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EQUITY COMPENSATION BASICS

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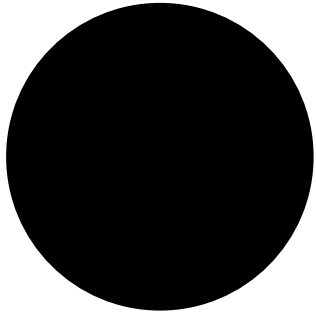
Agenda

- **Overview of Award Type**
 - Restricted Stock
 - Restricted Stock Units
 - Stock Options
 - Stock Appreciation Rights (SARs)
- **Plan Terms**
 - Administration
 - Plan and Award Limits
 - Change in Control
 - Award Agreement Structure
- **Private/Public Company Plan Considerations and Design Trends**
 - General Securities Law Considerations
 - Section 409A
 - Proxy Advisory Firms/Institutional Investors
 - Design Trends

Award Type Overview

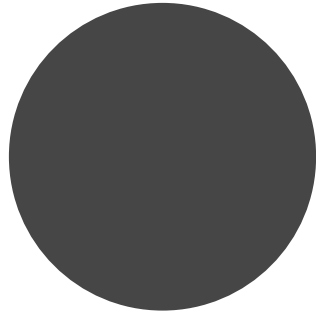
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Award Types



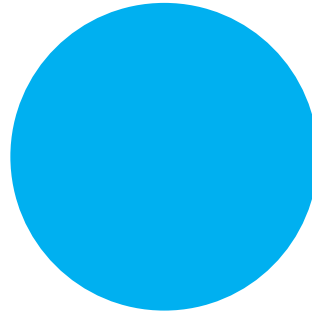
Full Value Awards

- **Restricted Stock**
- **Restricted Stock Units**

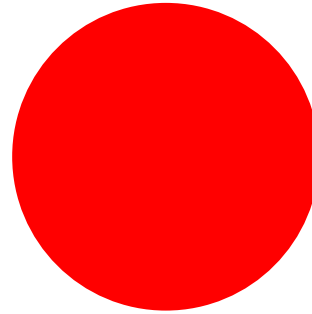


Appreciation Awards

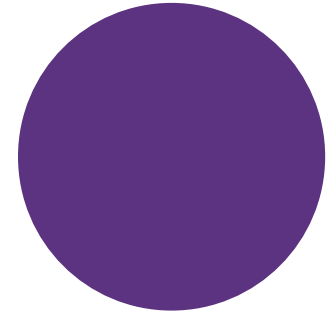
- **Options**
 - Incentive Stock Options
 - Nonqualified Stock Options
- **Stock Appreciation Rights**



Cash vs. Stock Settled Awards



Dividends and Dividend Equivalents



Equity Awards in LLCs

Restricted Stock

- Stock granted subject to vesting schedule
- Unvested shares generally have voting and dividend rights
- Dividends usually subject to vesting schedule
- Shares subject to transfer restrictions while unvested
- Tax consequences of restricted stock
 - Taxation on the employee
 - *Is there a substantial risk of forfeiture?*
 - Deductions for the company
 - *Amount, timing, and limitations*

Restricted Stock Units (RSUs)

- Promise to issue shares of stock in the future
 - May be settled in cash
 - Unlike restricted stock, no actual shares issued up front and no voting rights
- Tax consequences of RSUs
 - To the employee
 - Upon distribution/payment, ordinary income equal to FMV of shares at that time (FICA exception)
 - No IRC § 83(b) election
 - To the company
 - Deduction in the same dollar amount as the ordinary income employee recognizes
 - Deduction subject to the application of IRC §§ 280G and 162(m)
 - Impact of IRC § 409A
 - May be subject to IRC § 409A if: deferred issuance dates, retirement vesting, and walk-away rights
 - RSUs subject to IRC § 409A must provide for the issuance of the shares upon one or more permissible IRC § 409A distribution events

