Tips to Increase the Longevity of the Equity Plan's Share Reserve

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About Anthony “Tony” Eppert

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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

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  - Stock Ownership Policies & Clawback Policies: Design Pointers (10/10/2019)
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Our Compensation Practice – What Sets Us Apart

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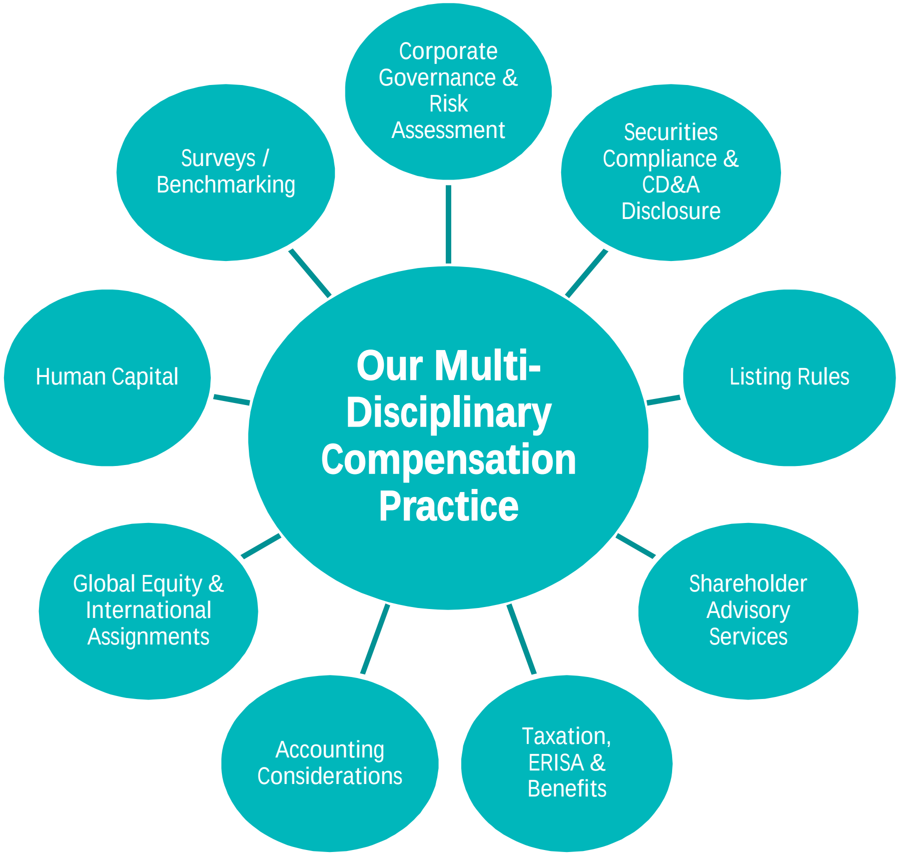
- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- For publicly traded companies, an increase in the share reserve of an equity incentive plan requires shareholder approval under NYSE and NASDAQ listing rules
  - Additionally, for public and private companies, shareholder approval is also required if any of the shares subject to the increase can be subject to incentive stock option treatment

- A problem can arise when management and/or the Board either:
  - Disfavors asking shareholders to approve an increase in the number of shares, or
  - Seeks shareholder approval for less than the desired number of shares due to concerns from institutional shareholder advisory services, market cap concerns or other factors

- The purpose of this presentation is to discuss how a company can increase the life expectancy of the equity plan's share reserve. Specifically, this presentation discusses:
  - Use of stock-settled SARs or net exercised stock options,
  - Use of restricted stock awards or RSUs,
  - Use of "inducement" grants,
  - Automatic forfeitures if the stock price falls below a certain value threshold,
  - Use of treasury stock in conjunction with an elective program, and
  - Implementation of an employee stock ownership plan

