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Executive Compensation Considerations Due to Market Volatility, Stock Prices and the Unknown

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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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  - Public Companies and ESOPs: Check Yes or No (07/09/2020)
  - Compensation Committee Governance (08/13/2020)
  - Preparing for Proxy Season: Start Now (Annual Program) (09/10/2020)
  - How to Design Effective Total Shareholder Return Awards (10/08/2020)
  - Building a Compensatory Peer Group: A Step-by-Step Approach (11/12/2020)
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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

Introduction

- Given stock price conditions and the surrounding market circumstances, many issuers will be turning their attention to executive compensation matters shortly following their 2020 annual shareholder meeting. Compensation Committees will need to strike a balance between incentivizing and retaining executive officers with the stark reality that shareholders have lost substantial value. This is not a simple endeavor

- To that end, the purpose of this presentation is to discuss various compensatory strategies, including:
  - Considerations with respect to annual incentives for 2020;
  - Thoughts with respect to outstanding performance-based equity awards where the performance condition in question is not likely to be attained;
  - Action items with respect to any upcoming 2020 equity grants, including:
    - How to address large stock awards that otherwise would result due to value-based equity grants (*e.g*., a grant equal to a % of base salary), and
    - Use of stock-price forfeiture provisions as a design feature to avoid ever having future underwater stock options;
  - Considerations with respect to executives reducing their base salary, including "good reason" waivers and possible impact on change-in-control pay;
  - Re-thinking equity plan share pool constraints and individual per-grant limitations within the equity incentive plan; and
  - Thoughts with respect to insiders cancelling their Rule 10b5-1 trading plans

Depressed Realizable Pay Levels

- If an executive's compensation is predominantly based upon stock compensation and stock performance, then that executive is likely suffering from depressed realizable pay levels

- If the executive is otherwise considered to be a good executive, he or she is subject to being poached by other issuers

- So in addition to the points discussed within this slide deck, issuers should consider whether it makes sense to add retention packages and specially formulated performance bonuses to the executive's existing compensation package

Outstanding Performance-Based Equity Awards

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- As background, many outstanding performance-based equity awards are at a point where the performance goals will not be achieved (or are highly unlikely to be achieved)
  - In that most long-term performance-based equity programs have a performance period of 3 years or more, the issue of unattainable performance goals generally applies to equity awards that were granted in 2018, 2019 and 2020

- If the Compensation Committee is considering replacing ill-performing performance goals with new performance goals, then check with legal counsel to determine whether the contemplated revision would trigger the SEC's tender offer rules. As background, and as a gross over-simplification:
  - The SEC's tender offer rules should be analyzed whenever the holder of a security is being asked to make an "investment decision"
  - Most award agreements would require consent of the holder in order to revise or replace the performance goals, and such consent requires the holder to make an investment decision
    - In contrast, amendments that can be applied unilaterally by the Compensation Committee without the holder's consent would not trigger an investment decision by the holder
  - Complying with the SEC's tender offer rules is expensive and would require (among other requirements):
    - Announcing the offer via press release and filing a Schedule TO with the SEC,
    - Keeping the offer open for 20 days and then issue a press release, and
    - Provide employees with withdrawal rights

Outstanding Performance-Based Equity Awards (cont.)

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- Alternatives that a Compensation Committee could implement without triggering the SEC's tender offer rules include (not an exhaustive list and set forth in no particular order):

- Alternative 1 – Implement the revision without consent of the holder, but first check the amendment paragraph of the award agreement to determine whether such would cause a breach of the award agreement
  - For example, eliminating an absolute shareholder return downward modifier to a relative total shareholder return award would not likely require consent of the holder
  - As a contrasting example, amending a total shareholder return formula to become a relative total shareholder return formula would likely require consent of the holder

- Alternative 2 – Implement the revision on an individually-negotiated basis, but only with respect to a small number of key executives. With respect to a repricing of stock options, the SEC had previously determined via an exemptive order that an exchange limited to a small number of executives would not trigger the SEC's tender offer rules

- Alternative 3 – Leave the outstanding award in place, and grant a new award
  - Doable if the outstanding award will expire soon
  - But most issuers have substantially constrained share reserves in their equity incentive plan. This Alternative 3 could increase the strain on available shares that remain for future grant under the equity incentive plan

Outstanding Performance-Based Equity Awards (cont.)