Stock Options

- Incentive Stock Options (ISOs)
 - Issued pursuant to plan with specified share reserve
 - Only available for grant to employees
 - Exercise price must not be less than 100% of FMV of shares on grant date
 - Amount first exercisable in any calendar year cannot exceed \$100,000
 - Maximum 10-year term
 - Must exercise within three months of termination of employment – one year for disability
 - Plan must be approved by stockholders
- Nonqualified Stock Options (NQSOs)
 - Options that do not qualify as ISOs
 - The major differences between ISOs and NQSOs are that NQSOs:
 - Are taxable upon exercise at ordinary income rates
 - Have applicable withholding taxes that must be collected
 - May be granted to nonemployee board members and consultants

Stock Options – Fair Market Value Exercise Price

- Public Companies – “Readily tradable on an established securities market”
 - Prices established in the securities market
 - Last sale before or the first sale after the grant
 - Closing price on the trading day before or the trading day of the grant
 - Average of the high and low prices on the trading day before or the trading day of the grant
 - Any other reasonable method using actual transactions in such stock as reported by such market
 - Average selling price (30-day requirement)
- Private Companies – “Reasonable application of a reasonable valuation method”
 - Presumption of reasonableness:
 - A valuation established by an independent appraiser (IRC § 401(a)(28)) – 12-month presumption
 - 409A factors – tangible and intangible assets of the corporation, present value of future cash flows, market value of stock or equity interests in similar corporations or recent arm’s-length transactions

Stock Options – Tax Consequences

- **NQSO**

- To the grantee

- No tax on grant
- Ordinary income on exercise equal to option spread
- Applicable withholding taxes must be collected
- Long-term capital gain if shares are sold more than one year after exercise
- Not subject to IRC § 409A if exercise price is not less than 100% of FMV of shares on grant date

- To the company

- Deduction in the same dollar amount and in the same tax year in which the employee recognizes ordinary income in connection with the option exercise

- **ISO**

- To the employee

- No tax on grant or exercise, but alternative minimum taxable income equal to spread at exercise
- No withholding taxes even if shares are immediately sold
- Long-term capital gain on sale of shares if more than two years after grant date and more than one year after exercise date
- Ordinary income equal to option spread at exercise if sale is within two years after grant date or within one year after exercise date

- To the company

- Deduction equal to ordinary income recognized by employee in a disposition of the shares within two years after grant or within one year after exercise

Stock Appreciation Rights (SARs)

Right to receive appreciation in value of stock from grant date to exercise date

No exercise price is paid, but applicable withholding taxes must be collected

Appreciation may be paid in cash or in stock

Tax treatment similar to NQSOs

Dividends or Dividend Equivalents

- May be paid on unvested equity (problematic pay practice for performance-based equity) or subject to the same vesting conditions as the underlying equity
- Payable on options or SARs
 - If accumulated amounts attributable to such rights are payable only to the extent the option or SAR is exercised, the payment will be treated as an offset to the exercise price, resulting in the loss of the exemption from IRC § 409A
- Dividend equivalents
 - Granted with RSUs
 - Payable in shares of company stock or cash

Equity Awards in LLCs

- **Profits Interests**

- Provide appreciation in value
- Can be transferred to an employee without current tax

- **Capital Interests**

- Like restricted stock
- Taxable on vesting

- **Options**

- Like options in corporations

- **Effect of Ownership**

- Ownership of profits interests or capital interests generally makes the holder a “member” instead of an employee, so income is reported on Schedule K-1 instead of Form W-2
- Limitations on ability to participate in tax-advantaged benefit plans
- No withholding of income taxes or employment taxes

Full Value vs. Appreciation Awards

- **Advantages of Restricted Stock/RSUs/Capital Interests**
 - Employee receives existing value of the equity
 - Cannot go underwater (i.e., when fair market value is less than grant date price)
 - Restricted Stock: Can lock in tax event at grant or vesting so future appreciation is capital gain
 - RSUs: Can postpone tax until distribution date
- **Disadvantages of Restricted Stock/RSUs/Capital Interests**
 - Employee receives existing value of the equity
 - Employee has little control over when the equity is taxed
- **Advantages of Options/SARs/Profits Interests**
 - Gives employee appreciation in value without having to make an investment or pay tax currently
 - Employee can choose when to exercise option/SAR and control date of taxation
- **Disadvantages of Options/SARs/Profits Interests**
 - Can go underwater
 - Options: Have to pay exercise price to get shares

