

Executive Change-in-Control Arrangements

Among Fortune 100 Companies

2006

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Introduction

As executive pay continues to come under intense scrutiny, so do company change-in-control ("CIC") programs. Arising out of the boom in merger and acquisition activity over the last 20 years, the purpose of these plans is to align executives' interests with those of their shareholders and provide maximum value to them.

Typically designed by compensation committees of corporate boards, an effective CIC program ensures the severance benefits provided to executives are perceived as fair and representative of the marketplace, and not as a windfall to executives. The data presented in this study should be one of many factors considered in a company's CIC program design. More importantly, the ensuring program should not be considered an entitlement for the executive, but in the best interest of the company, as well as shareholders.

The principal theory behind CIC programs is to afford protection for executives so they can focus on what is best for their organization, even at the possible expense of their own position. By affording executives this "golden parachute," they can focus their energies on increasing shareholder value without the concern of how their own position or future compensation will be affected. However, a delicate balance is required when designing a CIC in that the benefits offered should not be so excessive as to motivate executives to consummate a transaction. An effective CIC plan should serve as a critical element in allowing shareholders to achieve sufficient value in the event of a merger or acquisition resulting in a change of control of their company.

Designing an effective CIC program should consider the following factors:

- ◆ Does the program motivate executives to pursue transactions that will be in their shareholders' best interests, even at the expense of their own jobs?
- ◆ Are the CIC benefits so substantial they promote negative behavior on the part of executives?
- ◆ What is the right balance between providing the proper amount of benefits for executives versus protecting the interests of the company?

This study serves as an overview of the current basis for CIC programs in *Fortune* 100 companies. This survey also provides a resource for those companies who are designing or revising their current CIC plans.

About This Report

James F. Reda & Associates, LLC conducted this study of executive CIC arrangements in *Fortune* 100 companies. The purpose of this report is to provide a resource of current severance practices among those companies providing CIC protection for their executives.

The data for this study was collected from SEC filings of *Fortune* 100 companies. The Severance/CIC arrangements examined in this report include:

- ◆ cash severance benefits;
- ◆ excise tax provisions;
- ◆ bonus/short-term incentives;
- ◆ long-term incentives;
- ◆ health care benefits;
- ◆ SERP benefits;
- ◆ legal fees, perquisites and miscellaneous benefits; and
- ◆ employment restrictions.

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Report Highlights

Prevalence: 63% of *Fortune* 100 companies (“Study Companies”) provide cash-based CIC protection to their executives through individual agreements or executive plans. When including stock plan protections, 89% of Study Companies provide CIC protection.

Levels/Tiers: 58% of the Study Companies provide one consistent level of protection for all covered executives, while 42% provide various levels of protection for differing levels of covered executives/employees.

CIC Definition: Most CIC programs include: 1) acquisition of a percentage of company stock (typically between 20% and 30%), 2) significant change in the composition of the company’s board of directors, 3) consummation of a merger, consolidation or other reorganization, and 4) liquidation, dissolution or substantial sale of assets.

Protection Period: 10% of Companies offer protection prior to and following the occurrence of a CIC; 55% of Companies provide protection following a CIC. Executives typically have a two-year period of protection once a CIC occurs.

Triggering Mechanism: 75% of the CIC Companies have a double trigger CIC program that must be met for cash severance payments to be made.

Cash Severance: The typical payout for highest-level participants is three years pay, including base salary and annual bonus. Lower levels of executive participants typically receive two years pay or one year pay.

Timing/Form of Payment: Most companies pay cash severance benefits via a lump-sum payment (conversely, non-CIC severance is generally paid out as pay continuation).

Excise Tax: Executives typically have some form of “gross up” payment to offset the impact of excise taxes applicable to CIC benefits

Bonuses/Short-Term Incentives: Most CIC Companies in this survey (64%) pay a “short-year” bonus for the year the CIC termination occurs. Generally a pro-rata bonus is paid based on current year target.

Long-Term Incentives: 92% of the Study Companies accelerate stock option vesting upon a CIC and 91% lapse restrictions on restricted stock or restricted stock units following a CIC.

Supplemental Retirement Arrangements: The majority of the Study Companies (70%) provide additional benefits under supplemental retirement arrangements. In over fifty percent (57%) of the companies surveyed, the SERP benefit is 3 years age and service.

