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Training Course: Stock Options and Stock Appreciation Rights (Part 2 of 3)

Presentation for:
Executive Compensation Webinar Series
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Housekeeping: Questions

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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:
    - CLE: 1 credit hour (CA, FL, GA, NC, NY, TX and VA)
    - CPE: 1 credit hour (Texas)
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About Anthony “Tony” Eppert

HUNTON ANDREWS KURTH

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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 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

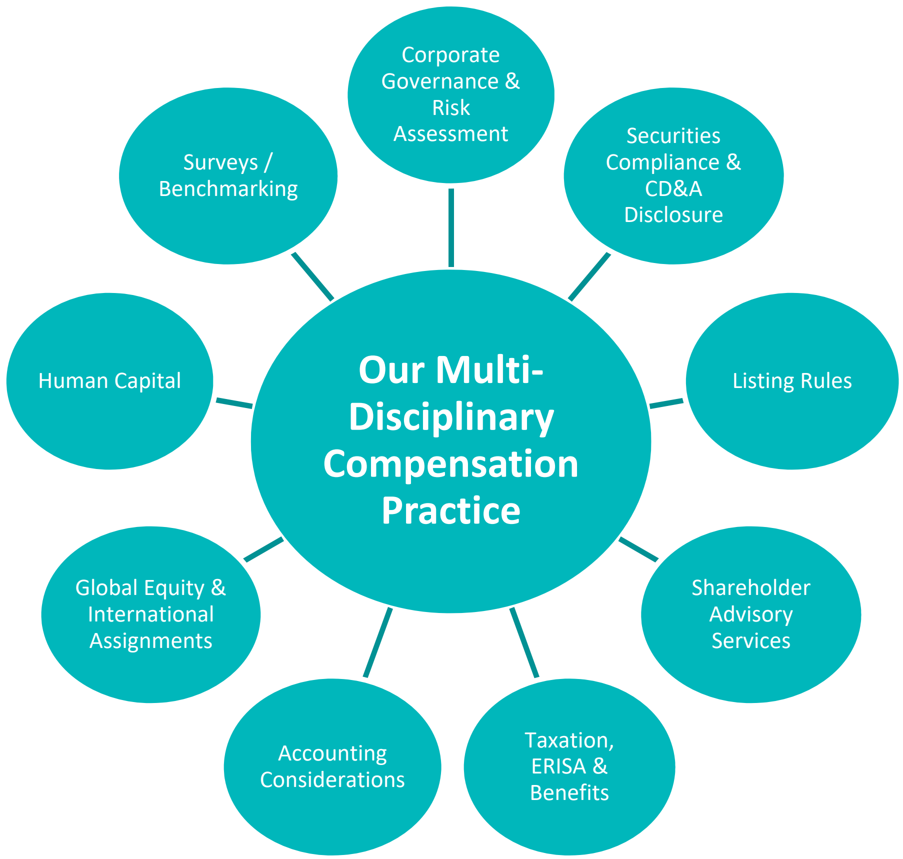
Our Compensation Practice – What Sets Us Apart

- 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 stock options and stock appreciation rights, including effective uses, other considerations, and tax structure

- This presentation is Part 2 of a 3-Part series, with the presentation in June and August covering:
  - June being a training course on designing an equity incentive plan (Part 1)
  - August being a training course on restricted stock and RSUs (Part 3)

Incentive Stock Options

- An incentive stock option (an “***ISO***”) is a stock option granted to an employee to purchase stock of the employer
  - Numerous tax rules must be satisfied for an option to qualify as an ISO
- Generally, ISOs are preferred by optionees (compared to NSOs) because of their favorable tax treatment to the holder, such as:
  - 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 fair market value of the underlying stock and the exercise price at the time of exercise is an item of adjustment for purposes of calculating any alternative minimum tax (“***AMT***”)
    - The only way to eliminate the spread as an adjustment for AMT purposes is to exercise the option and sell the underlying stock within the same calendar year
  - 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 (such being the “***Holding Period***”), then the gain realized on a later sale of the underlying stock would be taxed at favorable capital gains rates
- Neither the grant nor the exercise of an ISO provides the company with a compensatory deduction unless there is a Disqualifying Disposition of the ISO

Incentive Stock Options (cont.)