Background: ISOs and NSOs

- An ISO is a type of stock option that is preferred by optionees (compared to NSOs) because of their favorable tax treatment
  - ISOs can only be granted to employees
  - No taxable income is triggered to the optionee at the time of grant
  - No taxable income is triggered to the optionee at the time of exercise
    - However, the spread between the FMV of the underlying stock and the exercise price would be an item of adjustment for purposes of calculating any AMT
  - If the stock is held for at least 2 years from the date of grant AND at least 1 year from the date of exercise (the "***Holding Period***"), then any gain realized on a subsequent sale of the underlying shares would be taxed at capital gains rates
- Neither the grant nor the exercise of an ISO provides the company with any compensation deduction, though such point may not be an important consideration since the performance-based exception to the $1mm deduction limit under Section 162(m) was eliminated
- In contrast, NSOs are stock options that do not satisfy one of the many requirements for ISO treatment or fail the Holding Period
  - No taxable income to the optionee on the date of grant
  - At exercise, the difference between the FMV of the underlying stock as of the date of exercise and the exercise price is ordinary income (thus, the company receives a corresponding deduction)
  - Upon any sale of the resulting stock, the difference between the stock's tax basis and the sale price can be captured at capital gains rates

Background: Stock Appreciation Rights

- A stock appreciation right (a "***SAR***") is similar to an option except that a SAR represents a "promise" to pay (rather than a current grant of equity) and provides the participant with the right to receive an amount in cash/stock equal to the excess, if any, of the FMV of a share of common stock as of the settlement date over the "base appreciation amount"
  - Until settled, a SAR represents no ownership interest in the company
  - The base appreciation amount is typically the FMV of the company's common stock on the date the SAR is granted
  - The promise is "settled" on a pre-chosen date
    - Example: Grant 1,000 SARS with a base appreciation amount of $20 per share. If the SAR vested and settled when the company's stock price is $50, then the SAR would be settled for, if cash settled, a cash payment equal to $30,000 (1,000 x $30) or, if stock settled, the issuance of 600 shares ($30,000/$50)

- Tax treatment to participant:
  - Absent a timely deferral, at settlement the participant would have ordinary taxable income equal to the FMV of the spread

- Tax treatment to the company:
  - A compensation deduction would be triggered at the time the participant recognizes taxable income
  - Additionally, at that time the company would have a withholding obligation if the participant is an employee

Background: Restricted Stock

- Generally, the grant of unvested restricted stock would constitute a corporate transfer, but not a tax transfer, at the time of grant
  - A “corporate transfer” means the recipient is entitled to voting and dividend rights even if the award is subject to forfeiture
  - If the award is subject to forfeiture (*i.e.*, a vesting schedule), then the “tax transfer” typically coincides with vesting

- Tax treatment to the participant assuming no 83(b) election was timely filed:
  - Unless an 83(b) election is timely filed, the participant would generally recognize ordinary taxable income equal to the FMV of the award (less any amount paid) as of the earlier of: (i) the date the shares become transferable, or (ii) the date the forfeiture restrictions lapse (*i.e*., the date of vesting)
  - Until such above date, any dividends received by the participant would be treated as compensatory income, not dividends
  - After such above date, any sale of the underlying stock would be treated as capital gain or loss equal to the difference between the sale price and the tax basis

Background: Restricted Stock (cont.)

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- Tax treatment to the participant assuming an 83(b) election was timely filed:
  - The participant could attempt to capture as much of the anticipated future appreciation of the underlying stock at capital gains rates by making an "83(b) election" within 30 days from the date of grant
    - The purpose of an 83(b) election is to try and limit the ordinary taxable income to the value of the stock on the date of grant (which could be much lower than the amount of ordinary taxable income the participant would otherwise recognize at the time of vesting)
    - This means the participant would be taxed at the time of grant (at a time when the FMV of the stock may be lower than at the time of vesting)
    - Thereafter, any increase in the FMV of the stock subject to the 83(b) election would typically be taxed at capital gains rates when the participant sells the stock