Other Tax Considerations – Section 409A

- **Stock options**

- Exempt Awards
 - Statutory stock options (Section 422 and Section 423),
 - Nondiscounted options/SARs on common stock (consider service recipient stock issues)
 - No dividend equivalents on stock options or SARs contingent on exercise
- Nonexempt Awards
 - Discounted options/SARs
 - Dividend equivalents payable upon option/SAR exercise
 - Options that do not relate to service recipient stock
- Consider modification rules

- **Restricted stock**

- Exempt from Section 409A

- **Restricted stock units**

- Vest and pay vs. deferred compensation

Other Tax Considerations – Section 280G

- **IRC § 280G**

- Company will be denied a deduction for amounts paid to an executive that are deemed to be excess parachute payments
- IRC § 4999 imposes a 20% excise tax on the executive for any excess parachute payments made to the executive
- Excess parachute payments are any payments or benefits that vest or become payable upon a change in control and equal or exceed in the aggregate three times the executive's average compensation over the past five years
- Stock options and time-vested restricted stock and RSUs are often eligible for a special valuation rule under Section 280G
- Performance-based restricted stock and RSUs are not eligible for this rule and will be counted at fair market value

Plan and Award Agreement Terms

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Administration

- **Board of Directors**
 - Adopt the Plan
 - Administration of the plan?
 - Board, Committee, Subcommittee
- **Stockholders**
 - Approval of the plan (ISOs)
- **Committee of the Board of Directors (Compensation Committee)**
 - Independence Requirements
 - NYSE/NASDAQ
 - Section 16
- **Delegation of Administrative Duties**
 - Planning is key—think about day-to-day operation of plan going forward
 - Be clear!

Eligibility and Withholding Taxes

Who Is Eligible?

- Employees
- Nonemployee Directors
- Consultants, Advisors

Taxes

- Share withholding
 - Consider issues related to withholding above the statutory minimum
- Delivery of previously acquired shares (both with approval of administrator)
- Careful! FICA may occur before award is settled—watch for vesting at retirement

Plan Limits

- **Share Reserves**

- Omnibus Pool – a single pool applies for all awards under the plan
 - “The number of Shares initially reserved for issuance over the term of the Plan is limited to 1,000,000 Shares.”
- Bifurcated Pool – limits the number of shares that can be granted as full-value awards
 - “No more than 500,000 of such Shares may be issued in respect of Awards other than Options or Shares.”
- Evergreen Share Reserve
- Flexible/Fungible Share Reserves

Plan Limits – Share Counting, Restoration of Grants to the Plan

- Liberal share counting (net exercise, withheld for taxes, etc.)
- What provisions are not considered liberal share recycling?
 - Canceled or forfeited shares under prior plans
 - Shares settled in cash
 - Shares that otherwise terminate without payment being made

Award Limits

- Annual employee grant limit (not required, but good corporate governance)
- Maximum number of shares that may be granted as ISOs under the plan
 - Be aware of evergreen provisions.
- Nonemployee director limits (often includes cash compensation)

