

Granting Compensatory Equity Awards: A Checklist of Administrative Action Items

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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 2020 Webinars

- 2020 webinars:
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 - 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)
 - Employment Taxes: The 101 Course (12/10/2020)

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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.)

- 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

Share Counting Provisions

- There are a number of areas where the company will have to track the number of shares subject to awards, tracked on both a current and cumulative basis
- 1st - Verify that the equity plan's share reserve will not be exceeded with respect to the upcoming grants
 - To the extent the share reserve has liberal share counting, tracking will have to include both grants of equity (which are a subtraction from the share reserve) and equity award forfeitures (which are an addition to the share reserve)
 - Also, determine whether a sufficient number of shares would exist if all outstanding performance-based equity awards were to pay out maximum levels (i.e., some companies only track grants at the target levels)
- 2nd – Verify there are no holdover 162(m) sub-limits that would apply
 - The performance-based exception to the \$1mm deduction limits under 162(m) was eliminated by the Tax Cuts and Jobs Act (the “Act”)
 - Prior to the Act, compliance with the performance-based exception required the equity plan to have sub-limits, which were typically structured as an individual limit per calendar year
 - Though the Act eliminated the requirement to have such limits, institutional shareholder advisory services generally consider such limits to be “good governance,” and as a result, many issuers still have such limits in their equity plan

Share Counting Provisions (cont.)

- 3rd – If any equity award has a vesting schedule of less than 1 year, then verify that the equity plan does not have terms that would otherwise limit the award
 - As background, part of the “plan features” pillar of ISS’s equity plan scorecard (“EPS”) is that a certain number of points are allocated if the issuer’s equity plan has a minimum vesting feature. Full points are awarded in this bucket if the equity plan has a 1-year minimum vesting schedule required for all awards, subject to a 5% carve-out
 - Many times equity grants to non-employee directors are in arrears (i.e., payment for services previously performed), and as a result, these grants are issued to director fully vested. These fully vested grants will deplete the 5% carve-out
 - As a result:
 - Any vesting schedule prohibitions will need to be tracked; and
 - Companies with a 5% carve-out will need to track/count grants that are depletive to the 5% carve-out

Share Counting Provisions (cont.)

- 4th – Track and verify the number of shares of the equity incentive plan that remain registered under the Form S-8
 - As background, Form S-8 rules count share depletion on a **gross** basis and equity plans with liberal share counting (which is the majority of equity plans) count shares on a **net** basis
 - It is necessary to track Form S-8 share depletion because over time it will likely deplete faster than share depletion under the equity plan
 - This can be highlighted with the following example:
 - Assume the equity plan has a share reserve of 100 shares, and that Mary is awarded restricted stock covering 30 shares. Assume that Mary terminates employment at a time when she is vested in 20 of such shares and 10 shares become forfeited
 - If the equity plan has liberal share counting, then the 10 forfeited shares would revert to, and act to replenish, the equity plan
 - Counting a net basis means the equity plan's available share reserve would be 80 [(100 – 30) + 10]
 - Counting on a gross basis means the available shares registered under the Form S-8 is 70 [100 – 30]
 - Compound this example over multiple grants of equity and over multiple years, and the disparity can become substantially larger

- 5th – Verify whether any equity grants to non-employee directors would exceed any limitations in the equity plan
 - As background, and due to the teachings of *Seinfeld*, *Calma*, and *In re Investors Bancorp, Inc. Stockholder Litigation*, many equity incentive plans have share limitations that apply to equity grants to non-employee directors

Granting Documentation

- 1st – Make sure the granting documentation is in order and follows what the Compensation Committee (or its delegate) approved
 - It is important to have the granting documentation coincide in time with the action of the Compensation Committee to effectuate the grant
 - Though some flexibility exists in terms of the lag time between the equity grant and the providing of the documents to the participant, by way of example, a period of 6 months is too long

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 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 (e.g., an inside director or a non-director officer), 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 employer must be quick
- Background Note: downward delegations can include the authority to grant restricted stock (i.e., in addition to grants of options, RSUs, etc.)
 - Under prior law, only rights and options could be subject to downward delegation under DGCL 157(c)
 - As a result, a number of companies had designated an inside director (e.g., the CEO) as a single-member committee of the Board under DGCL 141(c)(2), to effectuate grants of all types, including grants of restricted stock
 - Remnants of this design still exist even though it is no longer required

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

Delegations of Authority to Grant Equity (cont.)

- Our thoughts:
 - Delegations of authority can simplify the process of granting equity in situations where non-executive officers are being hired (i.e., quick reaction)
 - Delegations of authority should be pursuant to a written document (i.e., a policy) that addresses many of the points on the prior Slides
 - Verify that the Charter of the Compensation Committee allows for a downward delegation of authority to grant equity
 - An amendment to the equity incentive plan might be needed if the terms of such plan provide that only the Compensation Committee has the authority to effectuate grants. Any such amendment would not likely require shareholder approval (*i.e.*, the amendment is not likely to be a “material revision” under NYSE and NASDAQ listing rules), but this issue should be vetted

Service Providers Cannot Be Entities

- Under Form S-8 rules (public companies) and Rule 701 (private companies), only a natural person may receive an award under the equity plan
- Additionally, the equity plan will likely require such person to be an employee, director or consultant to the company
- As a result, a service provider cannot be an entity and receive grants that are intended to be covered under Form S-8 or Rule 701
 - But if a consultant is adamant about taking the equity on behalf of the entity, then the award agreement could reference the individual in name only and on behalf of the entity
 - Such would satisfy the natural person requirement