- Tax treatment to the company:
  - If the participant is an employee, the company would have a withholding obligation and be responsible for employment taxes at the time the participant recognizes ordinary income
  - Additionally, the company would have a corresponding compensation deduction at that time

Background: RSUs

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- A restricted stock unit (an "RSU," also known as "phantom stock units") are similar to SARs in that they represent a "promise" to pay as opposed to a current grant
  - However, different from a SAR, an RSU provides the participant with an amount in cash/stock equal to the full FMV of a share of common stock (*i.e*., also known as a "full value award")
  - Assuming an RSU is to be settled in stock, an RSU represents no ownership interest in the company UNTIL the settlement date
  - The promise is "settled" on a pre-chosen date:
    - Example: Grant 1,000 RSUs that vest at a time when the company's stock price is $50. When the RSUs vest, the participant would receive cash/stock equal to $50,000 (1,000 x $50) or 1,000 shares of common stock (with a value equal to $50,000)

- Tax treatment to participant:
  - Absent a timely deferral, at settlement the participant has ordinary taxable income equal to the FMV of the amount settled

- Tax treatment to the company:
  - A compensation deduction would be triggered at the time the participant recognizes taxable income
  - Additionally, at that time the company would have a withholding obligation if the participant is an employee

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Idea No. 1: Use Full Value Awards

- The use of full value awards such as restricted stock and RSUs require less shares to provide the same economic value as a stock option
  - We know, a bit remedial, but worth mentioning

Idea No. 2: Implement Stock Price Forfeitures

- The following sets up the factual problem:
- Generally, if a company wants to reprice underwater stock options, the company would have to file a Schedule TO <u>unless</u>:
  - The repricing is conducted on an individually negotiated basis with a small number of key executives (*see* March 21, 2001 Exemptive Order); or
  - A repricing is permitted unilaterally (*i.e*., without optionee consent), thus negating the TO rules because there is no "offer" under applicable securities rules (*i.e*., the optionee would not make any investment decision)
    - A downside to unilateral repricing is that a "value-for-value" exchange could not be effectuated because such would create an "offer" and a corresponding investment decision on behalf of the optionee
    - The result is that unilateral repricings have a higher incremental compensation expense (when compared to value-for-value exchanges)
- Obviously, other issues to consider when repricing stock options include:
  - Whether the cancelled shares return to the share reserve under the equity plan;
  - Whether shareholder approval is required under the terms of the equity plan, NYSE or NASDAQ rules; and
  - Whether adverse tax and accounting consequences can be avoided

Idea No. 2: Implement Stock Price Forfeitures (cont.)

- The idea is simple. The stock option award agreement provides that if the stock option ever becomes underwater by $x.00 (or the stock price ever falls to $y.00), then it is automatically forfeited
  - The forfeited shares then return and replenish the share reserve

- The goal is to avoid the time, expense and shareholder relationship issues associated with repricings and compliance with the SEC’s tender offer rules

- Risk to be vetted
  - Under NYSE and NASDAQ listing rules, a cancellation followed by a **<u>required</u>** regrant is deemed to be a repricing, which generally would require shareholder approval
  - If considering whether to implement a stock price forfeiture, then the “cancellation” issue will need to be vetted
  - A possible solution to consider is whether a cancellation followed by a **<u>voluntary</u>** grant (the latter of which would be pursuant to an annual grant policy) would sufficiently negate the nexus to the cancellation, thus negating the repricing characterization

Idea No. 3: Net-Exercised Stock Options

- In the stock option context, a “net exercise” is similar to a broker-assisted cashless exercise, except that with net exercises there is no open market transaction
  - Instead, a portion of the exercised shares equal in FMV to the exercise price is tendered to the company in lieu of the optionee paying the exercise price in cash