- [Continued from prior slide]

- Alternative 4 – Amend the outstanding grant by adding the new performance goals to the pre-existing performance goals, but require that the executive receive the “better of” the two performance schedules
  - Such should not require consent of the holder under most equity award agreements, thus no investment decision by the holder
  - Issuers adopting this alternative should consider implementing a robust shareholder outreach program prior to the next proxy season

- Alternative 5 – Kick-the-can forward by adding another year to the performance schedule, such that the executive has 1 extra year within which to achieve the performance objective
  - For example, if the performance period was otherwise 3 years, such schedule would be amended so that the executive has 4 years within which to achieve the performance objective

Outstanding Performance-Based Equity Awards (cont.)

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- [Continued from prior two slides]

- Alternative 6 – Do nothing now, and later have the Compensation Committee apply positive discretion to waive the performance condition to the extent necessary
  - Generally, this alternative is not shareholder friendly and would not act to incent or retain the executive during the intervening period
  - If this alternative is desired, the equity incentive plan and award agreement would have to be reviewed to determine there are no constraints on the Compensation Committee applying such positive discretion. Prior to the elimination of the performance-based exception to the $1mm deduction limit, such positive discretion could not be retained. But since such exception was eliminated, many equity plans now allow (or don't expressly prohibit) the use of such positive discretion. But not all equity plans have been amended to allow for positive discretion

Upcoming Grants – Addressing Value-Based Awards

- When structuring the amount of an equity award to an executive, it is common for Compensation Committee members to first denominate the award as a dollar amount (*e.g*., 45% of Base Salary) and then convert that dollar amount into shares
  - Such conversion is typically pursuant to a Black-Scholes formula or other formula, or pursuant to the FMV of the stock on the date of conversion (the latter more applicable to time-based full-value awards)
  - Example: Assume Issuer's stock is trading at $1.00 per share and that CEO has a $100 base salary, with a contractual requirement (or expectation) that she will receive an equity grant equal to 45% of her base salary. In this example the CEO would receive a grant of time-based restricted stock covering 45 shares. And if instead the award was subject to a relative TSR formula, then the conversion could be pursuant to a Monte Carlo simulation, which would result with the CEO receiving more than 45 shares

- Some alternatives for the Compensation Committee (assuming no contractual restrictions) include:
  - Delay grants
  - Convert to a number of shares using a trailing average stock price (*e.g*., 6 months, 12 months) in order to help smooth the effect of the recent drop in stock price [Note that such conversion is also permitted for options since the point of the conversion is to determine the number of shares, but once the number of shares is known, the strike price cannot be based upon more than a 30-day average]
  - Convert using some other formula

Upcoming Grants - Avoid Underwater Options

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- The following sets up the factual problem:

- Generally, if the Compensation Committee desires to reprice underwater stock options, the issuer would have to file a Schedule TO with the SEC unless:
  - The repricing is conducted on an individually negotiated basis with a small number of key executives (*see* March 21, 2001 SEC Exemptive Order); or
  - A repricing is permitted unilaterally (*i.e.*, without optionee consent), thus negating the Schedule TO rules because there is no "offer" and the optionee would not have make an investment decision
    - However, a significant drawback to a unilateral repricing is that incremental compensation expense could be significant since a "value-for-value" exchange cannot be effectuated (such requires optionee consent because a lesser number of shares generally results under the amended award)

  - And too, other issues must be considered when repricing stock options, such as:
    - 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 and under applicable NYSE/NASDAQ listing rules (answer is most likely yes that such approval is required); and
    - Whether adverse tax and accounting consequences could be avoided

Upcoming Grants – Avoid Underwater Options (cont.)