Health Benefits: Top executives typically are eligible to receive company-provided health benefits for 24 to 36 months following termination of employment due to a CIC.

Other Benefits: Benefits provided to executives subsequent to termination following a CIC include outplacement services (54%) and financial counseling (39%).

Employment Restrictions: Most of the CIC Companies (85%) attach some form of restrictive covenant to their CIC benefits.

Fortune 100 Companies

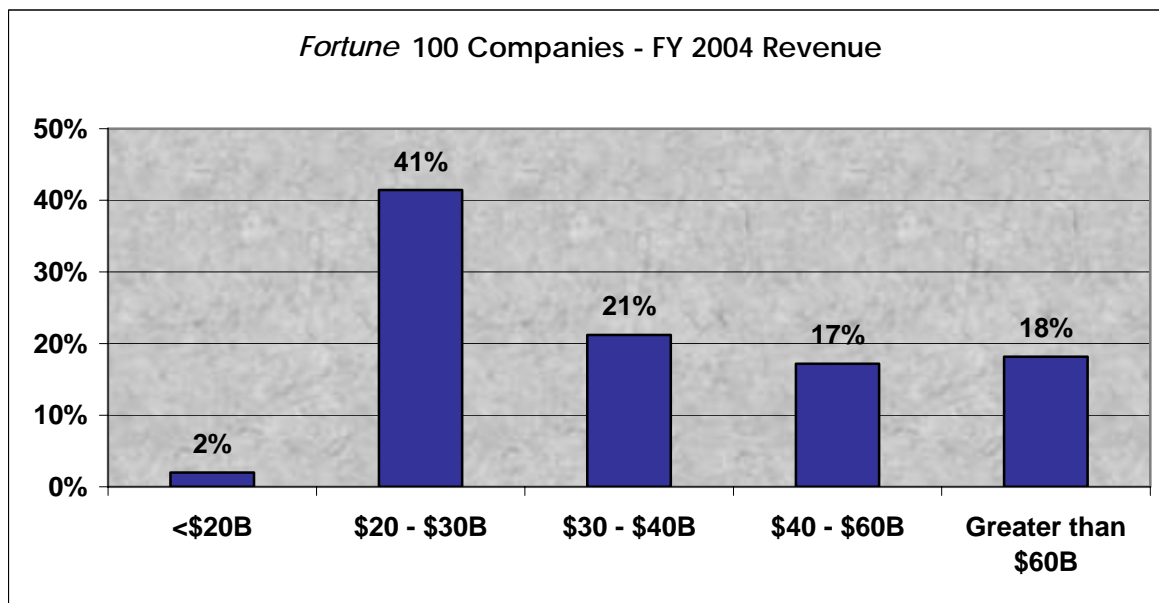
This study includes a review of all documents filed with the Securities and Exchange Commission ("SEC") for companies in the *Fortune* 100, as reported for 2005.

Abbott Laboratories	Johnson Controls
Albertson's	Kroger
Alcoa	Lehman Brothers Holdings
Allstate	Lockheed Martin
Altria Group	Lowe's
American Express	Marathon Oil
American Intl. Group	Mass. Mutual Life Ins.-Mutual
AmerisourceBergen	MCI
Archer Daniels Midland	McKesson
AT&T (SBC Communications)	Medco Health Solutions
Bank of America	Merck
BellSouth	Merrill Lynch
Berkshire Hathaway	MetLife
Best Buy	Microsoft
Boeing	Morgan Stanley
Bristol-Myers Squibb	Motorola
Cardinal Health	Nationwide Financial Services
Caremark Rx	New York Life Insurance-Mutual
Caterpillar	News Corp.
ChevronTexaco	Northrop Grumman
Cisco Systems	PepsiCo
Citigroup	Pfizer
Coca-Cola	Plains All Amer. Pipeline
ConocoPhillips	Procter & Gamble
Costco Wholesale	Prudential Financial
CVS	Safeway
Dell	SBC Communications
Delphi-2003	Sears Roebuck
Dow Chemical	Sprint-2003
Duke Energy	St. Paul Travelers Cos.
DuPont	State Farm Insurance Cos-Private
Electronic Data Systems	Sunoco
Exxon Mobil	Sysco
FedEx	Target
Ford Motor	TIAA-CREF-Private
General Electric	Time Warner
General Motors	Tyson Foods
Goldman Sachs Group	United Parcel Service
Hartford Financial Services	United Technologies
HCA	UnitedHealth Group
Hewlett-Packard	Valero Energy
Home Depot	Verizon Communications
Honeywell Intl.	Viacom
Ingram Micro	Wachovia Corp.
Intel	Walgreen
International Paper	Wal-Mart Stores
International Business Machines	Walt Disney
J.C. Penney	Wellpoint
J.P. Morgan Chase & Co.	Wells Fargo
Johnson & Johnson	Weyerhaeuser

