stay" as a condition within their retention arrangements, the Towers Watson 2012 M&A Retention Survey found that companies are increasingly interested in adding a performance requirement to these arrangements.

Whether or not the organization uses formal retention agreements with monetary incentives, successful retention strategies in spin-offs include a variety of tactics and are executed consistently. Consistency helps to build employees' trust in SpinCo.

To establish continuity at the top for completion of a successful spin-off and transition, ParentCo frequently offers "stay bonus" or other retention incentives to key employees. Retention incentives may be structured efficiently for a group of employees through a basic plan document, coupled with short participation agreements that identify the particular retention incentive and terms for earning them. In some cases, greater personalization and customization is desired, in which case individual retention agreements may be suitable. Whatever the vehicle, retention incentives are normally paid at the end of a key transition period (perhaps in stages), with accelerated payments being made if the key employee is terminated without cause. Whatever the triggers for vesting and forfeiture, the amounts tend to vary in direct relation to business needs and the relative negotiating strength of the parties.

[1.09] NEW COMPENSATION AND BENEFIT STRUCTURES AFTER THE DIVESTITURE

[1] Impact on SpinCo

A corporate spin-off necessitates and presents an opportunity to develop a new SpinCo compensation and benefit structure.

The new, independent or stand-alone nature of SpinCo (i.e., SpinCo is no longer an affiliate of ParentCo and its compensation and benefit structures are less influenced by ParentCo), should permit, and even require, SpinCo to undertake a fresh approach to the topic.

SpinCo may also have a new business model or strategy, or at least a revised business model and strategy, that needs to be supported by a revised or different compensation and benefit strategy and structure.

SpinCo may want to continue some parts of ParentCo's compensation and benefit program, to make the employee transition more seamless. The amount of carryover in the SpinCo compensation and benefit structure should be considered in a measured way, however, because SpinCo's resources, needs and circumstances may differ dramatically from those of ParentCo. Even if carryover in the near term is a reasonable approach, in the long-term SpinCo may need to establish plans and programs that better suit its resources, needs and circumstances. Employees will normally understand the need for changes, and show some patience on a post-spin basis. Nevertheless, if SpinCo materially changes overall compensation and benefit structures, there will be a need for SpinCo to restate and reposition its employee value proposition. Overall, the best spin-offs involve proactive communications with affected employees, as discussed further.

A tool that can help SpinCo establish its own compensation and benefit structure is the articulation of a SpinCo compensation and benefit philosophy. Such a philosophy will help SpinCo answer three important questions: What amount to pay? For what performance to pay? How (form and time) to pay?

[a] What amount to pay?

This component of a compensation and benefit philosophy addresses the benchmark or relevant basis for comparison, and the desired level of compensation and benefits relative to that benchmark.

Prior to the spin-off, ParentCo had a specific methodology for benchmarking ParentCo and SpinCo executives and employees. The divestiture causes a need to revisit that methodology, particularly its application to SpinCo executives and employees.

The relevant market for comparison or benchmarking changes due to the divestiture. ParentCo's business mix and size may be considerably different than the business mix and size of SpinCo. After the divestiture, the benchmarking strategy needs to focus on the financial and operational aspects of SpinCo, which are usually distinct and different from ParentCo.

Second, for some officers, such as the chief executive officer or the chief financial officer, SpinCo's separation from ParentCo increases the officer's job responsibility and complexity (e.g., the chief financial officer is now the principal financial officer for a publicly-listed and reporting company). For such positions, this increase in job responsibilities will necessitate the need to consider different market benchmarks than before the spin-off, and a need to adjust pay to the desired market position.

When a change to targeted pay levels is warranted, the timing by which these changes are phased-in will depend on their magnitude. For incremental changes, companies typically make these changes more rapidly – over one or two pay cycles. However, larger increases are more often made over a longer period of time. For short-term recognition, one-time, special long-term incentive awards are preferred.

[b] For what performance to pay?

As a ParentCo business unit, SpinCo may have had a different strategic focus. It may have had different metrics for determining success, and different incentive plans for dividing financial gains. Some SpinCo employees may have been participants in the ParentCo stock compensation plans. As a free-standing organization, success, accountability and the division of financial gains will be defined by SpinCo and provided for in its own incentive plans, which will reflect the change in strategy and business model.

After the completion of a spin, incentive plan measures will usually change for both the annual and/or long-term incentive plans. At a minimum, the measurement focus will need to change as there will no longer be a consolidated, corporate measure based on aggregate ParentCo financial results.