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- The idea is simple:
- The stock option award agreement would provide that if the stock option ever becomes underwater by $x.00 (or the stock price ever falls by $y.00), then both the vested and unvested portions of the stock option are automatically and immediately forfeited for no consideration
  - Depending on the equity plan's terms, the forfeited shares would return to, and act to replenish, the share reserve of the equity plan
- The goal is 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 **required** regrant is deemed to be a repricing, which generally would require shareholder approval
  - This "cancellation" issue will need to be vetted by legal counsel
  - A possible solution to consider is whether a cancellation followed by a **voluntary** grant (the latter of which would be pursuant to a written or operational annual grant policy) would sufficiently negate the nexus between a cancellation and regrant, thus negating the repricing characterization

Upcoming Grants – Delay & Other Considerations

- If the issuer's equity incentive plan does not require performance-based equity awards to be granted within the first 90 days or so of the fiscal year, then consider delaying performance-based equity grants for 3-6 months until performance targets can be assessed with more accuracy
  - As background, issuers will want to review their equity incentive plan. Prior to the elimination of the performance-based exception to the $1mm deduction limit, some equity incentive plans had hard wired 162(m) operational requirements into the plan document (thus making them document requirements). Some of these issuers were hesitant to strike such procedures from the equity plan document when the law later changed to eliminate the performance-based exception to the $1mm deduction limit. Thus, some equity incentive plans require that performance-based equity awards be granted within the first 90 days of the fiscal year
  - Such delayed awards might not be considered "performance-based compensation" in the classic sense

- Consider adding or bolstering provisions that would provide the Compensation Committee with significant discretion to adjust performance metrics while the award is outstanding. Idea is that the Compensation Committee would have more discretion than it typically would have in more traditional years

- Replace absolute metrics with relative metrics in order to lessen the negative impact of stock price return and instead focus on the issuer competing against its peer group

Compensatory Changes to Increase Cash Flow

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- If the Compensation Committee desired to make compensatory changes that would work to increase the issuer's cash flow and produce positive proxy disclosure, the Compensation Committees are considering (not an exhaustive list and set forth in no particular order):

- Idea No. 1 – Temporarily reduce base salary
  - If the executive has severance pay protection and one of the triggers to such severance includes his or her termination of employment for Good Reason, then the issuer will need to determine whether a temporary waiver of Good Reason is necessary (*i.e*., in most severance agreements, Good Reason could be triggered if the executive has a material diminution of Base Salary)
  - Change-in-control pay packages that cover executives will often be structured as a multiple of the executive's base salary and bonus. To the extent the executive voluntarily took a reduction in base salary, then the amount of his or her change-in-control pay could be negatively impacted. Issuers should review such to determine whether corrective action should be taken with respect to such multiple (*i.e*., defining base salary as the amount without regard to reductions in 2020)

- Idea No. 2 – Reduce cash compensation in exchange for equity
  - Conceptually this is no different from the scenario where the executive or non-employee director maintained his/her current cash compensation and then bought shares in the open market (this point is intended to alleviate shareholder perception that somehow the executive or non-employee director received an unfair benefit)
  - But what if the equity incentive plan lacks sufficient shares in its share reserve?

Compensatory Changes to Increase Cash Flow (cont.)

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- Idea No. 3 – If the issuer lacks available shares in its equity plan to implement the above, consider implementing an elective program whereby executives and/or non-employee directors elect to use their after-tax cash compensation to purchase treasury stock from the issuer

- Overview of the program
  - Cash compensation is deposited into a brokerage account;
  - Each participant elects the percentage of the cash compensation that he or she will direct towards a FMV purchase of treasury stock (hopefully 100%, minus the monies to pay the taxes associated with the participant's receipt of the cash);
  - 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 issuer based on the FMV of the issuer's stock on the day the trade is executed (*i.e.*, no discount)
  - Brokerage fees could be paid by the issuer

- The issuer's cash outlay is essentially returned, except for the amounts used by the participants 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

Compensatory Changes to Increase Cash Flow (cont.)