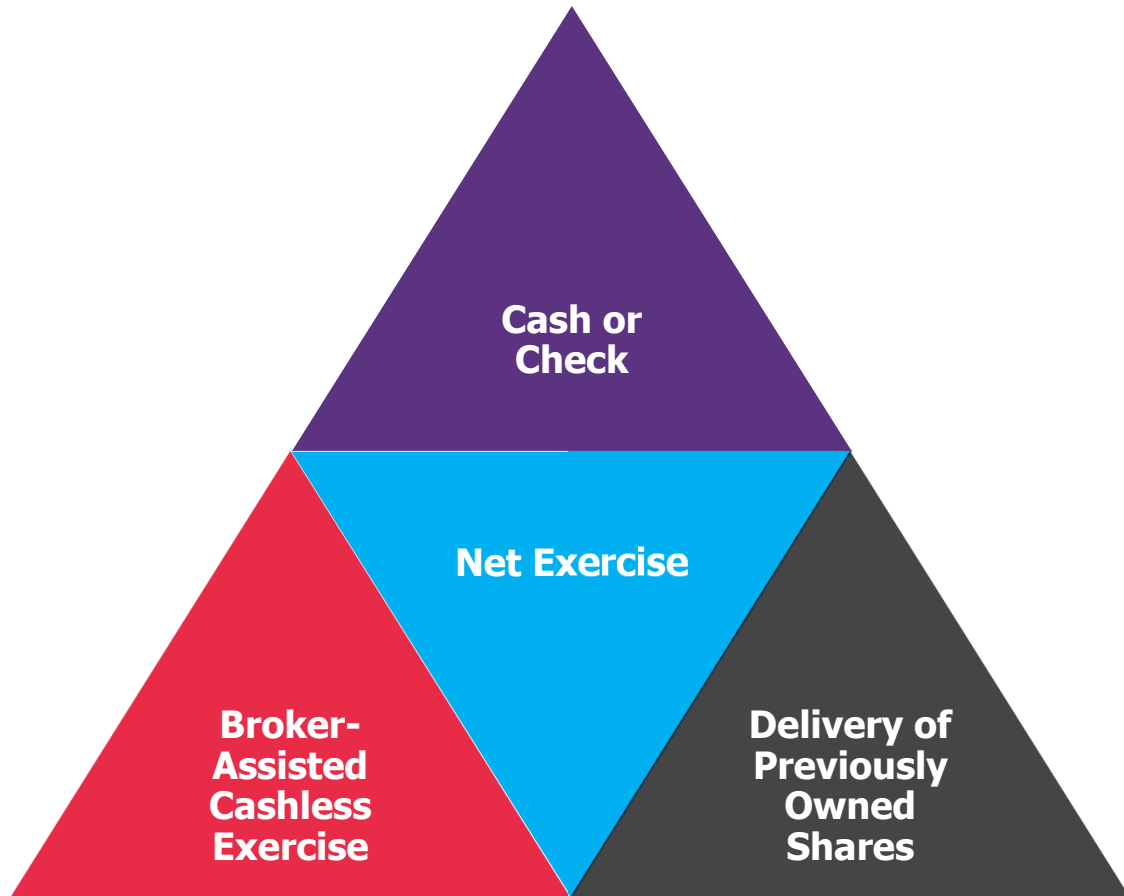
Change in Control

- 409A definition of change in control
 - Change in Ownership – acquisition of more than 50%
 - Change in Effective Control – acquisition of 30% or more, or turnover of majority of board of directors within 12 months
 - Change in Ownership of Substantial Portion of Assets – more than 40% within 12 months
 - Note that spin-offs and IPOs typically are not change-in-control events
- Double-trigger payment event
- Committee authority to determine what happens to grants
 - Plan should include broad flexibility in connection with a change in control (assumption, cash out, accelerate and exercise, cash out and/or cancel equity awards)
 - Include express language to cash out underwater options for no consideration – *Lillis v. AT&T*

Transferability and Term

- Awards are generally transferable upon death (laws of descent and distribution)
- Also typical to allow transfer to family members, trust, or charity (NQSOs)
- Repurchase rights by the corporation/right of first refusal (private company)
- 10-year term – ISOs can only have five-year term if granted to a 10% stockholder

Exercise Provisions



Award Agreements/Plan Structure

- Provide maximum flexibility to grant different types of stock-based or related awards (broad-based plan)
- Leave specific terms in award agreements (you do not want to have to amend plan for every change)
- Noncompetition covenants/clawbacks