[c] How (form and time) to pay?

It is usual in the event of a spin-off that SpinCo would rethink its approach to total rewards and the resulting mix between key elements of total compensation (salary, annual incentives, long-term incentives and benefits). As SpinCo goes from being a subsidiary or unit of ParentCo to a free standing public company, it needs its own approach to equity compensation. SpinCo may want to extend equity awards further into the organization than before the spin-off given that the entity goes from having a single unit head to an organization with a CEO and a number of top level direct reports who would also likely receive equity. In addition, depending on the culture of the new organization, it would not be uncommon to extend equity throughout the new organization on a broad basis as part of a one-time, divestiture-related award.

Based on our research, it is prevalent for SpinCo to provide special, one-time equity awards to executives and employees. The purpose of these awards is to help retain key employees as SpinCo starts as an independent company. These awards also help draw employees' attention and align it with that of SpinCo's shareholders. Our experience and review of these awards show that companies use a mix of time-based stock options or restricted stock for these special awards. Vesting tends to require three to five years of continued employment. Participation in such special awards covers the top cadre of executives, and may extend into the lower levels of executives, such as the vice president rank. The value of such awards can range from half the value of the typical annual award to lower executive levels, up to in excess of four-times base salary for the chief executive officer.

[2] Impact on ParentCo

One thing revealed by our research over the years is that, depending on the scale of the divestiture, targeted base salary levels at ParentCo may not be affected much – if at all – by the transaction. Compensation committees and management in divestiture situations often tend to view the perceived (or actual) reduce size and complexity of the organization as not requiring a decrease in pay levels for incumbents. First, there may be a desire to reward executives who divest a business unit under favorable conditions with continuing pay levels that remain near pre-spin-off levels, despite the decrease in organizational size. There is also a general reluctance to decrease pay levels for executives, especially cash compensation, based on a transaction within the control of management, as that would tend to discourage management from undertaking necessary, beneficial changes or transactions.

Although companies anticipating a change in corporate size commonly are keen to review executive pay levels, our research shows that only a large change in revenues is likely to have much impact on market-based salary levels. For example, a company declining from $3.5 billion in revenue to $3 billion may not experience a sizable change in base salary levels in the market data. The “market” does not view much difference between a $3 billion and $3.5 billion company, despite the potential, reduced complexity of the organization or jobs that the reduction of $500 million in revenue may bring.

In the case of ParentCo downsizing, it is unusual to reduce salary levels unless the change in ParentCo’s size and complexity is substantial and permanent. It may be more common and less disruptive to reduce long-term incentives. One exception to this is where the divestiture is also accompanied by a change in incumbent management, such as a new chief executive officer or chief financial officer at ParentCo (e.g., the incumbent retires with the divestiture or departs to lead SpinCo). Any new officers (including promotions) should see compensation levels sized more closely to the size of the resulting ParentCo organization.

Returning to the question of whether and how corporate pay structure should change after ParentCo executives accomplish a spin-off, our advice continues to be that compensation committees should not be distracted by this one-time event in setting the amount of ParentCo ongoing pay. The same discipline should be used to apply market data and ensure that the pay programs are designed to reward executives in strong performance years. There may be a temptation to provide one-time, above-market annual and/or long-term incentive awards due to the extraordinary transaction. Our advice would be to avoid this temptation and instead continue to focus on properly calibrating the existing compensation structure to reward the intended performance. Thus, if the transaction does accomplish the goals of increasing corporate performance and shareholder value, the plan would provide the proper rewards to executives, without creating a one-time windfall.

SECTION 1.10 CHANGE MANAGEMENT AND COMMUNICATION

The magnitude of change to which employees must adapt in a spin-off can be enormous, and people adapt at varying paces and to differing degrees. Employees' behaviors, whether positive or negative, can affect SpinCo's performance and the speed and efficiency with which the organization can meet the spin-off goals.

The best way to help employees navigate the period of uncertainty and keep them engaged is to have a detailed change management plan in place when the spin-off is announced. The plan, which includes a communication component, has multiple goals:

help employees understand the business rationale for the spin-off and SpinCo's business strategy; focus employees on the future; get workers to buy into SpinCo's mission, strategy, vision and values; gather input from all levels about the desired attributes of SpinCo's culture; generate excitement and nurture commitment to SpinCo; accelerate the adoption of behaviors that will bring value to SpinCo; clarify roles and expectations; support the retention of key talent; and prepare the organization for SpinCo's first day as a stand-alone entity.

