Training Course on Designing an Equity Incentive Plan (Part 1 of 3)

Presentation for:
Executive Compensation Webinar Series
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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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- Recording
  - This presentation is being recorded for internal purposes only
- Continuing education credits
  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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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

Upcoming 2021 Webinars

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- 2021 webinars:
  - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
  - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
  - How to Properly Hire and Fire an Executive Officer (10/14/21)
  - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

Sign up here: https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html

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

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- The purpose of this discussion is to help train the attendee on the design of an equity incentive plan. To that end, this discussion will include design considerations from the perspective of:
  - ISS,
  - Institutional shareholders,
  - Share reserve management,
  - Rule 16b-3 and other governance-related provisions,
  - Tax efficiency,
  - Change-in-control provisions, and
  - More

- This presentation is Part 1 of a 3-Part series, with the presentation in July and August covering:
  - Training course on stock options and SARs (Part 2)
  - Training course on restricted stock and RSUs (Part 3)

Select Defined Terms - Types of Awards

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- It is important to list all of the various types of awards being subject to the plan, including any awards currently not intended to be used
  - Under NYSE and NASDAQ listing rules, expanding the types of awards after-the-fact will require shareholder approval

- The types of awards that should be covered by an equity incentive plan include:
  - Incentive stock options,
  - Non-statutory stock options,
  - Stock appreciation rights ("***SARs***"),
  - Restricted stock awards,
  - Restricted stock units ("***RSUs***"),
  - Performance shares,
  - Performance units, and
  - Other stock-based awards

Select Defined Terms – Award Agreement

- Just a note that typically all of the possible types of award agreements will be drafted and attached to the Form S-1 or Form 10-K as exhibits, even the forms of award that are not intended to be currently used
- Reason is to avoid a later Form 8-K (i.e., no form 8-K would later be required if the new award is materially consistent with a previously filed arrangement)
- That said, the foregoing is not required

Select Defined Terms - Cause

- Considerations with respect to the term Cause in an equity incentive plan include:
  - The defined term should be Company favorable
    - Whereas, within an executive contract the term is often defined pursuant to a negotiated process
  - The term should not apply to the extent the Participant is a party to an employment agreement or similar agreement between the Company and the Participant where Cause is defined therein
  - It is common to NOT include a procedure for the determination of Cause, and instead to simply have such defined in the sole and absolute discretion of the Committee
  - Consider including an after-acquired evidence clause

Select Defined Terms – Change in Control

- This term is important because it often acts to accelerate vesting of equity awards
- Market practice is for a change in control to be triggered if:
  - 50% of the Company is sold (either vote or value),
  - All or substantially all of the Company's assets are sold, or
  - Pursuant to a turnover of a majority of the Board within a twelve month period)
- Be wary so as to NOT use the defined term of change in control or effective control as set forth in Section 409A
  - Such should be used, if at all, only for purposes of non-qualified deferred compensation arrangements subject to 409A
- If the Company is a start-up technology company with IP as assets, consider whether a change in control should also be triggered upon a monetization of the IP (*e.g.*, licensing of the IP resulting with the Company receiving royalty streams resulting in a complete loss of operations at the Company level)

Select Defined Terms - Committee

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- Typically it is the Committee that administers the Plan, and the Committee is comprised of certain Board members

- A point to consider is whether the Committee will have the authority to effectuate grants of equity, or instead, will the Committee only have the power to recommend grants to the Board (with the latter holding the sole authority to effectuate grants of equity)

- Consider whether it makes sense to have the authority to effectuate grants downward delegated to, for example, the CEO so that the latter may effectuate grants to new hires within certain written parameters contained within such written delegation

- For publicly-traded companies, the Committee members must consist of two or more independent directors (as set forth in Rule 16b-3, and listing rules)

Select Defined Terms - Consultant

- Under Rule 701 (exemption from registration) and Form S-8 registration rules, a consultant must be a "natural" person