- A "***Disqualifying Disposition***" occurs when the Holding Period (prior slide) is not satisfied. In such instances:
  - The optionee would recognize ordinary taxable income (and the company would have a corresponding compensation deduction) equal to the excess (if any) of the fair market value of the stock as of the date of exercise over the exercise price
  - Such compensation income would be added to the stock's basis to determine any capital gain that must be recognized within the Disqualified Disposition

- In addition to satisfying the Holding Period, in order for an option to qualify as an ISO, the option must comply with all of the following tax rules:
  - <u>Rule No. 1</u>: The plan providing for the grant of ISOs must be approved by the company's shareholders within 12 months before or after the date the plan is adopted by the Board
  - <u>Rule No. 2</u>: The plan must specify the aggregate number of shares of stock that are available for issuance under the plan AND the number of such shares subject to ISO treatment
  - <u>Rule No. 3</u>: The plan must specify the employees or class of employees eligible to participate
  - <u>Rule No. 4</u>: The option must be granted within 10 years from the date the plan is adopted or approved, and must be exercised (if at all) within 10 years from the date the option was granted

Incentive Stock Options (cont.)

- [Continued from prior slide]
  - Rule No. 5: The optionee must be an "employee" of the granting corporation, its parent or its subsidiary (or an employee of an entity that has assumed the options pursuant to a reorganization)
  - Rule No. 6: The optionee must remain an employee from the time the ISO is granted until the date that is 3 months before the ISO is exercised (*i.e.*, 3-month post-termination exercise period), which period can be extended to up to 1 year if termination of employment is the result of the optionee's "Disability" (and no time limit if termination of employment is due to death)
    - The terms of the plan may specify a shorter period than the above
  - Rule No. 7: The exercise price must be equal to or greater than the fair market value of the underlying stock as of the date the ISO is granted
    - However, for optionees owning 10% or more of the company's voting power or 10% or more of all classes of stock of the company, the exercise price must be at least 110% of the fair market value of the underlying stock as of the date the ISO is granted

Incentive Stock Options (cont.)

- [Continued from prior slide]
  - Rule No. 8: There is a $100,000 limit on the aggregate fair market value (valued at the time the option is granted) of employer stock that can be exercisable under an ISO for the first time by an employee during any calendar year
    - Any options exceeding this limit are automatically converted into NSOs
    - The $100,000 limit is valued at the time the option is granted
    - The $100,000 limit results in a cap on the dollar amount of shares that can first become exercised during a calendar year
    - Examples, assuming $1.00 stock value and grant of 500,000 shares subject to the option:
      - ✓ If the vesting schedule is 5 years and the option must be vested in order to become exercisable, then the full grant satisfies the ISO rules because no more than $100,000 can first become exercisable in any calendar year
      - ✓ Same facts as above, but in year 3 there is a change in control of the company and vesting is fully accelerated. Thus, in year 3, 200,000 shares would have already vested and 300,000 shares would have been unvested. The result is that 300,000 shares are subject to ISO treatment because: (i) 200,000 shares previously vested satisfy the $100,000 limit, (ii) 100,000 shares in year 3 would satisfy the $100,000 limit, and (iii) the remaining 200,000 shares would be NSOs because they exceeded the $100,000 limit in year 3
  - Rule No. 9: An ISO cannot be transferable (except at death), and during the employee's lifetime the option must be exercisable only by the employee

Non-Statutory Stock Options

- NSOs are stock options that do not satisfy one or more of the requirements for ISO treatment
  - Put another way, an option that was intended to be an ISO but that failed one of the ISO requirements automatically becomes an NSO by operation of law
- NSOs may be granted to employees and to non-employees
- Exercise price
  - To avoid application of Section 409A, the exercise price of an NSO must be at least equal to the fair market value of the underlying stock as of the date of grant
  - However, there are instances where factually it makes sense to grant an NSO with an exercise price lower than fair market value as of the date of grant. In such instances, the NSO must comply with Section 409A. Though permitted under Section 409A, such compliance destroys “optionality” because the NSO must be exercised (if at all) upon the earlier of the chosen 409A events (*e.g.*, separation from service, change in control, death, disability, a set time, etc.)

