Developments in Executive Compensation and Avoiding Pitfalls Under Sections 409A and 162(m)

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Factors That Contributed to Where We Are Today

- Global financial crisis of 2008 heightened awareness and criticism of executive pay
- Dodd-Frank Act – “say-on-pay” vote
- Influence of ISS and pay-for-performance
Increased Use of Stock-Based Pay

• Findings of an ISS study conducted on Russell 3000 companies for the period 2008-2010:
  – Many companies have scaled back on certain elements of executive compensation such as discretionary bonuses, perquisites and “golden parachutes” and other forms of exit pay
  – The decline in these elements of compensation have been more than offset by other elements of compensation, most notably company stock
  – Stock awards now constitute more than half of total compensation
Increased Use of Stock-Based Pay (cont’d)

– A marked shift toward the use of stock-based pay for non-CEO executive officers

– Shift from fixed numbers of shares to fixed value in determining grant size of long-term incentives; 77% in 2011 compared to 92% in 2012 (Meridian Compensation Partners survey published April 2012)
Types of Stock-Based Awards

- Share price appreciation awards - options, SARs
- Full-value awards based on basis and share price appreciation - restricted shares, restricted units
- Performance-based awards - performance shares, performance units, performance-based restricted stock or units
- Approximately 82% of surveyed companies use 2 or more types of awards
Performance-Based Awards

- Over half of long-term incentive value is now delivered through performance-based awards
- Performance shares used by approximately 73% of companies
- Performance-based restricted stock or restricted units used by approximately 14% of companies
Performance Metrics

- Most companies (approximately 80%) use two or more metrics
- Profit measures-e.g. EBIT/EBITDA; net income; EPS
- Return measures-e.g. return on invested capital; return on assets; return on equity
- Cash flow measures-e.g. sales, free cash flow
Performance Metrics

- Most common metric is total shareholder return; used in about half of performance plans
- About 85% use total shareholder return relative to peer group or index
• Time-based full value awards still account for approximately 25% of long-term incentive value

• Many companies are shifting from restricted shares to restricted share units
  – 55% of companies used restricted stock units settled in shares
  – 13% restricted stock units settled in cash
  – 32% of companies used restricted shares
Ownership/Holding Requirements

• Requirement to hold shares after exercise of options or vesting of restricted shares or units
• Generally allow shares to be withheld for tax purposes
• May become more popular as claw back policies are implemented
Treatment Upon Separation

- Continued vesting
- Accelerated vesting
- Double trigger change in control
Other Considerations

- Accounting expense
- Share usage
- Tax treatment
- Dilution and overhang
Stock Ownership Guidelines

• What is included in counting shares owned?
• How should equity be measured for purposes of guidelines?
• What are appropriate levels of ownership?
• Hold until retirement policies
• Hedging policies
Claw Back Provisions

• Dodd Frank §954-SEC proposed rules regarding recovery of executive compensation expected by end of June 2012

• Many companies have adopted claw back policies or plans with claw back provisions
Perquisites

• Tax gross-ups are rare for new executives, but still available to CEOs or legacy executives

• Financial/tax planning, executive physicals still common
Realizable Pay

- Target versus realized or realizable pay
- Some compensation committee review realizable pay as part of annual compensation setting process
- Voluntary disclosure in proxy statements more common in 2012
What’s Ahead?

• Further implementation of Dodd-Frank (proposed rules expected by end of June 2012):
  – Disclosure of internal pay ratio
  – Disclosure of pay-for-performance
  – Disclosure of claw back policies
  – Disclosure of hedging policies
Section 409A Generally is Applicable to:

- Supplemental Retirement Plans
- Deferred Compensation Plans and arrangements
- Employment, Change in Control, Severance arrangements
- Phantom Stock
- Deferred Shares
- Restricted Stock Units
Section 409A Generally is not Applicable to:

- Restricted Stock
- Stock Options
- Stock Appreciation Rights
- Qualified Plans
- Partnership (or LLC) Interests
Scope of Entities/Recipients

- Both public and private companies
- Corporations, partnerships, LLCs
- All service providers, including:
  - Directors
  - Employees
  - Independent contractors or consultants
Issue 1: Ways to measure FMV for purposes of setting the strike price of an option granted by a public company

Company wants to grant an option with a strike price based on the average trading price over a specified period of time.