- [Idea No. 3 continued from prior slide]

- Advantages of a treasury stock purchase program include:
  - Shareholder approval is NOT required under NYSE and NASDAQ rules;
  - There is no draw from (or dependency upon) the share reserve of the equity incentive plan, thus such share reserve is preserved;
  - It encourages ownership in the issuer, thus serving the purpose of aligning the participant's interest with those of the issuer'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 that the participant used insider information; and
  - Issuances from treasury stock adds a small amount to the outstanding share count, which increases market cap (thus helping to satisfy ongoing listing requirements)

Stock Ownership Policy Requirements

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- Stock ownership requirements
  - Stock ownership goals are generally denominated in shares or dollars (the latter being a fixed dollar amount or a percentage of compensation)
  - Dollar-denominated guidelines are the most common, and many of these have their guidelines based upon a percentage of base salary
  - If the stock ownership policy is denominated as a number of shares, then the current economic environment should have little to no impact on the policy

- A couple of points to consider for issuers with stock ownership policies denominated in dollars:
  - Any reduction in an executive's base salary would proportionately reduce his or her stock ownership requirement
    - For these executives, consider when addressing the waiver for Good Reason and any negative impact on change-in-control pay (see prior slides), that such document also waives the executive's right to decrease the number of shares subject to the policy

  - And if an executive's compensation to which the stock ownership policy is pegged remains unchanged (*e.g*., base salary remains unchanged), then any significant drop in stock price is likely going to cause the executive to fail the policy's requirements
    - In this instance, the Compensation Committee should consider a temporary waiver, with the idea that the Compensation Committee will revisit the issue again in the Fall 2020
    - But . . . in exchange for the waiver, consider adding a prohibition on any sales of stock currently owned by the executive

Non-Qualified Deferred Compensation

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- As background, non-qualified deferred compensation programs are not secure from the claims of the issuer's creditors. In contrast, such are subject to the claims of the issuer's general creditors

- In light of today's market volatility and the fear by some issuers that bankruptcy could be possible, some executives will naturally be worrying about the monies in their non-qualified deferred compensation plan

- There is no magic solution. That said, secular trusts could make a resurgence
  - With a secular trust, the assets are held outside of the issuer and are generally not subject to the claims of the issuer's creditors
  - Taxation is generally triggered at the time the dollars are contributed by the issuer to the secular trust (*i.e.*, taxed to the executive), though certain designs could be implemented that, when combined with insurance products, could be used to alleviate the tax burden at the time of contribution

Dwindling Share Reserves

- Only a few issuers have the luxury of too many shares in the share reserve of their equity incentive plan
- For issuers who need to constantly monitor their share reserve, a significant drop in stock price will exacerbate the problem (*i.e.*, issuers will have to grant more shares to their employees in order to provide equivalent value to what each employee received in the past)

83(b) Elections?

- Generally, executives of publicly-traded issuers do not make 83(b) elections

- As a result, and assuming no deferral, the executive would recognize ordinary taxable income on the date the equity award becomes vested and at the then fair market value of such award

- But if the executive made a timely 83(b) election (*i.e.*, within 30 days from the date of grant), then his or tax treatment would be as follows:
  - Ordinary taxable income on the date of grant, even though such equity award is subject to forfeiture pursuant to a vesting schedule
  - The purpose of an 83(b) election is to limit the ordinary taxable income element to the value of the stock on the date of grant, which is hopefully substantially lower than the value of the stock at time of vesting
  - Any increase in the fair market value of the stock from the date of grant would be captured at capital gains rates

- So should executives consider making 83(b) elections while the value of the stock is maybe artificially low due to market conditions?

Modifying or Terminating a 10b5-1 Trading Plan

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- Many executives and directors will think about modifying their existing 10b5-1 trading plans because the minimum sale price scheduled therein is likely higher than the issuer’s current stock price
  - If making a modification, be sure to comply with the issuer’s insider trading policy and any pre-clearance procedures
  - Also, the executive or director should not possess material non-public information at the time of implementing the modification, and for that reason, effectuating modifications only during open windows is desirable
  - A waiting period (at least 30 days) should be implemented before any trades could be reinstated

- Cancelling a 10b5-1 trading plan can be effectuated even if the executive or director is in possession of material non-public information
  - Given the circumstances of the market, it is unlikely that any such cancellation would create a suspicion that the 10b5-1 plan was not entered into in good faith (*i.e*., meaning that it is likely that any prior trades would remain covered by the affirmative defense to any allegations of insider trading)

Don’t Forget Next Month’s Webinar

- Title:
  - Administrative Perspectives when Granting Compensatory Equity: A Checklist of Action Items
- When:
  - 10:00 am to 11:00 am Central
  - May 14, 2020