Non-Statutory Stock Options (cont.)

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- The tax treatment to the optionee is as follows:
  - No taxable income to the optionee on the date of grant
  - At exercise, the optionee would generally recognize ordinary taxable income equal to the positive difference between the fair market value of the underlying stock on the date of exercise and the exercise price
  - At sale, the difference between the stock's tax basis and the sale price could be captured at capital gains rates (*i.e.*, long-term capital gains rates if the underlying stock is held for 1 year or more from the date of exercise)

- The tax treatment to the company is as follows:
  - At exercise, any taxable income recognized by the optionee would be subject to withholding and employment taxes if the optionee is an employee
  - At exercise, the company would have a compensation deduction equal to the amount recognized by the optionee as ordinary taxable income

Modifications of ISOs and NSOs

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- Generally, modifications, extensions and renewals of an ISO or an NSO would be deemed a new grant. If no other changes are made to the exercise price, then:
  - The ISO would lose favorable ISO treatment and be deemed an NSO (because it did not comply with Rule No. 7 (see Slide 4)
  - The NSO would likely violate Section 409A and therefore would likely be subject to adverse tax consequences under Section 409A (though this issue is resolvable with pre-planning). Such adverse tax consequences include:
    - An earlier inclusion of ordinary taxable income (earlier than likely contemplated)
    - An additional tax equal to 20% of the amount that is required to be included as ordinary taxable income, and
    - Interest, fines and penalties

- Do not forget!
  - Whenever an amendment to an outstanding option is being considered (whether an ISO or NSO), be sure to determine whether the amendment would be considered a “modification,” “extension,” or “renewal” of the option under ISO rules (if applicable) and Section 409A
  - For example, adding a “net exercise” feature after-the-fact IS a modification for ISO purposes but is NOT a modification for NSO (i.e., 409A) purposes

Stock Appreciation Rights

- A SAR is similar to an option except that it represents a “promise” to pay and provides the participant with the right to receive an amount in cash/stock equal to the excess, if any, of the fair market value of a share of the company’s common stock as of the settlement date over the “base appreciation amount” (*i.e.*, the amount similar to the exercise price)
  - Until settled, a SAR represents no ownership interest in the company
  - The base appreciation amount is typically the fair market value of the company’s common stock on the date the SAR is granted (and such is required if the SAR has optionality)
  - The promise can either be settled on a pre-chosen date or have optionality.
    - Example of a pre-chosen date: Grant 1,000 SARs with a base appreciation amount of $20 per share. If the SAR is vested and settled when the company’s stock price is $50, then the SAR would be settled for a cash payment equal to $30,000 (1,000 x $30) or the issuance of 600 shares ($30,000/$50)

- The tax treatment to the participant is as follows:
  - At settlement, the participant would have ordinary taxable income equal to the positive spread between the fair market value of the stock on such date and the base appreciation amount

- The tax treatment to the company is as follows:
  - A compensation deduction would be triggered at settlement; at that time a withholding obligation would apply if the participant is an employee

Technique to Avoid Underwater Options

- A stock option becomes “underwater” when at some point its exercise price is greater than the fair market value of the underlying stock
  - Depending upon the amount of the negative spread involved, the stock option might have nil retention value in the eyes of the holder
  - However, such option continues to be a drain on the share reserve of the equity incentive plan

Technique to Avoid Underwater Options (cont.)

- With respect to publicly-traded companies, if the Board desires to reprice the underwater option, 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," thus the optionee would not be making any 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 (*i.e.*, a value-for-value exchange 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 or 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
- Note: tender offer rules apply to privately-held companies too, but in a more limited fashion

Technique to Avoid Underwater Options (cont.)