A change management task force, comprising leaders from throughout the organization, crafts the change management plan. At the start, it's helpful to measure employee engagement levels, and continue measuring during and after the transaction — this helps SpinCo and its leadership know whether it's managing the change successfully. Also, the involvement of senior executives in the change management effort is essential. Leaders not only model appropriate behaviors, but also paint a picture of the future SpinCo for the workforce. That picture is critical for the retention and engagement of key talent.

Among the components of the change management program are explanations of SpinCo's employee value proposition, the behavioral changes needed for SpinCo to reach its business goals, and the workforce initiatives that will motivate those changes. There's also a detailed communication plan. This plan reflects the specific communication needs of each stakeholder group — both internal and external — and includes targeted and aligned messages delivered before, during and after the transition period.

Leaders and other communicators can dramatically mitigate employees' uncertainty and angst during a spin-off by communicating openly, honestly and frequently. Communication begins early, with frequent, timely updates along the way. Targeted groups include employees based in SpinCo facilities and those in remote locations, as well as external stakeholders, such as customers, vendors, shareholders and media outlets.

Communication about the spin-off should go in two directions. That is, it's important for leaders to provide employees with not only information, but also channels through which employees can ask questions and voice their concerns. Leaders need to adjust their communication plans and messages in light of employee feedback. And leaders do well to remember that effective change management programs include messages that appeal to employees' hearts as well as those that appeal to their heads.

[1] Communication Plan Details

When a spin-off is announced, employees want to know what will change and what will remain the same. Delivering that information quickly and updating it frequently supports the talent retention program. And to secure workers' commitment to SpinCo, leaders deliver customized messages to each stakeholder group about the rationale for the spin-off and SpinCo's business goals. These messages and others throughout the transition are delivered via the channels and media most appropriate for each group. A new SpinCo company intranet is an essential channel in the mix.

The messages include information about SpinCo's leadership, mission, vision, strategy, values, culture and organizational structure. Of most importance to employees are specifics about what's changing in their compensation and benefit packages, as well as company programs, processes and policies. And because employees need to know the timetable for these changes, the plan includes messages about what will happen when, before the spin-off, during the transition and after SpinCo is operational. Leaders explain changes in products, target customers and marketplace focus, and provide details about SpinCo's short- and long-term performance goals. Other key items include the impact of SpinCo on roles, departments or teams, and how it impacts managers and leaders. It's also important to explain the impact of SpinCo on employees' roles and departments, and on their managers and leaders. As much as possible, the messages aim to help employees understand how the changes will bring positive results for the organization and the individual employee.

The communication plan includes a schedule with milestones for specific communications with the workforce and various stakeholder groups. The overall plan sets the stage for SpinCo's launch, engages and educates employees, and reinforces key messages throughout the transition. It also provides information about who employees may contact with questions at every stage of the transition. And there's a section devoted to preparing employees for SpinCo's first day.

[2] Preparing for Day One

A major goal of Day One preparations is generating excitement in the workforce, so that SpinCo begins operating with high levels of employee engagement. This positive energy is not likely if employees are still uncertain about their roles in the new organization, what will end, what will remain the same, and what will begin. That's why preparing for Day One involves ensuring that employees have the information they need to perform effectively on Day One and sustain operational performance. This typically includes information about process changes, including new processes that will take effect on Day One. In addition, it's essential for leaders to be highly visible on Day One — this helps employees to form positive attitudes and exhibit the behaviors that will contribute to the organization's success.

Clear, concise communication materials — as well as easy-to-access, two-way communication channels — are essential elements of Day One preparations. Symbolic activities also play an important role. Those activities, including such things as award ceremonies and celebrations, acknowledge what's ending and what's beginning. Along with external and internal SpinCo branding, activities help to strengthen employees' attitudes of team membership, belonging and loyalty that keep them engaged and help SpinCo get off to the right start.

The spin-off change management program, including the detailed communication plan, is not a static tool. Leaders continually modify it throughout the transition, in response to changing employee needs. To ensure that these modifications are timely and appropriate, it is best to measure the plan's effectiveness throughout the change period by gathering employee feedback at periodic intervals. And before implementing the change management plan, it is wise to design a method for revising the plan as needed.