Award Agreement – Terms

- **Terms**

- Approval Process
 - Board/committee approval
 - Set FMV for options
- Date of Grant
 - No backdating
 - Can provide credit for vesting (prior to date of grant)
- Exercise Price
- Number of Shares
- Vesting Terms (time-based or performance-based)
 - Performance-based awards often require specific change-in-control provisions
- Other Forfeiture or Acceleration Provisions
- Post-termination exercise periods (ISOs – three-month rule)

Private/Public Company Plan Considerations and Design Trends

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Securities Law Requirements

- **Rule 701 for private company**

- Threshold limits
 - During any consecutive 12-month period, the greatest of
 - \$1 million
 - 15% of the total assets of the company
 - 15% of the outstanding amount of the class of securities being offered and sold under Rule 701
- Limits applicable to disclosure (now \$10 million in any 12-month period)
 - a summary of the plan's material terms
 - description of risks associated with investment in the company's securities
 - the financial statements that otherwise would be required in an offering statement

Securities Law Requirements

- State securities laws (“blue sky laws”)
 - Could require filings, fees, and/or specific plan provisions
 - Filing deadlines may apply prior to grant or be triggered upon grant
- Private placement
- Public companies
 - Proxy proposal
 - Disclosure of plan and forms of award agreements
 - Form S-8 for public company
 - 10(a) prospectus memorandum
 - Form 4 filings
- Special considerations for non-US grants

Shareholder Approval Requirements

- **Private Company**

- ISOs
- Blue sky (CA)
- Bylaws
- Other

- **Public Company**

- Stock exchange requirements
(consider material amendments)
- ISOs

Proxy Advisory Firms/Institutional Investors

- **Proxy Advisory Firms**

- Institutional Shareholder Services (ISS)
- Glass Lewis & Co.

- **Institutional Investors**

- Hedge Funds
- Mutual Funds
- Pension Plans

ISS Equity Plan Scorecard

- ISS supports plans based on whether the plan achieves the requisite number of points under the ISS analysis and has no overriding factors
 - Plan needs 57 or 55 (depending on type of company) out of 100 points for ISS approval
 - Number of points dictates number of shares available for new grants
 - Consider fungible share counting

ISS Equity Plan Scorecard (cont.)

- **Overriding factors:**

- Liberal change-in-control definition
- Repricing/cash buyout of underwater options without shareholder approval
- Plan is a vehicle for problematic pay practices or pay-for-performance misalignment; problematic pay practices include:
 - Repricing without shareholder approval
 - Excessive perquisites/tax gross-ups
 - Excessive change-in-control severance/voluntary termination severance trigger
- Plan is estimated to be excessively dilutive to shareholders
 - Actual threshold depends on the type of company (ranging from 20% to 25%)
- Other plan features detrimental to shareholder interests

ISS Equity Plan Scorecard (cont.)

- Points are awarded based on a range of factors under three “pillars”:
 - 1. Plan Cost**
 - Dilution
 - Overhang
 - 2. Grant Practices**
 - Burn rate relative to peers
 - Vesting schedule and performance measurement period for the CEO’s most recent equity grants during the prior three years
 - Proportion of CEO awards that are performance based
 - Estimated plan duration
 - Clawback policy
 - Postexercise/postvesting shareholding requirements

ISS Equity Plan Scorecard (cont.)