Size of *Fortune* 100 Participants

The size of the companies by revenue in this study ranged from \$20 billion to almost \$300 billion. The table and chart below summarize the annual revenues of the *Fortune* 100 companies for fiscal year 2004.

Percentile	FY 2004 Revenue (Billions) (n=100)
25 th Percentile	25.0
50 th Percentile	34.2
75 th Percentile	52.5
Average	48.9



Overview of Change-In-Control Programs

This study focuses on executive CIC programs in U.S. *Fortune* 100 companies. The benefits provided by these programs are sometimes referred to as “golden parachutes,” and are designed to keep senior executives focused on the best long-term interests of the organization, while alternative value strategies are explored.

Severance programs can be comprised of various forms:

- ◆ Individual employment contracts;
- ◆ Individual CIC plans; or
- ◆ CIC plan covering multiple executives.

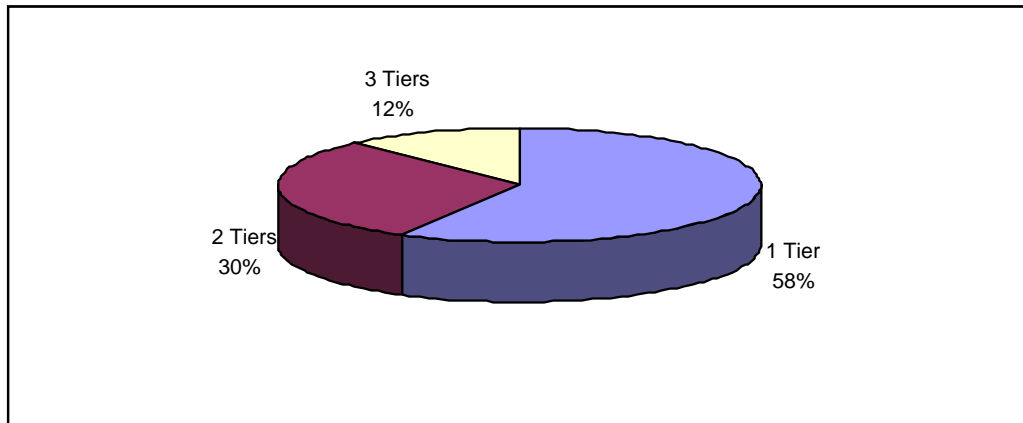
Additional protections may also be provided in the form of long-term incentive plans (e.g., stock options, restricted stock), annual bonus plans, voluntary deferred compensation arrangements, supplemental retirement arrangements, or other benefits such as outplacement assistance and financial counseling. These additional benefits will be discussed later in this report.

Participation in CIC Arrangements

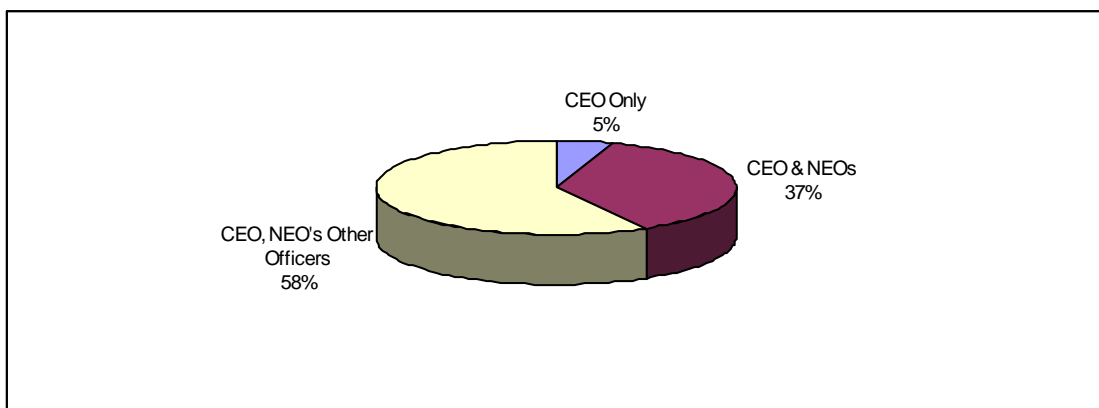
The survey asked companies how many levels or “tiers” of CIC protection they provide.