Well-intended employer communications have the potential to stir litigation when they turn out to have been wrong or incomplete. Cooperation between ParentCo and SpinCo will be critical to fairly alleviate employee concerns without over-promising. The discussion above about retirement and health plans suggests the importance of proper planning for a smooth transition. Black-out notices prior to the spin-off are routinely required for equity transactions such as stock option exercises and changes in participants' investment allocations within the defined contribution and other retirement plans. For health plans, ParentCo and SpinCo will need to coordinate mid-year deductibles and pre-existing exclusions to avoid employee morale problems, and this takes a delicate touch in communications.

The issues reach fewer employees but tend to involve greater tensions and risks when the spin-off affects executive compensation. Poor communications about the value of company stock can backfire into claims when executives feel short-changed. Third-party appraisals are generally the best defense, and generate a sense of fairness. Overall, the best employers are sensitive to employee concerns, and are careful in their responses.

Appendix A

Summarized below in question and answer format are the general U.S. federal income tax consequences that apply to common types of awards under an omnibus stock compensation plan. .

[a] What are the tax effects of Incentive Stock Options (sometimes referred to as "ISOs")? ISOs are intended to qualify for special treatment available under section 422 of the Internal Revenue Code. An employee generally does not have to include any amount in income upon grant or exercise of ISOs (except at exercise for purposes of the alternative minimum tax, if applicable). Upon a subsequent sale of the shares received upon the exercise of an ISO that occurs both more than one year after the exercise of the ISO and more than two years after the grant of the ISO, the optionee will generally recognize long-term capital gain or loss in the amount of the difference between the amount realized on the sale and the exercise price for the shares.[22] Generally, upon a sale or disposition of the shares prior to the foregoing holding requirements, referred to as a "disqualifying disposition", the optionee will recognize ordinary income equal to the lesser of (i) the excess of the fair market value over the exercise price of the shares on the date of exercise, or (ii) the excess of the amount realized on the disposition over the exercise price for the shares.[23] Any remaining gain or loss will be long-term or short-term capital gain or loss depending on whether the optionee has held the shares for more than one year. Utilization of losses is subject to special rules and limitations.

[22] Code §422(a).
[23] See Code §422(c)(2) and Treas. Reg. §1.422-1(b)(1).

The favorable tax treatment associated with ISOs is available only to the extent that the value of the shares, as determined at the time of grant, covered by the shares that are first exercisable in any single calendar year does not exceed $100,000.[24] If ISOs that cover an aggregate amount of shares in excess of $100,000 become exercisable in the same calendar year, the excess will be treated as a non-ISO.

[b] What are the tax effects of non-ISOs? Generally, an optionee will not recognize taxable income at the time a non-ISO is granted. Upon the exercise of a non-ISO, the amount by which the fair market value of the shares on the date of exercise exceeds the exercise price will be taxed to the optionee as ordinary income and will be subject to wage withholding taxes for employees or former employees.[25] In general, an optionee's tax basis in the shares acquired by exercising a non-ISO is equal to the fair market value of the shares on the date of exercise. Upon a subsequent sale of any of these shares in a taxable transaction, the optionee will recognize capital gain or loss in an amount equal to the difference between the optionee's basis in the shares and the sale price, which will be either long-term or short-term depending on whether the shares were held for more than one year before the sale. Utilization of losses is subject to special rules and limitations.

[c] What are the tax effects of stock appreciation rights (sometimes referred to as "SAR")? The holder of an SAR generally is not deemed to receive any taxable income at the time it is granted. Upon exercise of an SAR payable in cash and/or shares, the holder will recognize ordinary income equal to the amount of cash and/or the fair market

[24] Treas. Reg. §1.422-2(b)(3).
[25] Treas. Reg. §1.83-7.

value of the shares received.[26] In general, a holder's basis in any shares acquired by exercising a SAR is equal to their fair market value at the time of transfer.

[d] What are the tax effects of restricted stock grants? Generally, the recipient of restricted stock will not recognize taxable income at the time the stock award is granted, unless the recipient makes an election under section 83(b) of the Internal Revenue Code, as discussed below. In the absence of a section 83(b) election, the recipient is deemed to receive an amount of ordinary income equal to the excess of the fair market value of the shares at the time the shares vest over any purchase price the recipient paid. The recipient's tax basis in the shares is their fair market value at the time of vesting, and any later appreciation in the value of the shares is taxed as capital gains when the shares are sold. The holding period in the shares will start at the time of the vesting, and the capital gains or losses will be either long-term or short-term depending on whether the shares were held for more than one year before the sale. Any cash dividends paid on unvested stock are treated as taxable compensation.