- If the Company intends to effectuate grants of equity to an entity, then:
  - The award must be designed to be granted to an individual on behalf of the entity,
  - For tax purposes, the Code respects that the individual took the equity award in name only, and
  - For Rule 701 and S-8 purposes, the "natural" person requirement is satisfied

Select Defined Terms - Others

- Dividend equivalents
  - Consider whether to expressly state that any dividend equivalents will be subject to the same restrictions on transferability and forfeitability as the underlying award to which they were paid
  - ISS desires the foregoing language

- Fair market value
  - Consider having a provision at the end of the defined term Fair Market Value that states, notwithstanding the above, Fair Market Value for tax purposes will be determined by the Administrator in accordance with a uniform and non-discriminatory manner
  - Point is to provide flexibility to the determination of value for tax reporting and tax withholding purposes

- Performance Goals
  - The run-on sentence of performance goals (e.g., EBITDA, AEBITDA, etc.) is no longer required due to the elimination of the performance-based exception to the $1mm deduction limit
  - Consider whether the defined term should simply state as determined by the Committee in its sole discretion

Select Defined Terms – Other (cont.)

- Plan
  - Sounds simple?
  - A question arises when there are outstanding equity plans at the time a new equity plan is being considered
  - Should that (or those) outstanding equity plans be absorbed into the new Plan
- Service Provider
  - The defined term could also be “Continuous Service” instead of Service Provider
  - Purpose of the defined term is to allow for movement between an employee, a Board member and a Consultant without unvested equity becoming forfeited
  - 99% of time this term will never come up, but when it does, the Company is typically dealing with a retiring or exiting NEO who will leave employment status and become a consultant

Shares Subject to the Plan

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- The number of shares subject to the Plan must be specifically set within the equity plan document
  - ISO issue
    - For incentive stock option purposes, the Plan must specifically state how many (or what percentage) of the share reserve may be subject to ISO treatment
    - Such is a shareholder approval requirement under the ISO rules
    - Purpose of this tax requirement is to let the shareholders know how much of the share reserve could be non-deductible (*e.g.*, no compensatory deduction to the Company upon the exercise of an ISO)
  - IPO companies
    - Consider having an evergreen clause
    - Example includes: "The maximum aggregate number of Shares that may be issued pursuant to all awards under the Plan will increase annually on the first day of each fiscal year after the adoption of the Plan by the number of Shares equal to the lesser of: (i) [______]% of the total issued and outstanding common shares of the Company on the first day of each fiscal year, (ii) [______] Shares, and (iii) such lesser amount determined by the Board."

Shares Subject to the Plan – Lapsed Awards

- Lapsed awards addresses the concept of what happens when awards are granted but the underlying shares are never issued due to forfeitures, net exercises, net tax withholdings, etc. An example of a lapse provision, which is intentionally abbreviated for purposes of this example, is as follows:
  - "If all or any part of an outstanding Award expires, terminates, is canceled, is forfeited or is repurchased, then the Shares allocable to such shall again be available for grant under the Plan."
  - The above is considered "liberal share counting" according to ISS, and its existence is a negative when evaluating the Plan Features portion of the Equity Plan Scorecard

- Our thoughts:
  - The existence of a liberal share counting provision, when used in conjunction with cash-settled awards, net exercises of stock options, and net tax withholding provisions, would likely prolong the life expectancy of the equity plan's share reserve (*i.e.*, reduce the frequency to which the company has to seek shareholder approval to increase the share reserve of the equity plan)
  - Do Not Forget: If the equity plan has a liberal share counting provision, then always register more shares under the Form S-8 than are otherwise available under the equity plan
    - With liberal share counting, forfeited shares revert to the equity plan to replenish the share reserve (*i.e.*, shares are counted on a net basis)
    - In contrast, under a Form S-8, forfeited shares are counted towards the number of shares that were initially registered (*i.e.*, shares are counted on a gross basis)

Delegations of Authority to Grant Equity

- Absent a valid delegation, only the Board has the authority to grant equity
  - The Charter of the Compensation Committee is typically the vehicle that delegates the authority from the Board to the Compensation Committee
  - Such Charter may allow for a further downward delegation from the Compensation Committee to a sub-committee or the CEO, but typically such are implemented (if at all) only in situations where there are administrative burdens associated with the Compensation Committee acting through unanimous written consent

- Downward delegations could be helpful in new hire situations where reaction on behalf of the Company must be quick

Delegations of Authority to Grant Equity (cont.)