- ◆ **One tier** – “no tiering” of protection for all covered executives and employees. A common level of protection is extended to all participants.
- ◆ **Two or more tiers** – differing levels of CIC protections for differing executives and employees or groups of executives and employees.

The illustration below summarizes the general approach to participant tiering among the *Fortune* 100 companies in this study. Overall, a majority (58%) of the Study Companies provide one level of CIC protections to covered participants.



The following chart illustrates the depth of CIC coverage. The majority (58%) of companies extends CIC protection to CEO, NEOs and other executives.



CIC Defined

The “trigger” for determining a CIC can be defined in various ways. More than 90% of the Study Companies use a significant change in the composition of the board of directors or a merger/consolidation included in their definitions of a CIC.

The following table summarizes all the events that may constitute a CIC among the companies in this study.

Events Constituting a CIC

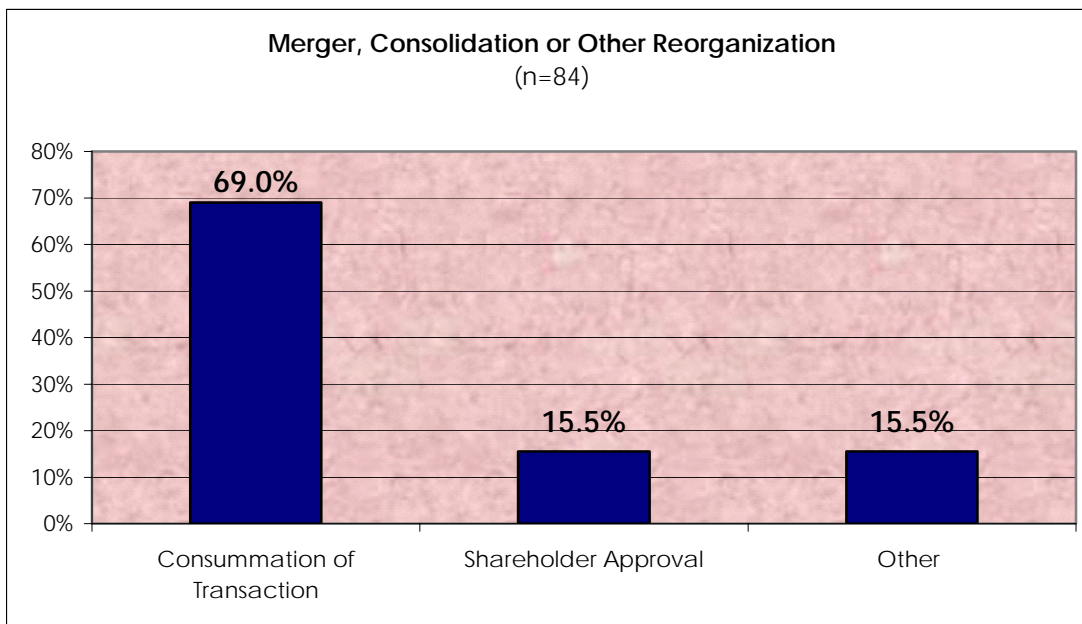
Type of Event	<i>Fortune 100</i> (n=89)
Significant change in the composition of the board of directors	94%
Merger, consolidation or other reorganization	94%
Acquisition of a specific percentage of company stock	84%
Liquidation, dissolution or substantial asset sale	94%
Other (e.g., Board discretion, SEC filing being required)	12%

The table below provides more detailed information about the acquisition of a specified percentage of stock defining a CIC.