Code section 83(b) permits the recipient of restricted stock to elect, within 30 days after the award date, to be taxed at ordinary income rates on the excess of the fair market value of the stock at the time of purchase over any purchase price that the recipient paid.[27] If the recipient makes a section 83(b) election, his or her tax basis in the shares is their fair market value at the time of acquisition, and any later appreciation in the value of the stock is taxed as capital gains when the stock is sold. If the recipient of

[26] Rev. Rul. 80-300.
[27] Treas. Reg. §1.83-2.

restricted stock makes a section 83(b) election and the stock is later forfeited, the recipient is not entitled to a tax deduction or a refund of the tax paid.

[e] What are the tax effects of restricted stock units, deferred stock units, and performance share units? The recipient of awards of this kind is not deemed to receive any taxable income at the time of grant, although employment taxes may apply on the date the grants vest even if that precedes the payment date. When the recipient of these awards receives payment to settle it, the amount of cash received and the fair market value of any shares of stock received results in ordinary income.

[f] What are the general tax effects on employers in connection with awards? Employers that make awards of the kind described above generally will receive a federal income tax deduction equal to the amount of any ordinary income that the award recipient recognizes from the award. Section 162(m) of the Code contains special rules regarding the federal income tax deductibility of the compensation paid to the top executive officers of public companies. It is possible to preserve the deductibility of additional compensation, with a threshold requirement being shareholder approval.

How does Code Section 409A affect equity awards? Most awards will qualify for exemptions relating to restricted stock, and for stock options and SARs that have an exercise price that equals or exceeds the fair market value of the underlying shares on the grant date. If an award is not exempt from Section 409A, it may have a fixed exercise or settlement date that establishes compliance. If an equity-related award violates Section 409A, increases in its vested value may create ordinary income for the holder, plus a 20% additional tax, for so long as the award remains outstanding. Section

409A violations may also arise from certain modifications to awards (such as reducing the exercise price for an option or extending its expiration date).

Generally, employees are taxed on any equity awards only at the time the recipient gains actual value. This is at the time of vesting for full-share awards, and at exercise for stock options.[28] They are taxed using regular employment income rates, based on the dollar value of the equity at the time of vesting (full share awards) or exercise (stock options and SARs). Conversely, the company is allowed to record an expense for tax purposes for an equal amount, also at the time of vesting or exercise. Less common equity instruments such as Incentive Stock Options may have different tax treatment.

[28] [Citation to Section 83]

Appendix B

ParentCo Equity Compensation Choices

The following are the four most probable ways outstanding ParentCo equity awards are addressed in a spin-off:

[a] Adjustment of ParentCo Equity

For ParentCo employees, it is common to adjust ParentCo equity compensation to maintain the intrinsic value that existed at the time of the divestiture. Also, if ParentCo employees may no longer have a continuing interest in SpinCo performance and success after the divestiture there may be no need strategically to provide SpinCo equity to ParentCo employees.

Concept:	For ParentCo employees not receiving a proportional distribution of SpinCo equity, ParentCo equity is adjusted to preserve or restore the intrinsic value caused by the divestiture; for stock options, this requires an adjustment to the ParentCo option exercise price, and the granting of additional stock options (i.e., to maintain aggregate intrinsic value(“spread”) and per share ratios that existed before the divestiture). For restricted stock, this requires the issuance of additional shares equal to the lost value due to the spin-off

Accounting:	If ParentCo equity plan documents require the preservation of intrinsic value, the adjustment will not be regarded as a modification and there will not be additional compensation expense. If the plan must be amended to require the preservation of value, the adjustment will be considered a modification
Protection of Intrinsic Value:	The intrinsic value of ParentCo equity will be restored and provided by ParentCo equity
Future Value:	ParentCo employees will receive future compensation from ParentCo equity
Strategic Consideration:	Continues ParentCo employees on ParentCo success and performance

[b] Conversion of ParentCo Equity

For SpinCo employees, a conversion of ParentCo equity compensation is the common (and the most prevalent) approach. This recognizes that SpinCo employees in the future will be focused on SpinCo performance and success, and the conversion into SpinCo equity brings what is considered to be more appropriate alignment for SpinCo employees.

