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Due Diligence Needed When Compensating Management for Major Asset Sales

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Much has been written in legal circles on the significant fiduciary and corporate governance implications of the Ontario Court of Appeal's July 10, 2014 decision in the case of Unique Broadband Systems (UBS) vs. Mr. Gerald McGoey.[1] *One of the factors the appeal court took into account in deciding that $5.7 million of special compensation payments could not be supported was the fact that UBS board did not obtain independent compensation advice.*[2]

This article considers the approaches that an independent compensation consulting firm, such as McDowall Associates, might take in helping boards of directors use their business judgment when special compensation is warranted for selling a significant portion or all of a company's assets.

BACKGROUND

UBS's shares traded on the TSX Venture Exchange, as did the shares of Look Communications. Look in turn was 51.8% controlled by UBS. Mr. McGoey was the CEO and a director of both companies and a voting member of both compensation committees. During 2008, Look was not doing well and was close to bankruptcy, resulting in the need to explore potential value creation opportunities for its shareholders, including UBS. At the time, the book value of Look was $15 million and the book value of UBS was $14 million.

Subsequently in May 2009 Mr. McGoey negotiated the sale of Look's largest asset, its wireless spectrum, for net proceeds of $64 million. The deal closed in September 2009, much earlier than had been anticipated. Mr. McGoey attempted to sell the rest of Look's assets during the same period, but ultimately with no success.

In June 2009, the directors of both companies approved special compensation awards for the executives related to the Look asset sale. They also approved stock-based awards for the executives (and for themselves) that assumed a significant increase in the stock prices of the two companies had occurred, which did not happen. All the Look awards were conditional on the closing of the asset sale (which occurred in September 2009), while the UBS awards were in turn conditional on receipt of sufficient cash payments from Look (which never happened). The total value of the Look award payments was approximately $20 million and the potential value of the UBS awards was $5.7 million. The total UBS and Look compensation of $25.7 million represented 43% of the net proceeds of Look's $64 million asset sale.

After the magnitude of these awards was disclosed in a UBS proxy circular in January 2010, a dissident shareholder group forced out all the UBS directors and triggered Mr. McGoey's resignation from both companies.

A series of lawsuits, countersuits and appeals ensued, as one would expect. The Ontario Court of Appeal ultimately decided that the best interests of UBS had not been served by Mr. McGoey or by the other UBS directors in making the special awards, contrary to the requirements of the Ontario Business Corporations Act. The Court found that each UBS director had a conflict of interest due to the impact of the high stock price assumption on their outstanding equity awards and that their decisions were made in their own best interests.

[1] Unique Broadband Systems, Inc. (Re), 2014 ONCA 538

[2] "The UBS Board did not seek or receive any expert advice on an appropriate bonus structure. Nor did they have any comparable or other data regarding executive compensation in the marketplace."

Compensation Consulting Scenarios

There are a number of situations in which a compensation consultant might be engaged by a board of directors in connection with actual or potential asset sales. For example, the consultant might be engaged in the early stages of the sale process, ideally before an actual deal is imminent, and preferably before management has proposed a compensation incentive and/or retention program. In other situations, a sale is about to close and management has made compensation proposals that the board hopes a compensation consultant can support.

The purpose of the payments needs to be taken into account by the consultant when benchmarking the appropriateness of any proposals. For example, they could be intended to retain of the employees who will lose their jobs as a result of the deal, to reward successful completion of the deal, to recognize the additional work required on the part of key employees, etc.

If the company's shares are publicly traded, the company is typically in a black-out period throughout the sale process, so that existing equity compensation awards may be frozen and new equity-based awards may not be possible.

Relevant Market Sources

Surveys

Regardless of the asset sale situation, the first step for the consultant would be to look for the most readily available survey data. However, in the Canadian market, the data on asset sale compensation is very sparse, especially for small cap companies.

An international study of merger and acquisition compensation conducted by Mercer LLC included some large Canadian companies, such as RBC Financial and SNC-Lavalin[3]. The Mercer survey indicated that transaction bonus pools rarely exceeded 0.5% of deal value and that the median retention pool for deals under $100 million was 2% of the total deal cost.

Private Equity

Another source the consultant could consider is private equity style compensation. Here one would typically see 20% of the appreciation going to the management team upon the sale of each individual investment.