- Assuming a downward delegation from the Compensation Committee is appropriate, then the following points should be considered:
  - Delegations must comply with applicable state law (*e.g.*, DGCL 157(c))
  - Delegations should be governed by a written equity grant policy (the "***Policy***") that was approved by the Compensation Committee and/or the Board
  - The Policy should include a reporting mechanism to the Compensation Committee of all equity grants. To avoid "date of grant" issues, the Policy should clearly state that only a "reporting" to the compensation committee is required (*i.e.*, no ratification or approval by the Compensation Committee is required)
  - Award agreements that were pre-approved by the Board or the Compensation Committee should be attached as exhibits to the Policy (*i.e.*, to address minimum vesting schedules, whether par value is required, etc.)
  - The Policy should specify the total number of awards (individually and collectively) that may be made pursuant to the delegation and the time period within which shares can be issued
  - The Policy should specify whether any minimum consideration is required (*e.g.*, par value)
  - Delegations should exclude the ability to make grants to those who are Section 16 insiders as of the date of grant
    - Compliance with Rule 16b-3 requires the full board of directors or a committee of 2 or more non-employee directors to approve, in advance, all grants to Section 16 insiders

Powers of the Administrator

- This section of the Plan appears visually boring, but do NOT be fooled, this section is important for a number of reasons, including:
  - Enlarging the class of awards, or the rights and benefits afforded to participants, may require additional shareholder approval under applicable NYSE and NASDAQ listing rules
  - A wide and broad set of powers will help avoid the future issue of whether an outstanding stock option has been modified or extended. For example:
    - A modification of an ISO will result in the loss of ISO treatment, resulting in a deemed new grant of an ISO
    - A modification of an NSO will result in a deemed new grant of an NSO
    - If the ISO or the NSO are in-the-money at the time of such modification, and the exercise otherwise remains the same, then the option will fail to comply with Section 409A, thus triggering the negative tax consequences under Section 409A
  - Determine whether the net withholding rate should be at the minimum supplemental rate of 22% (for 2021) or the maximum individual income tax rate and state such within this section of the Plan
- Indemnification
  - It is standard to address indemnification of the Administrator, the Board, the Committee and the officers and employees of the Company who act to administer the Plan, provided such action was done in good faith

Post-Termination Exercise Period

- The post-termination exercise period for stock options is typically set forth in the Plan as a default provision, to apply if the award agreement does not otherwise address the issue

- From a default perspective, the standard post-termination exercise period for a stock option is (though any amount of time is permitted, so long as such time period does not exceed 10 years from the date of grant):
  - 30 days for a normal termination of employment situation (up to 90 days),
  - 12 months in the context of a Disability, and
  - 12 months in the context of death

- Keep in mind that longer post-termination exercise periods will likely increase the compensation expense associated with the award

Change in Control

- The Plan document sets forth the default provisions of what happens to an outstanding equity award upon a change in control of the Company (assuming the award agreement is otherwise silent on the issue)
  - In other words, the equity plan sets forth the default position, so that award agreements may be individually tailored

- Under the default provision, the alternatives include:
  - No acceleration;
  - Accelerated vesting at the discretion of the Company;
  - Accelerated vesting upon a change in control (single trigger vesting);
  - Accelerated vesting upon a change in control, but only if the acquirer does not otherwise assume or replace the equity in question; or
  - Double trigger acceleration, requiring both a change in control and a termination of employment within a certain time period following such change in control

Change in Control (cont.)