Percentage of Stock Acquisition Defining a CIC

Company Definition	Prevalence (n=89)
15% of stock or less	3%
20% of stock	44%
25% of stock	25%
30% of stock	17%
35% of stock	3%
40% of stock	2%
50% of stock or greater	6%

The following chart provides additional information about mergers, consolidations, or other reorganizations defining a CIC.



A merger, consolidation or other reorganization in which the voting securities immediately prior to the transaction continue to represent a specified percentage of the surviving entity will typically not constitute a CIC.

Percentage of Surviving Entity Owned by Current Shareholders for CIC not to Occur

	Prevalence
	(n=58)
Less than 50% of stock	1.7%
50% of stock	25.8%
Greater than 50% and less than 60% of stock	29.3%
Between 60% and 70% of stock	37.9%
75% of stock	1.7%
Greater than 75% of stock	3.4%

Potential CIC

A potential CIC typically sets forth other events short of a true CIC which, if triggered, also provide some form of CIC protections. In this study, 16% of the *Fortune* 100 companies define a potential CIC.

Cash Severance Benefits

Triggers for Cash Severance

There are three general types of triggers for severance benefits:

“Double Trigger” – an involuntary or constructive termination within a specified time following a CIC (i.e., requiring two distinct events; the CIC and an involuntary or constructive termination);

“Single Trigger” – typically a voluntary termination by the executive following a CIC (i.e., the executive has the ability to initiate the termination following the CIC, or the CIC itself may trigger the benefit payment); and

“Modified Single Trigger” – a double trigger requirement in effect at all times except for a short period during which a voluntary termination will trigger benefits (e.g., during the 13th month following the CIC)

The table below summarizes *Fortune* 100 company practices for initiating cash severance benefits. Some companies have differing arrangements even within a single tier of coverage, i.e., provide double trigger provisions to some members of the tier and single trigger coverage to others. Regardless of the type of trigger for cash severance benefits, most companies make use of a single trigger for other aspects of their CIC programs (e.g., long-term incentive vesting).

Trigger for Cash Severance

<u>Types of Triggers</u>	<u>Tier I (Where Multiple Tiers Exist)</u>
	(n=63)
Double trigger arrangement	75%
Single trigger arrangement	8%
Modified single trigger arrangement	17%

* Insufficient data for Tier II companies

Protection Periods

55% of the Companies provide protection to their covered executives and employees following a CIC; 10% of Companies offer protection prior to the occurrence of a CIC. The most common post-CIC protection period is two years (46%), while the second most prevalent is three years (24%), as noted in the table below. If the post-CIC protection is provided through an employment agreement, the protection is often the remaining term of the agreement (18.5%).

Post-CIC Protection Periods for <i>Fortune</i> 100 Cos.	Percentage (n= 54)
12 months	7.5%
24 months	46.0%
36 months	24.0%
Term	18.5%
Other (e.g., 48 months, 4 yrs, etc)	4.0%

Constructive Terminations

In most double trigger and modified single trigger arrangements, CIC severance benefits are provided if the executive is constructively terminated, (i.e., terminated for "good reason"). Among the *Fortune* 100 companies in this study, "good reason" can include the following:

Definition of termination for "good reason"	Prevalence (n=56)
Material change in duties or responsibilities	87%
Material change in pay or benefits	82%
Material relocation	83%
Failure of a successor to assume the CIC arrangement	57%
Material breach of agreement	23%
Failure of successor to continue perquisites and fringe benefits	30%
Failure to be re-elected to the board of directors	23%
Failure of successor to give written notice of termination	23%
Failure to award equity	22%
Increased business travel	7%

In defining a material relocation, companies typically based this on a number of miles from the executive's current place of employment, as indicated in the table below:

Number of Miles	Percentage (n=46)
Less than 25 miles	2.2 %
25 miles	10.9%
30 miles	4.3%
35 miles	28.2%
40 miles	4.3%
50 miles	43.5%
Metro area	6.5%

How Severance Benefits are Determined

Severance benefits are usually determined as a fixed multiple of pay. Typical amounts are three times pay for Tier I protection and two times pay for Tier II protection. The chart below illustrates the prevalence of different severance multiples. Data for Tier III executives is often not available in publicly filed documents.