[3] Mercer LLC "Survey of M&A Retention and Transaction Programs", 2012

Other Company Examples

The next step would be to consider the public disclosures of Canadian companies that have faced similar situations. MDS Inc. and BCE Inc. come to mind.

1. *MDS Inc.*

After reviewing its strategic alternatives, MDS decided to sell approximately $1 billion of its assets in 2010 through a series of transactions, leaving only one relatively small business unit, Nordion. The MDS board knew that the potential magnitude of the asset sales would be considered a change of control for purposes of the executives' agreements and would result in many of the corporate executives being terminated.

After receiving advice from the board's independent compensation consultants and its legal advisors, the MDS board decided to create special compensation pools equal to 1% of the gross asset sales plus the net indebtedness of the company.[4] No adjustments were made to the terms of the executives' outstanding stock options or share units, however. No special compensation was received by the independent directors from the asset sales. The total cost of the special program was $11.2 million over and above the cost of the change of control payouts.

2. *BCE Inc.*

In the BCE situation, an investor group led by the Ontario Teachers Pension Plan (Teachers) offered to take the company private in 2007 for approximately $3.5 billion at a 40% stock price premium.

BCE's board hired an independent compensation consulting firm to provide advice on the treatment of its outstanding equity awards and to recommend a retention program for its executive team. While no adjustments were made to their stock options, the executives' restricted stock units were cancelled and turned into one year fixed cash "retention" awards. The value of the awards was fixed at 125% of the number of cancelled units multiplied by the Teachers stock price offer, subject to a minimum of one year's salary.[5] The executives received the full cash retention amounts one year later at a total incremental cost of about $10 million, even though the Teachers deal did not go through and BCE's stock price fell back to its previous range.

The executives and other key individuals were also given one year discretionary cash "recognition" awards in 2007 with a potential aggregate value of $25 million (no more than 10% of which would be for any one individual, such as the CEO). One half of the recognition awards were paid out in 2008 for a total cost of $12.5 million, but the other half were forfeited because the Teachers deal did not go through.

The total cost of the BCE program, had the Teachers deal been successful, was approximately 0.1% of the value of the buyout offer.

No additional equity-based compensation was received by the independent directors.

[4] MDS Inc. September 2009 proxy circular

[5] It should be noted that the former CEO, Michael Sabia, declined participation in the retention program, so that his RSUs continued in effect and were paid out at their fair market value when he retired from BCE.

Situation Analysis

The relevance of the available information sources such as the foregoing would then be considered by the consultant in the context of the specific asset sale situation.

In the UBS/Look case, it would have been difficult to argue that a 1% MDS type asset sale pool would have been a sufficient reward for their executives, given (i) UBS/Look's much smaller size, (ii) the size of the Look deal relative to its small asset base, and (iii) the fact that all the UBS and Look stock options and stock appreciation rights were well underwater. In addition, MDS incurred significant investment banking fees over and above the cost of the compensation program: UBS/Look did not use investment bankers, however.

The UBS/Look program had a parallel to the first "retention" part of BCE's program in that the in -the-money values of outstanding equity awards were increased by the board and were not subsequently decreased. In the UBS/Look case, however, all of their outstanding equity awards received enhanced treatment, whereas only the BCE executives' restricted stock units were enhanced, not their stock options. More importantly, BCE had received a firm offer from Teachers, whereas no concrete offer was received by Look at any time for its shares.

In addition, the total cost of the UBS/Look program of $25.7 million exceeded the $22.5 million final cost of the BCE program, while the Look $64 million net deal represented only 2% of the 2007 Teachers offer.

The international Mercer study would be considered by the consultant, but the 2% small deal data did not reflect companies facing potential bankruptcy, such as Look.

When considering a private equity approach, consideration would need to be given to the appreciation value of the existing equity awards. In UBS's and Look's case, the number of outstanding options and stock appreciation rights already exceeded 20% of the number of outstanding shares. Even though they were all underwater, it would be difficult to justify further dilution by suggesting a private equity style solution for UBS or Look.

Additional Perspectives

The consultant would need to give the board an overview of how the proposed program might be viewed by investors, using the Canadian Coalition for Good Governance's (CCGG) Executive Compensation Principles, for example.

The appendix to this article illustrates how the UBS and Look compensation arrangements would have compared to the CCGG criteria.