Concept:	For SpinCo employees, ParentCo equity is converted to SpinCo equity with an equivalent intrinsic value; when converting to SpinCo options this means providing a number of SpinCo options and an option exercise price that preserves the aggregate intrinsic value, and adjusting the SpinCo option price so that the per share ratio of the exercise price and market value of the stock is equivalent before and after the conversion
Accounting:	If the equity plan documents require the preservation of intrinsic value, the conversion will not be considered a modification and there will not be a revaluation and additional expense because of the conversion; the expense for services after the divestiture will be SpinCo's expense. If the plan must be amended to preserve value, the adjustment will be considered a modificaiton
Protection of Intrinsic Value:	The intrinsic value of ParentCo equity as of the spin date will convert to intrinsic value in the replacement SpinCo equity
Future Value:	SpinCo employees will look to SpinCo equity for future value creation
Strategic Consideration:	Conversion is the most typical way to effect the preserve the intrinsic value for SpinCo employees in a divestiture, and is

	used strategically when the two companies are not expected to significantly interact post-spin

[c] Combination of Conversion and Adjustment

There are circumstances where continuing employees of either ParentCo or SpinCo (or both) receive some combination of ParentCo and SpinCo equity. In other words, the ParentCo equity may be partially adjusted (as described previously) or partially converted (as described previously), or participate in the proportional distribution of SpinCo equity the same as the public shareholders. The strategic pay implications for a combination may be driven by the expectations that ParentCo and SpinCo may have continuing interactions or business dealings, at least for a period of time, and that the combination of awards facilitates a continuing awareness of interest by the employees of the one company in the success and performance of the other. It may also allow employees the benefit unlocked by the transaction.

Concept:	Where the employees of ParentCo and the employees of SpinCo may have a continuing interest in the performance and success of the other company, ParentCo-based equity is partially converted to SpinCo equity and partially adjusted
Accounting:	If the equity plan documents require preservation of intrinsic value, this will not be considered a modification and there will

	not be additional compensation expense
Protection of Intrinsic Value:	The intrinsic value of ParentCo equity as of the spin date will be reflected in the value of the combined post-spin equity of both companies, i.e., some value will be reflected in the adjusted ParentCo equity, and some value will be reflected in the ParentCo equity converted to SpinCo equity
Future Value:	ParentCo employees and SpinCo employees will receive future value based on the financial performance of **both** SpinCo and ParentCo, regardless of which company is the employer post-spin
Strategic Consideration:	This approach is used most frequently when SpinCo and ParentCo are expected to maintain a post-spin business relationship; or where the circumstances would suggest ParentCo employees have a strong interest and relationship to the SpinCo becoming a separate public company

We note that the general exemption of stock awards from an application of Code Section 409A may not be available if SpinCo employees receive awards relating to ParentCo (or vice versa). Careful structuring of the awards for compliance with Code Section 409A is required.[29] Also, we note that there may be some employees, such as

[29] See Treas. Reg. 1.409A-1(b)(5)€(iii)(1) and Treas. Reg. 1.409A-1(b)(4)(D).

retiring ParentCo employees, who participate in the proportional distribution of SpinCo equity (as do ParentCo public shareholders). Because of their termination from employment (and not continuing with SpinCo) their status relative to the transaction is similar to that of public shareholders, and thus, they participate in the proportional distribution the same as public shareholders.

[d] Cancellation

There may be instances when there is no intrinsic value of ParentCo equity awards (i.e., an "underwater" stock option) and its best that ParentCo equity awards expire without being exercised and are deemed forfeited, allowing the accounting expense of time-based awards to be reversed.

Concept:	The time-based restricted stock (or units) are allowed to expire before vesting and/or the time-based stock options expire before exercise and are deemed to be forfeited. This would occur because SpinCo employees have incurred a separation from service or a termination of employment, and ParentCo does not take action to avoid the forfeiture
Accounting:	ParentCo will reverse the expense associated with forfeited awards; the awards are not modified so there should be no incremental cost
Protection of Intrinsic	Loss of compensation although (with underwater options)

Value:	there's typically little or no intrinsic value at the time of spin-off
Future Value:	No future value of compensation
Strategic Consideration:	This approach is commonly used to eliminate the non-cash expense of "underwater" stock options (i.e., stock option for which the exercise price is greater than the fair market value); or when preserving intrinsic value is not required by the equity plan documents and the cost of the modification is prohibitive

Appendix C

[Insert Chart 3]