- For example:
  - Assume a holder is granted an option to purchase 8 shares of stock with an exercise price of $1.00 per share (*i.e*., FMV as of the date of grant)
  - Assume further that at the time of exercise the FMV of the underlying stock is $4.00 per share
  - In this example, a net exercise means the holder would tender 2 of the 8 shares of common stock in exchange for paying the exercise price of $8.00
  - Immediately thereafter, the holder would own 6 shares of common stock having a then FMV of $24.00
  - Depending upon the terms of the equity plan, the two shares tendered would return to the share reserve. Just keep in mind that ISS considers this practice to constitute liberal share counting

Idea No. 4: Stock-Settled SARs

- Stock-settled SARs generally provide the holder with the number of shares of stock equal in FMV to the accumulated appreciation in the underlying stock from its FMV at the date of grant
  - However, unlike net-exercised stock options, no shares are tendered to the company

- Using the same example as the prior Slide, the accumulated appreciation of the underlying stock from the date of grant would also provide the holder with 6 shares of stock (*i.e*., $24.000 of accumulated appreciation divided by $4.00 per share)

- Thus, compared to a net exercised stock option, the holder and the share reserve are in the same position, except that:
  - The holder lost the “optionality” that accompanies a stock option

Idea No. 3 & 4: SARs and Net Exercises - Advantages

- Compared to stock options utilizing a cashless exercise feature, the advantages of net exercises and/or stock settled SARs include:
  - Assuming the plan document contains appropriate share counting provisions, the life expectancy of the equity plan's share reserve should be longer because a lesser number of shares are issued. This could then lessen the frequency within which shareholders are asked to increase the equity plan's share reserve
  - Reduced shareholder dilution because only the net shares are considered issued and outstanding
  - The holder receives the same economic benefit as stock options with a cashless exercise feature (only economic difference could arise if the optionee were to exercise without a cashless exercise feature and hold the resulting shares)
  - Broker fees associated with cashless exercises are avoided
  - There could be less problems associated with insider trading blackout periods since net-exercises and/or stock-settled SARS do not use open market transactions

Idea No. 3 & 4: SARs and Net Exercises - Disadvantages

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- Compared to stock options utilizing a cashless exercise feature, the disadvantages of net exercises and/or stock settled SARs include:
  - The company may have decreased cash flow because no monies are paid to the company in conjunction with an exercise
  - The holder might be unable to obtain favorable incentive stock option treatment (this depends upon whether the company adopts the conservative analysis on this point)
  - Depending upon the underlying facts, it may become more burdensome for the company to satisfy its withholding obligation
  - Shareholder advisory services such as ISS might assign a higher cost to the awards than it would otherwise assign to traditional stock options

Idea No. 5: Inducement Grants

- Under both NYSE and NASDAQ listing rules, shareholder approval of inducement grants to new hires is NOT required

- To qualify as an inducement grant, the grant of restricted stock or stock options must act as a material inducement to the person being hired as an employee (or such person being rehired following a bona fide period of interruption of employment)
  - Inducement awards include grants to new employees in connection with an M&A transaction

- An additional qualification requirement is that promptly following any such inducement grant, the company must disclose in a press release the material terms of the award, including the identity of the recipient(s) and the number of shares involved

Idea No. 5: Inducement Grants (cont.)

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- In terms of the “form” of award, some companies provide inducement grants as stand-alone awards, whereas some others will have an inducement plan from which to make grants (the latter particularly prevalent in M&A transactions)

- Important to note is that inducement grants are “outside” of the shareholder approved equity incentive plan
  - Therefore, inducement grants are not covered by the equity plan’s S-8

- The filing of a Form S-8 should be considered to register the grant and any resale

Idea No. 6: Treasury Stock

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- The following use of treasury stock could be implemented for the benefit of directors and/or executive officers, but for purposes of this discussion, we will assume such is implemented by outside directors