In a situation like UBS/Look, the compensation consultant would summarize each of the foregoing sources, and provide relevant illustrations.

CONCLUSION

It is highly likely that the consultant would have been unable to support the magnitude of management's proposals in the UBS/Look case, nor would the consultant have made precise compensation recommendations. Instead, a reasonable range would have been provided for the board's consideration.

The UBS/Look board of directors then would had have the information needed to apply their business judgment in making their decisions in a more appropriate manner than was the case, as reflected by the Ontario Court of Appeal decision.

Nevertheless, even if appropriate market information had been available, the UBS/Look directors would still have had very difficult decisions to make, due to the magnitude of management's proposals relative to the size of the Look transaction and the low impact it ultimately had on the stock prices of the two companies.

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CCGG Executive Compensation Principle [6]	Related CCGG Commentary	UBS / Look Executive Compensation Practices	McDowall Associates Comments
1. A significant portion of executive compensation should be "at risk" and be based on performance.	• Rewards should reflect business performance achievements and be linked to the risks taken during the relevant time periods. • Stock options should de-emphasized in favour of other performance-vested equity compensation. • If used, stock options should be performance-vested	• Both companies awarded bonuses entirely on a discretionary basis. • Both companies used stock options and stock appreciation rights (SARs). • Two large UBS CEO stock option awards were subject to significant stock price vesting hurdles .	• Both the UBS and the Look directors wanted the CEO to make deals. • The CEO probably expected to be well compensated for making deals, e.g. on a private equity basis. • However, the intentions of the directors and of the CEO were never documented or publicly disclosed.
2. "Performance" should be based on key business metrics that are aligned with corporate strategy and the period during which risks are being assumed.	• Short, medium and long-term goals should be identified in advance. • Payouts should reflect the performance of the business both in absolute terms and relative to a peer group.	• Both companies awarded bonuses and equity awards on a discretionary basis. • No peer groups were identified in their compensation disclosures.	• No specific short or long term goals were evident in the disclosures (other than significant stock price increase requirements attached to two UBS stock option awards).
3. Executives should build equity in the company to align their interests with those of shareholders.	• Executives should be required to hold a significant portion of their net worth in company shares or share equivalents	• The CEO owned 3.1 million UBS shares • His UBS shareholdings were worth about 80% of his salary • The CEO owned no Look shares	• Early on in his tenure, the CEO purchased 3.0 million UBS shares, but he did not purchase any more shares thereafter

[6] Canadian Coalition for Good Governance: *Executive Compensation Principles January 2013*

CCGG Executive Compensation Principle [6]	Related CCGG Commentary	UBS / Look Executive Compensation Practices	McDowall Associates Comments
4. A company may choose to offer pensions, benefits and severance and change-of-control entitlements. When such perquisites are offered, the company should ensure that the benefit entitlements are not excessive.	• Companies should ensure that employment arrangements with executives only provide reasonable payments on termination and that unvested deferred compensation be forfeited. • Change of control provisions should require double triggers, i.e. the executive has to be let go after the change of control in order to receive the compensation.	• The UBS CEO's severance and change of control package was 3 years' cash compensation plus immediate vesting of long-term incentives. • The change of control provision was on a "single trigger" basis. • No special pension or benefit arrangements were given by either company. • The CEO received directors' compensation from both companies in addition to his UBS executive compensation.	• The UBS CEO's severance and COC package was very generous relative to the market at the time (and would be heavily criticized today). • CEOs are rarely given directors compensation in addition to their regular executive compensation package.
5. Compensation structure should be simple and easily understood by management, the board and shareholders.	• The board must clearly explain the key elements and the process for determining variable awards in sufficient detail so that shareholders can understand it and consider whether the approach to compensation is appropriate.	• Aside from base salaries that were fixed by management agreements, the two companies' compensation structures were entirely discretionary.	• The Look spectrum sale transaction bonus arrangements were not implemented prior to the commencement of the sales process.
6. Boards and shareholders should actively engage with each other and consider each other's perspective on executive compensation matters.	• CCGG recommends that companies hold an annual "Say on Pay" advisory vote on their approach to executive compensation.	• No shareholder engagement activity was evident on the part of either company based on the public disclosures.	• The UBS shareholders revolted and all the directors were voted out of office.

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