Problem: To avoid application of Code Section 409A, options must be granted with a strike price at or above FMV on date of grant.
Grant Procedures

- Period cannot extend more than 30 days before or 30 days after the grant date
- Recipient of each stock option and the number of shares subject to each stock option must be identified before the beginning of the strike price measurement period
- Commitment to measure fair market value based on the average trading price during the specified period must be irrevocable before the beginning of the period
Issues with Stock Options (cont’d)

Alternatives:

• Closing price on the grant date
• Closing price on the day preceding the grant date
• Mean of the high and low trading prices on the grant date
• Mean on the high and low trading prices on the day preceding the grant date
Issue 2: Measuring FMV of Underlying Stock for a Private Company

Problem: Valuation rules for private companies are vague

When valuing private company stock under Section 409A, fair market value must be based on a:

• Reasonable application of reasonable valuation method
• Valuation that is no more than 12 months old, but should be based on a more recent valuation if it would otherwise fail to reflect new information materially affecting the value of the company
Issues with Stock Options (cont’d)

Suggestion:

• Use one of the safe harbor methods, such as an independent appraisal
• Also, other safe harbors for start-up companies and using formulas
• There is risk with using a non-safe harbor method
Issue 3: Grant of Dividend Equivalent Rights

Problem: An employer wants to grant dividend equivalent rights on a stock option and wants to require that once the stock option is exercised and the employee is a stock holder, the dividend equivalent rights terminate.

They may be viewed as an indirect reduction in option exercise price. This causes a stock option that is not otherwise subject to Section 409A to become subject to Section 409A. If a stock option is subject to Section 409A, it loses much of its flexibility and requires, among other things, a fixed payment date.

• Solution: Terminate dividend equivalent rights on vesting, not exercise
Issue 4: Modification of a Previously Granted Option

• Problem: Modifications of a properly structured option that directly or indirectly reduces the strike price or extends the term of the option
Issues with Stock Options (cont’d)

• Problematic Modifications:
  • Repricing a stock option that has an exercise price that is less than fair market value at the time of repricing (an in-the-money option)
  • Extending the term of an in-the-money option beyond the shorter of:
    – The original expiration date; and
    – Ten years from the grant date
  • Providing for deferral stock option gains or deferred payment of an exercised stock option appreciation right
Issues with Stock Options (cont’d)

Modifications That Do Not Cause Section 409A Problems:

- Shortening the term of the stock option
- Adding cashless exercises or cash-out features
- Accelerating or delaying the vesting of the stock option
- Extending the post-termination exercise period, but not beyond the shorter of:
  - The original expiration date; and
  - Ten years from the grant date
- Proportionately adjusting the stock option to reflect a stock split or corporate transaction
- Tolling the term of a stock option while the exercise of the stock option would violate law or would jeopardize the employer’s ability to continue as a going concern
- Permitting a transfer of stock options without consideration
Issue 1: RSUs can be structured to avoid application of Section 409A. However, some common mistakes in structure or design can subject them to 409A.

- Example: Structured as a short term deferral (pay upon vesting), but contains:
  - Accelerated vesting on retirement
  - Accelerated vesting upon termination for non-compliant “good reason”
  - Vesting continues post-employment during restrictive covenant period
Alternatives:

- Properly Structure as a Short Term Deferral, or
- Otherwise Comply with Section 409A
Issues with Restricted Stock Units (cont’d)

Issue 2: Request of a Release Following Termination of Employment

- Problem: Failure to qualify as a short-term deferral; IRS views the ability to defer payment by not timely signing the release to violate 409A
- Both documentary and operational failures
Issues with Restricted Stock Units (cont’d)

Suggestion: Draft Document to Comply with Short Term Deferral Rules

- Provide that payment will be made after the execution of the release and termination of any revocation period
- Include the maximum number of days following termination of employment that the employee has to execute the release
- Require that the employee forfeits his right to payment if the release is not executed within the maximum number of days
- The sum of the following should not exceed 74 (corresponding to the earliest possible two-and-a-half month short-term deferral deadlines)
Coordination Between Section 162(m) and Section 409A

Issue: Failure of a payment to be made within the short term deferral rule

Two Scenarios:

- 162(m) application was not expected
- If it was, follow payment timing requirements