Benefit Amount/Period For Study Cos.	Level of Participation	
	Tier I (and Single Tier Cos.) (n = 56)	Tier II (n = 57)
Fixed multiple of pay		
* 3 years' pay	69.6%	--
* 2.99 years' pay	10.7%	--
* 2 years' pay	16.0%	88.2%
Other (e.g., 1, 1.5 or 2.5 years' pay)	3.6%	11.8%

Definition of Pay for Severance Benefits

The definition of “pay” for computing the severance benefit amount typically includes base salary and annual bonus. As the table below indicates, most *Fortune* 100 companies define the computation of the severance amount as a multiple (usually 3x) of base salary plus bonus (89%), although a small percentage (6%) also offer long-term incentives.

Components of Pay for Study Cos.	Percentage (n = 58)
Base salary only	0%
Base salary plus annual bonus	89%
Base salary plus annual bonus plus long-term incentives	6%
Base salary plus separation payment	3%
Fixed amount	2%

As indicated in the table below, the companies in this study vary on how they define annual bonus within the severance multiple, with the current target being the most prevalent option among the Study Companies.

Definition of Bonus for the Severance Multiple	Percentage (n = 45)
Current year target	40%
Last bonus paid	10%
Highest paid last 3 years	18%
Prior 3-year average	18%
Prior 5-year average	4%
Other (e.g., highest annual bonus, greater of target or 2-year average)	10%

How Cash Severance is Paid Out

Most companies (86%) pay cash severance in one lump sum. Other alternatives include pay continuation (12%) while one company provided either a lump sum payment or pay continuation.

Mitigation of Severance Amounts

If pay is continued, only one of the companies in this study discontinues cash severance benefits upon a participant's subsequent employment with another organization. Generally this is because in most cases CIC benefits are paid out in a lump sum rather than pay continuation, and most companies do not require executives to repay severance benefits.

Response to Golden Parachute Excise Taxes

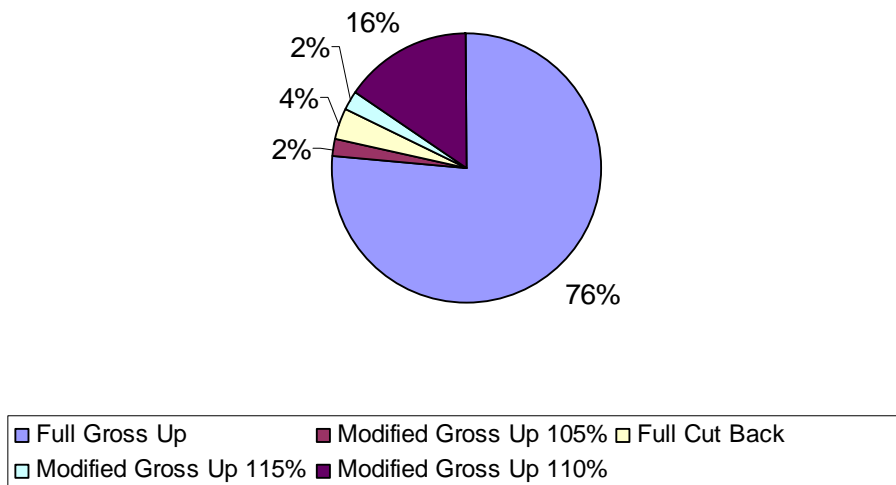
If the value of an individual's CIC payments exceeds 2.99 times the individual's "Base Amount" (prior 5-year average taxable earnings), the "excess amount" (over one times the Base Amount) may be subject to a 20% excise tax (as per IRS Code Section 280G). Such excise taxes are levied on the executive, and amounts payable to the executive subject to excise taxes are not deductible by the company. The table below depicts how company programs are designed to respond to this "golden parachute" excise tax.

Golden Parachute Plan Design	Prevalence
Gross-up or modified gross-up	85%
* Full gross-up	77%
* Modified gross-up	24%

Eighty-one percent (81.6%) of the *Fortune* 100 companies in this study require that an outside firm determine the amount of the gross-up. Within the gross-up payment, all but three of the Study Companies gross-up to offset some, if not all, of the following taxes: excise taxes, federal and state income taxes levied on the excise taxes and FICA taxes levied on the excise taxes.

Gross-Up Provisions

The chart below provides cut-backs provisions associated with modified gross-ups.