- Overview of the program
  - The annual director fee of cash is deposited into a brokerage account;
  - Each outside director elects the percentage of the fee that they will direct toward a FMV purchase of treasury stock (idea being 100%, minus the monies to pay the taxes associated with the director's receipt of the fee);
  - The brokerage shop executes the trade on the director's behalf, consistent with instructions, depositing treasury shares into their account and delivering cash to the company based on the FMV of the company's stock on the day the trade is executed (no discount);
  - Brokerage fees could be paid by the company

- The company's cash outlay is essentially returned, except for the amounts used by the directors to satisfy their income tax liability

- Issues to consider include:
  - A plan document is required
  - A Form 8-K would be required
  - A Form S-8 covering the shares should be filed

Idea No. 6: Treasury Stock (cont.)

- Advantages of a treasury stock purchase program
  - Shareholder approval is NOT required under NYSE and NASDAQ rules;
  - There is no dependency upon the share reserve of the equity incentive plan, thus such share reserve is preserved;
  - It encourages ownership in the company, thus serving the purpose of aligning the director's interest with those of the company 's shareholders;
  - It can help to facilitate stock ownership requirements/guidelines, which can act as a mitigating factor to negate "materiality" in the risk assessment process;
  - It is more efficient than open market purchases since all directors would be able to satisfy their ownership goals on the same day rather than over an extended period of time (the latter of which could otherwise be required if there were low trading volume);
  - It is more equitable than director purchases in the open market because all directors will pay the same price (open market purchases could result in price disparity depending on when purchases take place);
  - Scheduling of purchases shortly after earnings release provides transparency and reduces risk of allegations regarding the use of insider information; and
  - Issuances from treasury stock adds a small amount to the outstanding share count, which increases market cap (helping to satisfy ongoing listing requirements)

Idea No. 7: Employee Stock Ownership Plan

- For those companies who provide ownership deep into the employee pool, consideration should be given to an employee stock ownership plan (an "***ESOP***")
- One advantage of an ESOP is that shareholder approval is NOT required to implement an ESOP
  - For public companies, NYSE and NASDAQ listing rules generally provide that plans intended to satisfy the requirements of Section 401(a) of the Internal Revenue Code are exempt from the shareholder approval requirement
- Another advantage is that dividends paid to the ESOP are tax-deductible to the company
- And yet another advantage is that ESOPs can help a public company defend against a hostile takeover
  - Studies show employees vote favorably with management when a possible hostile takeover exists because employees fear a takeover would result in loss of jobs
  - Voting rights of <u>allocated</u> shares would be passed through to ESOP participants in tender offer situations
  - A mirror provision could be implemented whereby ESOP trustee would vote <u>unallocated</u> ESOP shares in same manner/percentage as <u>allocated</u> shares were voted by ESOP participants; though ESOP trustee would not be required to follow mirror provision where its fiduciary duties dictated otherwise

Idea No. 7: Employee Stock Ownership Plan (cont.)

- Whether registration is required depends upon the structure of the ESOP

- In a series of releases, the SEC concluded that the grant of stock pursuant to an ESOP would generally not constitute an offer and sale if no “value” is paid in connection with the grant
  - Continued employment or the obligation to perform future services does not constitute “value” for this purpose

- However, registration would be required if the employee has discretion on whether to participate in the ESOP **and** has the right to direct the investment of his or her account balance
  - For this purpose, a participant’s right to diversify during the “qualified election period” is disregarded

- Though registration of the underlying ESOP securities may not be required, a company might wish to consider registration so as to facilitate resales by participants who are Affiliates
  - Otherwise, the bonus stock exemption might be able to be applied

Idea No. 7: Employee Stock Ownership Plan (cont.)

- If registration is desired or required, then a Form S-8 should be used
  - A prospectus must be delivered to eligible employees (such is not filed)
  - An annual report on Form 11-K is required, which obligation could be satisfied by filing the financial statement required by Form 11-K with Form 10-K
    - Certifications under SOX 302 and 906 are not required

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- Title:
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- When:
  - 10:00 am to 11:00 am Central
  - July 11, 2019