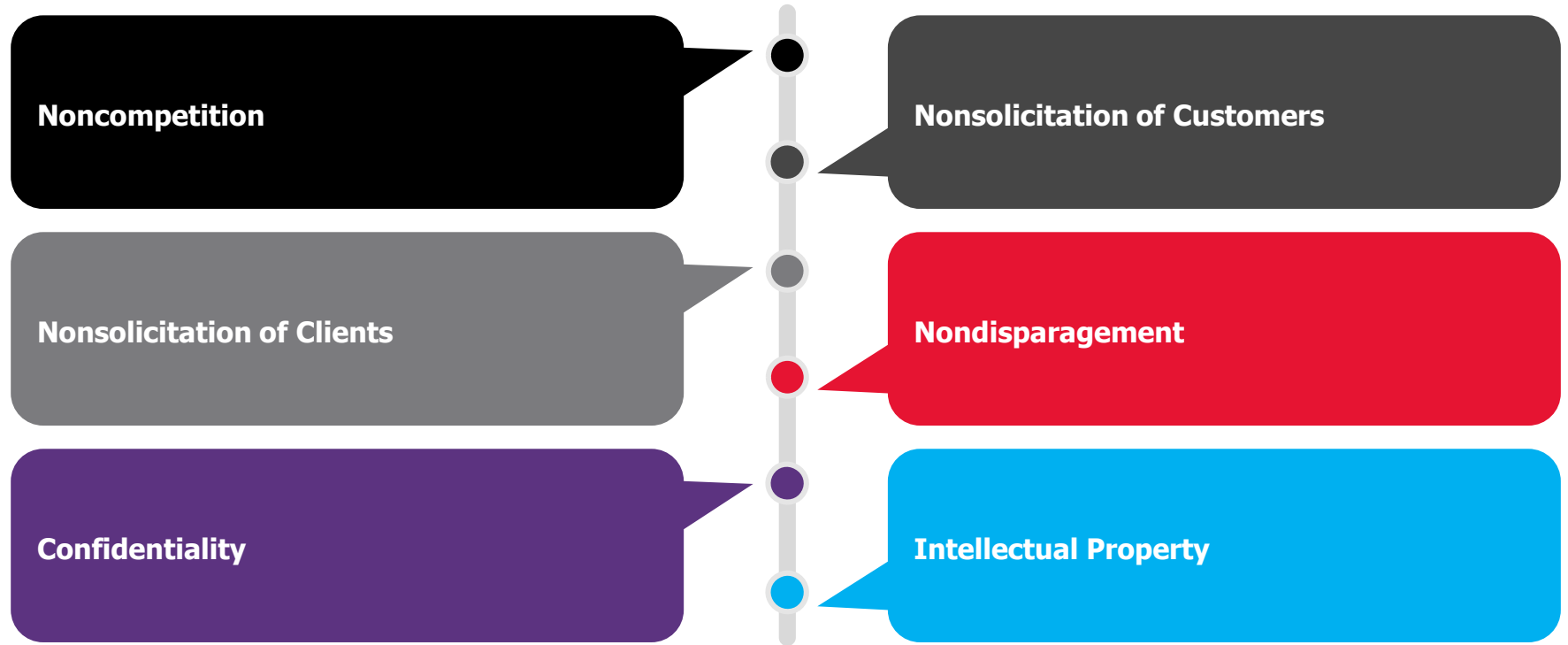
3. Plan Features

- Quality of disclosure around vesting upon a change in control
- Liberal share counting
- Minimum vesting period
 - 5% carve out
 - Must apply to all types of awards
- Dividends payable upon vesting (performance or time vested)
- Discretion to accelerate vesting
- Factors within each pillar are not weighted equally
- In allocating points:
 - Some factors are all or nothing
 - Some factors may generate a partial portion of available points

Design Trends – Clawback

- Clawback/Recoupment Requirements
 - Forfeit outstanding awards
 - Return shares of common stock received in settlement of the award (or FMV of such stock)
 - Covered group
 - State law concerns
 - Tax issues
- Restrictive Covenants

Design Trends – Restrictive Covenants



Design Trends – Other

- Limiting payment of unvested dividends/dividend equivalents
- Double-trigger vesting acceleration/payment
- Minimum vesting periods
- Performance vesting
- Employee/nonemployee director limits
- Separate cash plans

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

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To help keep you on top of developments as they unfold, we also have launched a resource page on our website at www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.



Biography



Gina Lyn Lauriero

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Gina advises clients across the spectrum of employee benefits and executive compensation matters. Her practice encompasses designing, implementing, and administering equity, incentive compensation, nonqualified deferred compensation, employment, and severance plans and agreements for public and private companies. When clients undertake mergers, acquisitions, and other corporate transactions, she offers advice on all employee benefits and compensation-related aspects. Gina's recent work has included advising a credit ratings agency on its acquisition of a leading provider of analytical tools and data.