Bonus/Short-Term Incentives

In addition to severance pay, the majority (64%) of companies in this study pay a bonus in the “short year” in which a CIC termination occurs. These bonuses are typically paid on a pro-rata basis (89%). Similar to the inclusion of bonuses within the severance multiple, companies vary on the definition of the short-year bonus, as the table below illustrates.

Definition of Bonus for the Short-Term Incentives	Percentage (n = 37)
Current year target (pro rata)	41%
Current year actual performance	13%
Previous year actual	11%
Current year target (full year)	8%
Other (e.g., greater of performance or target, highest of prior 3 years)	27%

Long-Term Incentives

The vast majority of *Fortune* 100 companies (92%) provide accelerated vesting of stock options upon a CIC. Other study participants may provide accelerated vesting, but leave it at the discretion of their board of directors. Similarly, 91% of the organizations in this study lapse restrictions on restricted stock following a CIC.

For performance-based long-term incentives that are vested or deemed earned, 23% of the companies in this study pay out a pro rata value. The table below depicts the prevalence of how payouts for performance-based awards are determined.

Basis for Payout of Performance-Based Award	Percentage (n=64)
Current year target/Full Performance	52%
Pro-rated at target	8%
Earned	5%
Pro-rated	14%
No restrictions - accelerated vesting	8%
Other (e.g., board discretion, 1.5x, 2x or 3x target)	13%

Exercise Period for Stock Options Following Termination of Employment

As the table below illustrates, more than half (58%) the Study Companies have the exercise period for stock options subsequent to termination employment be the full remaining term, while 19% of the *Fortune* 100 group indicated an exercise period of more than three years. Only 16% of the companies limit the exercise period to one year or less.

Exercise Period	Percentage (n=43)
Full remaining term	58%
12 months or less	16%
18 to 24 months	5%
36 months	2%
In excess of 36 months (e.g., 60, 72 months)	19%

Supplemental Retirement Arrangements

The majority of the companies in this study (70%) provide additional benefits under supplemental retirement arrangements. Over fifty percent (57%) of the Survey Companies provide for a SERP benefit of 3 years of additional age and service for purposes of calculating the SERP benefits following a CIC. Other practices are shown in the table below for companies providing supplemental benefits.

Retirement/ Benefits acceleration

Additional SERP Benefit	Percentage (n=40)
3 years age and service	57%
2 yrs age and service	14%
3 years service	7%
Full retirement	4%
Immediate vesting	7%
Other (e.g. 15% Inc, early payment discount)	11%

Health Care Benefits

All but two of the companies in the study (96%) with CIC severance protections continue health care benefits following a CIC-related employment termination. The most prevalent benefit period for executives with this protection is three years (63%), while 19% provide health care benefits for two years following a CIC. In most cases, the continuation period matches the severance benefit continuation period.

Continuation of Health Care Benefits

Benefit Period	Percentage (n=53)
36 months	63%
24 months	19%
18 months	4%
12 months	4%
Life of the executive	4%
Other (e.g., age 65, term of the agreement)	6%

Legal Fees, Perquisites and Miscellaneous Benefits

Legal Fees

The majority of the Study Companies (78%) provide executives some reimbursement for legal fees related to the enforcement of CIC benefits.

Perquisites and Miscellaneous Benefits

There are additional perquisites and benefits provided to executives by many *Fortune* 100 companies, although there is less transparency around these practices than other CIC elements. As indicated below, outplacement assistance for executives is the most prevalent of these perquisites (54%), followed by financial counseling (38%).

Perquisites and Miscellaneous Benefits Provided	Prevalence
Outplacement services	54%
Financial counseling	38%
Automobile allowance/transfer	30%
Secretarial and/or office availability	17%
Club membership continuation	5%
Continued use of company aircraft	11%
Other (e.g., tax preparation services, physical)	5%

Employment Restrictions

The majority of the Study Companies (85%) with CIC protections attach restrictive covenants to the CIC benefits. The terms associated with these covenants are shown in the table below.

Restrictive Covenant Provisions	Prevalence
Prohibition on disclosure of trade secrets	72%
Non-compete clause with the company for a specified period	62%
Prohibition on raiding company employees	62%
Non-disparagement clause	26%

For both the non-compete clause and the prohibition on raiding company employees, the most prevalent time period was one year, although many of the Study Companies extended this restriction to two years.