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webinar

Executive Compensation Basics | A Webinar Series

Anatomy of an Equity Compensation Plan

Webinar 2 of 4

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May 21, 2014

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Overview

- Overview of Award Type
 - Restricted Stock
 - RSUs
 - Options
 - SARs
- Plan Terms
 - Administration
 - Plan and Award Limits
 - Exercise Price/FMV
 - Change in Control
 - Award Agreement Structure
- Private/Public Company Plan Considerations and Design Trends
 - General Securities Law Considerations
 - Section 162(m)
 - Section 409A
 - Proxy Advisory Firms/Institutional Investors
 - Design Trends



Award Type Overview

Award Types

- Full Value Awards
 - Restricted Stock
 - Restricted Stock Units (RSUs)
- Appreciation Awards
 - Options
 - *Incentive Stock Options*
 - *Nonqualified Stock Options*
 - Stock Appreciation Rights (SARs)
- 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
 - To the employee
 - *If nontransferable and subject to substantial risk of forfeiture, not taxed until vesting*
 - *Upon vesting, ordinary income equal to FMV of shares at that time*
 - *IRC § 83(b) election – must be made within 30 days and no tax recovery if shares subsequently forfeited; particularly important where employee has paid purchase price for unvested shares*
 - To the company
 - *Deduction in the same dollar amount as the ordinary income recognized by the employee*
 - *Deduction will be recognized in the taxable year that includes the last day of the calendar year of vesting*
 - *Deduction subject to the application of IRC §§ 280G and 162(m)*

Restricted Stock Units (RSUs)

- Promise to issue shares of stock in the future
 - May be settled in cash
 - No actual shares issued up front; no voting rights
- Tax consequences of RSUs
 - To the employee
 - *IRC § 83(b) election not possible; no property is transferred until distribution*
 - *Upon distribution, ordinary income equal to FMV of shares at that time (FICA exception)*
 - 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 unless shares are issued at the time of vesting or within the short-term deferral period*
 - *Provisions that may subject RSUs to IRC § 409A: 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*

Options

- Incentive Stock Options (ISOs)
 - Issued pursuant to plan with specified share reserve
 - 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*

Options – Tax Consequences

- 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*
- 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*

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

- Dividends or dividend equivalents paid on unvested equity (problematic pay practice)
- Payable on options or SARs
 - If accumulated amounts attributable to such rights are payable only to the extent the option 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 at grant
- Options
 - Like options in corporations
- Effect of ownership
 - Ownership of profits interests or capital interests generally makes the holder a “member” instead of any employee so income is reported on Form 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 of 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



Plan and Award Agreement Terms

Administration

- Board of Directors
 - Adopt the Plan
 - Administration of the Plan?
 - *Board, Committee, Sub-Committee*
- Stockholders
 - Approval of the Plan (ISOs)
- Committee of the Board of Directors (Compensation Committee)
 - Independence Requirements
 - *NYSE/NASDAQ*
 - *IRC § 162(m)*
- 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
 - Non-Employee Directors
 - Consultants, Advisors
- Taxes
 - Share withholding
 - Delivery of previously acquired shares (both with approval of administrator)
 - Careful—FICA may occur before award is settled - watch out for vesting at retirement

Taxation

- Section 409A
 - Exempt Awards – statutory stock options (Section 422 and Section 423), nondiscounted options/SARs, restricted stock
 - Non-Exempt Awards – discounted options/SARs, dividend equivalents payable upon option exercise
 - Vest and Pay Issues – RSUs
 - Modification of Awards – “In the money” options
- 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 of control and equal or exceed in the aggregate three times the executive’s average compensation over the past five years
 - Be careful of gross-up provisions – they are quite costly and considered a poor pay practice

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.”*
 - 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 as liberal share recycling?
 - Cancelled or forfeited shares under prior plans
 - Shares settled in cash
 - Shares that otherwise terminate without payment being made

Award Limits

- Aggregate number of shares available for individual grants (Standard Pool)
- The plan states maximum number of shares to which options/SARs can be granted during a specified period to any employee
- Maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation
- Maximum number of shares that may be granted as ISOs under the Plan

Exercise Price Fair Market Value

- 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*

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 5-year term if granted to a 10% stockholder.

Exercise Provisions

- Cash or check
- Delivery of previously owned shares
- Broker assisted cashless exercise
- Net Exercise

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)
- Non-competition covenants/clawbacks
- IRC § 280G

Award Agreements-Terms

- Terms
 - Approval Process
 - *Board/Committee Approval*
 - *Set FMV for Options*
 - Date of Grant - Not prior to employment/service
 - *No backdating*
 - *Can provide credit for vesting (prior to date of grant)*

Award Agreements-Terms (Cont.)