Biography



Ryan R. Montgomery

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Ryan advises clients with respect to employee benefits and executive compensation. He drafts and assists with equity plans and compensation arrangements, deferred compensation plans, tax-qualified pension and profit-sharing plans, bonus plans, and employment agreements. Ryan has experience designing equity incentive programs in the United States and in over twenty other countries, and assists clients with the tax and securities aspects of global equity incentive programs.

Biography



Lauren E. Sullivan

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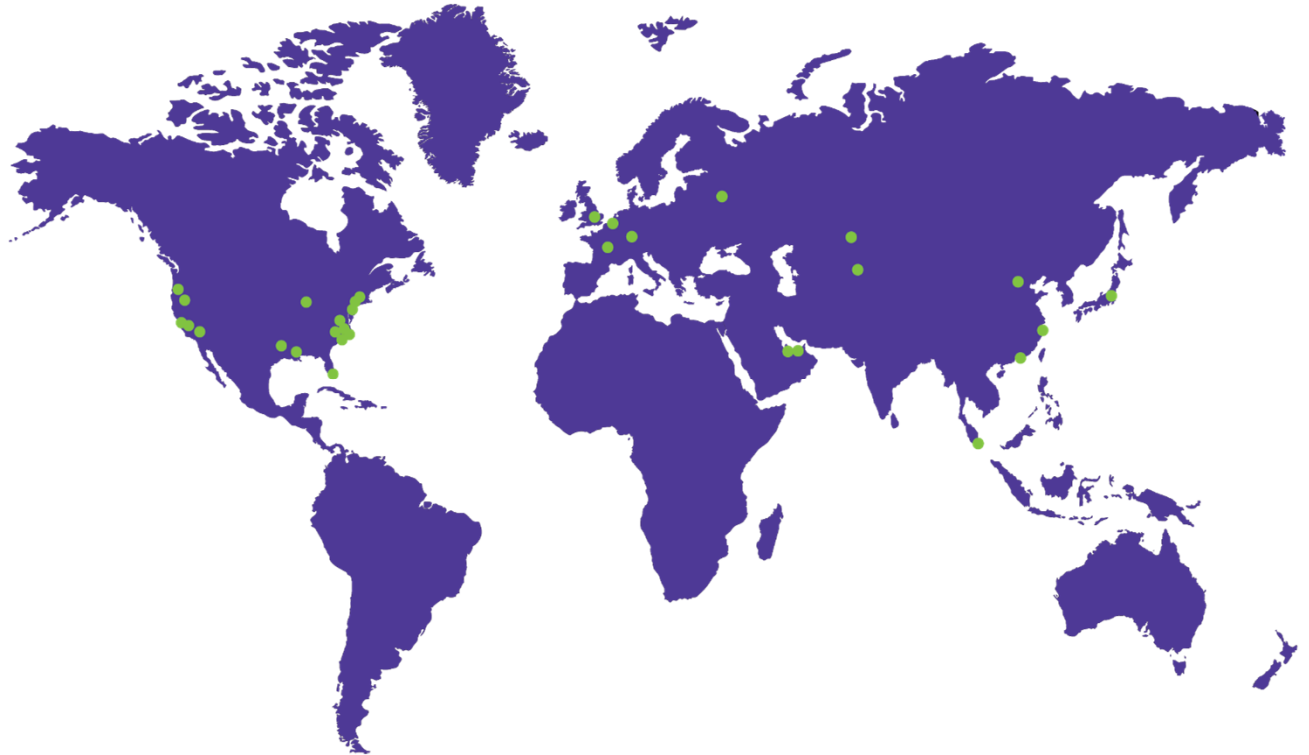
Lauren counsels employers on employee benefits and executive compensation matters. She advises on qualified and nonqualified retirement plans, health and welfare plans, and executive and equity compensation arrangements. She also counsels clients on the legal issues arising under ERISA, the Internal Revenue Code, the Affordable Care Act, and certain securities laws.

Our Global Reach

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Asia Pacific
Europe
Latin America
Middle East
North America

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