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- Consider adding other provisions within this section that could provide the Company with flexibility as of a change in control
- For equity plans that require the optionee to exercise immediately prior to the change in control (or else the stock option is terminated), care consideration should be given to how many days of advance notice must be provided to the optionee
  - Sufficient notice should be provided so that the optionee can make an informed investment decision
  - However, too much advance notice being required can be problematic in situations where the Company is not prepare to tell all optionees of the upcoming change in control (*i.e.*, no "sure thing" until the transaction closes)
- Consider adding a cashout provision to provide the Company with flexibility
  - For example, consider the following: "Additionally, the Administrator shall have the sole and unilateral authority to effectuate the automatic cashout and termination of one or more Awards immediately prior to the Change in Control and without regard to whether the Participant consents to such cashout, and if such Award is an Option or a SAR, such cashout being equal to the positive "spread" (if any) between the price per Share provided in the Change in Control and the Exercise Price per Share (or if a SAR, the Exercise Price per Share as of the date of grant), multiplied by the number of Optioned Shares (or if a SAR, the number of underlying units). For avoidance of doubt, if an Award is an Option or a SAR and no positive spread exists pursuant to the foregoing, then such cashout of the Award shall be effectuated with no cash payment to the Participant holding such an Award."

Award Agreements

- This portion of the presentation will discuss award agreement issues that are not unique to options or RSAs (such being discussed in Parts 2 and 3 of this Training Series)

- In lieu of one document, consider having both a Notice document and an Award Agreement, with each incorporating the other by reference
  - All of the business terms would be contained in the Notice

- Consider having a "Date of Grant" and "Vesting Commencement Date" as separately defined terms, thus allowing the Company to provide retroactive credit towards a vesting schedule that otherwise might not match the Date of Grant

- Common triggers that accelerate vesting include:
  - Termination of service by the Company without Cause,
  - Termination of service by the Participant for Good Reason,
  - Immediately prior to consummation of a Change in Control,
  - The Participant's death,
  - The Participant's Disability, and
  - Performance hurdles

Award Agreements

- Consider whether to allow for electronic acceptance
  - First verify such is permitted under state law
  - An example of such provision could be as follows:
    - Electronic Signature. Participant acknowledges and agrees that by clicking the "Accept Grant Online" button on the "Notice and Award Agreement" page of the XYZ Corp website (https://XYZCorp.com), it will act as the Participant's electronic signature to this Agreement and will constitute Participant's acceptance of and agreement with all of the terms and conditions of the Award, as set forth in the Notice, the Award Agreement and the Plan

- In the risk of forfeiture provisions that address vesting, it is common practice to provide that certain events will result in the forfeiture of unvested awards. But consider having one or more of the following apply to trigger the forfeiture of BOTH vested and unvested awards
  - The Participant is terminated by the Company for Cause;
  - The Participant breaches any provision of the Notice, the Award Agreement, or the Plan;
  - The Participant fails or refuses to timely execute any exhibit to the Award, examples of which include:
    - Restrictive covenants agreement and confidentiality agreement,
    - Waiver and release, and
    - Voting proxies

Award Agreement

- This slide applies mostly to privately held companies
- Irrevocable proxy and power of attorney
  - The purpose of this form is for the Participant to appoint [the Board] as its lawful proxy and attorney for purposes of voting the shares subject to the award
  - Such could be attached as an exhibit to the Award Agreement, and as a condition precedent to the issuance of any shares
- Drag-along and tag-along provisions
  - What happens if you are a large shareholder and want to sell, but the buyer won't purchase unless all of the shareholders participate and one or more minority shareholders do not want to participate?
  - A drag-along provision could be incorporated into the award agreement. A drag-along provision allows a majority shareholder to force a minority shareholder to participate in the sale of the Company (*i.e.*, the majority shareholder drags the minority shareholder into the transaction)
  - Conversely, a tag-along provision could be incorporated into the award agreement. A tag-along provision allows a minority shareholder to join in the sale on the same terms and conditions as the majority shareholder (*i.e.*, the minority shareholder tags along with the majority shareholder in the transaction)
- Rights or first refusal and repurchase rights should also be considered

Don't Forget Next Month's Webinar

- Title:
  - Training Course on Stock Option Awards and Stock Appreciation Rights
- When:
  - 10:00 am to 11:00 am Central
  - July 8, 2021