- Terms
 - Exercise price
 - Number of shares
 - Vesting terms (time-based or performance-based)
 - *Typical vesting schedules are between three and five years with vesting at a cliff, annually, quarterly or even monthly (typically after the first year)*
 - Other forfeiture or acceleration provisions
 - Post-termination exercise periods (ISOs - three-month rule)



Private/Public Company Plan Considerations and Design Trends

Securities Law Requirements

- Rule 701 for private company
- State securities laws (“Blue Sky Laws”)
- Private placement
- Form S-8 for public company
 - 10(a) prospectus memorandum

Shareholder Approval Requirements

- Private Company
 - ISOs
 - Bylaws
 - Other
- Public Company
 - Stock exchange requirements
 - ISOs
 - Section 162(m) of the Code

Section 162(m) of the Code

- Limits deductible compensation paid to certain officers of publicly held companies to \$1 million
 - CEO and the three highest compensated officers (other than CFO)
 - On the last day of the taxable year
- Exception for performance-based compensation
 - Compensation paid solely on account of attainment of one or more preestablished performance goals
 - Stock options and SARs

Section 162(m) of the Code – Stockholder Approval

- Stockholder approval requirement is met if stockholders approve material terms of performance goal:
 - Class of eligible employees
 - Description of business criteria on which performance goal is based
 - Maximum amount of compensation that could be paid or formula to calculate compensation
- Amendments to material terms
- Frequency of approval
 - New approval required every five years if the committee has authority to change the targets under a performance goal after stockholder approval of the goal

Section 409A

- Initial deferral election
- Subsequent deferral election
- Permissible distribution events
 - Six-month delay on separation from service (applies only if public company)
- Release

Proxy Advisory Firms/Institutional Investors

- Proxy Advisory Firms
 - Institutional Shareholder Services (ISS)
 - Glass Lewis & Co.
- Institutional Investors
 - Hedge Funds
 - Mutual Funds
 - Pension Plans

Proxy Advisory Firms Plan Terms Considered in Voting Recommendation

- Total cost of equity is unreasonable
 - Full value awards
 - Cap on full value awards
- Liberal share recycling
 - Tendered shares in payment of an option/SAR that are added back to the plan
 - Withheld shares for taxes that are added back to the plan
 - Shares that are repurchased by the company using option proceeds that are added back to the plan
 - Stock-settled SARs, where only the actual shares delivered with respect to the award are counted against the plan reserve and the remaining shares are added back to the plan (net settlement vs. gross settlement)

Proxy Advisory Firms Plan Terms Considered in Voting Recommendation (Cont.)

- Specific limitation as to no repricing of options/SARs
- Minimum vesting schedules
 - Time-based – at least three years
 - Performance-based – at least one year
- Three-year burn rate exceeds burn rate of industry group

Proxy Advisory Firms Plan Terms Considered in Voting Recommendation (Cont.)

- Liberal change in control definition
- Single-trigger vesting acceleration on change in control
 - Double-trigger vesting - change in control and covered employment termination
- IRC § 280G gross-up

Proxy Advisory Firms Plan Terms Considered in Voting Recommendation (Cont.)

- Pay-for-performance misalignment
 - Misalignment of CEO's pay
 - CEO participant in plan that is up for vote
- Problematic pay practices include:
 - Repricing without shareholder approval
 - Excessive perquisites/tax gross-ups
 - Excessive change in control severance/voluntary termination severance trigger

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

Design Trends – Restrictive Covenants

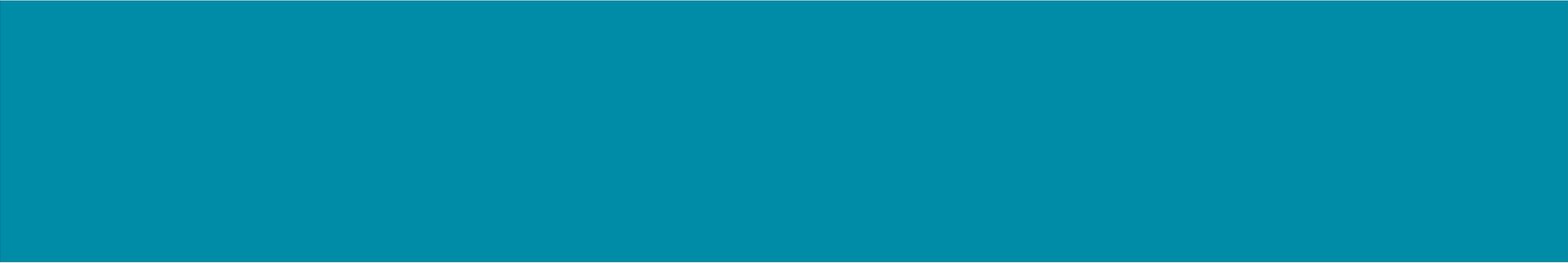
- Noncompetition
- Nonsolicitation of Customers
- Nonsolicitation of Clients
- Nondisparagement
- Confidentiality
- Intellectual Property

Design Trends – Other

- Limiting payment of unvested dividends/dividend equivalents
- Double-trigger vesting acceleration/payment
- Performance vesting
- Electronic disclosure issues
- Statute of limitations

Next Webinar

- Join us for the next webinar in this series, “Anatomy of a Deferred Compensation Plan,” on June 17, 2014



Questions?

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