- The idea is simple:
- The option award agreement would require that if the 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 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 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 recharacterization

Options: Post-Termination Exercise Period

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- The default post-termination exercise period is typically contained within the equity incentive plan as one of the following:
  - A set time within a range of 30 to 90 days for a typical termination of employment (with a possible carve-out to zero days if terminated for Cause),
  - 12 months in the context of a Disability,
  - 12 months in the context of death (though any amount of time not to exceed the 10 year life of the option is permitted)

- Keep in mind that longer post-termination exercise periods will increase potential shareholder dilution and will likely increase the compensation expense of the option

- The post-termination exercise period of an option (both ISOs and NSOs) can be extended to the earlier of: (i) 10 years from the date of grant and (ii) the remaining post-termination exercise period
  - However, ISO status would be lost if the option is not exercised within 3 months from the optionee's termination of employment

Options: Post-Termination Exercise Period (cont.)

- Consider whether to add a Skype-type of provision that would, immediately prior to consummation of the change-in-control, allow the company to repurchase certain stock held by former optionees at the exercise price
  - Concept would apply to only former employees who previously terminated employment and exercised in conjunction with the change in control transaction
  - Should the former employee be permitted to partake in the financial upside of the change in control transaction even though they “jumped ship” at some prior thereto?
  - Shouldn’t employees be treated comparable to shareholders by requiring them to be “in-it-to-win-it”?

Options: Post-Termination Exercise Period (cont.)

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- A factual question comes up when an optionee is furloughed. Does the act of furloughing of an employee cause a termination of such employee for purposes of:
  - The vesting schedule, and/or
  - The start date of the post-termination exercise period

- The answer depends upon the terms of the equity incentive plan and the option award agreement, but likely this determination will be made by the plan administrator. As background:
  - Many equity plans contain a concept of an approved leave of absence. This provision should be vetted to determine whether it applies to those who are furloughed
  - Or . . . Is vesting tolled during the period of time the employee is furloughed
  - Or . . . If the award is governed by Section 409A, the analysis is whether the individual had (or will have) a "separation from service"
    - If the employee is on a bona fide leave of absence, then a separation from service is not likely triggered so long as such leave is less than 6 months, or if longer, the employee has a contractual or statutory right to re-employment

Withholding Obligation & Compensatory Deduction

- Upon the exercise of an NSO, the employer has a withholding obligation with respect to the spread between the fair market value of the underlying stock on the date of exercise and the exercise price
  - The employer is entitled to a corresponding compensatory deduction at such time
- There is no withholding obligation associated with the exercise of an ISO since there is no income recognition event at the time an ISO is exercised
- But what happens if the holder of an ISO has a Disqualifying Disposition (*i.e.*, the optionee sold the ISO before the later of 2 years from the date of grant and 1 year from the date of exercise)?
  - The employer is now entitled to a compensatory deduction
  - The employer would still have no withholding obligation

Options: NSOs and Timely Remittance of Deposits

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- Employment taxes are triggered at exercise of an NSO on the spread between the exercise price and the fair market value of the underlying shares on the exercise date
  - A separate data point is that if the employer has accumulated $100,000 or more in employment taxes during a monthly or semi-monthly deposit period (the "One-Day Rule"), then the One-Day Rule starts on the date of exercise for NSOs and SARs
- In practice, the One-Day Rule causes a problem for publicly traded companies in instances where the optionee sells shares in the open market on the date of exercise in order to fund IRS tax withholding obligations
  - The problem is one of timing, that is, the proceeds from the same-day sale will not be deposited until two days later
  - Thus, the One-Day Rule facially would not be satisfied
- IRS relief:
  - According to an IRS field directive, IRS examiners are instructed to not challenge the timeliness of deposits relating to NSOs if:
    - The employer deposits the taxes within one day from the date the employee received the underlying stock, and
    - The date the employee received the underlying stock is not more than [2/3] days from the date the stock option was exercised
  - The forgoing analysis also applies to SARs (pursuant to Generic Legal Advice Memorandum 2020-004)

Don’t Forget Next Month’s Webinar

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- Title:
  - Training Course on Restricted Stock and Restricted Stock Unit Awards

- When:
  - 10:00 am to 11:00 am Central
  - August 12, 2021