Issues with Furloughs

- Question is whether the act of furloughing an employee causes a termination of employment of that employee for purposes of:
 - The vesting schedule, and
 - The start date of the post-termination exercise period of a stock option

- Answer depends based upon the terms of the equity plan and the award agreement, but likely this determination will be made by the plan administrator
 - Many equity plans contain a concept of an approved leave of absence. This provision needs to 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 the leave is less than 6 months, or if longer, the employee has a contractual or statutory right to reemployment

Employment Taxes - RSAs & RSUs

- There are a number of issues to consider that could streamline the administrative process associated with employment taxes
- 1st – Consider structuring all vesting provisions of restricted stock and RSUs to occur on the first payroll date that immediately follows satisfaction of the vesting schedule, thus mitigating the frequency of having to comply with the IRS “next day” deposit rule
 - As background, if an employer accumulates \$100,000 or more in employment taxes on any day during a deposit period, then it must deposit these taxes by the end of the next business day
 - If vesting occurs during a non-payroll cycle and no net-withholding provision is applicable, then the employer will have to get the money from the employee by the next day
 - But be wary. Under Section 402 of SOX, publicly-traded issuers cannot extend credit or provide loans to executive officers. Query whether an employer’s advancement of the deposit to the IRS prior to getting the money from the executive is a “loan” or an “extension of credit”

Employment Taxes – NSOs and Deferred RSUs

- 2nd – Verify the administrative procedures to ensure timeliness of deposits when non-statutory stock options (“NSOs”) are exercised
 - As background, 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
 - Question is whether the employment tax deposit rules apply from the date of exercise or from the date the employee receives the underlying stock (often a few days later)
 - 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 3 days from the date the stock option was exercised

- 3rd – With respect to RSUs that are subject to a deferral feature, verify that the administrative procedures will capture FICA taxes at vesting (i.e., capturing FICA taxes at the later time when the RSU is settled is often too late)
 - Though under a rule of administrative convenience, an employer is permitted to withhold FICA taxes at the same time it withholds income tax if vesting and settlement of the award are in the same calendar year

Employment Taxes – ISOs

- 4th – Verify that the compensatory deduction is captured whenever a holder of an ISO exercises and sells the underlying stock within the later of (such being a “disqualifying disposition”):
 - Two years from the date the ISO was granted, and
 - One year from the date the ISO was exercised

- Noteworthy is that the employer has no withholding obligation even in situations where ISO status is lost due to a disqualifying disposition; but in such instance, the employer is NOW permitted a compensatory deduction

Employment Taxes – Retirement Provisions

- 5th – Verify that FICA is timely withheld for those equity awards that have vesting fully accelerate if the employee “retires” (typically defined as attaining a certain age and having a requisite number of years of service with the employer). There is a bifurcation in the analysis, as follows:
 - If the award is time based, then the substantial risk of forfeiture is no longer present the moment the individual satisfies retirement eligibility, because all that the individual has to do is quit to receive the award. As a result, FICA taxes are owed at the time the individual satisfied retirement eligibility
 - However, if the award is performance based, then it is likely that the performance schedule would continue to act as a substantial risk of forfeiture even if the individual otherwise satisfied the requirements for retirement. As a result, FICA would continue to be deferred until the performance condition becoming satisfied

- 6th – Verify how the next day deposit rule is satisfied in situations where the employer is waiting for the employee to remit sufficient dollars to the employer. Solutions include:
 - Over withhold on other cash due to the employee (e.g., regular paycheck)
 - Subject to Section 402 of SOX, the employer could estimate the withholding amount and then deposit such amounts early with the IRS. Then on the required due date the employer could instruct the IRS how that deposit should be allocated
 - Require the employee to transfer the estimated withholding obligation to the employer prior to the deposit date
 - Implement a “net withholding” feature

Incentive Stock Options

- 1st – Verify that the grant is only to an employee
 - Only an employee is eligible for ISO treatment
- 2nd – If the optionee owns 10% or more of the company’s voting stock or all classes of stock, then:
 - The exercise price must be at least 110% of the fair market value of the underlying stock at the time the ISO is granted, and
 - The ISO must expire no later than 5 years from the date the ISO was granted
- 3rd – Verify that the \$100,000 limit is not exceeded, and to the extent such is exceeded, then the shares subject to such excess automatically converts to an NSO
 - The \$100,000 limit is valued at the time the option is granted
 - The \$100,000 applies a cap on the dollar amount of shares that can first become exercised during a calendar year
 - Examples assuming \$1.00 stock value and a 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 but in year 3 there is a change in control of the company and vesting is accelerated. In year 3, 200,000 shares would have already vested and 300,000 shares are unvested. Result is that 300,000 shares are subject to ISO treatment because: (i) 200,000 share previously vested, (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

Securities Rules

- 1st - With respect to Section 16 insiders, verify that any proposed sales of equity will comply with the Issuer's pre-clearance procedures and insider trading policy
- 2nd – To the extent a 10b5-1 trading plan is being implemented by an insider, such plan should be vetted pursuant to the issuer's pre-clearance procedures and insider trading policy
- 3rd – Verify current administrative procedures will capture both grants and sales of compensatory equity so that Form 4s can be timely filed

Privately-Held Companies

- 1st – Verify whether the participant holding the award will become subject to the shareholders agreement
 - Sometimes the shareholders agreement is a sweet-heart deal between a small group of founders and its provisions are not intended to apply to the participant
 - In that instance, the award agreement will need to address one or more of the following:
 - Drag-along rights and tag-along rights,
 - Rights of repurchase,
 - Rights of first refusal, and
 - Voting rights

Don't Forget Next Month's Webinar

- Title:
 - Compensatory Ideas within a Partnership Structure

- When:
 - 10:00 am to 11:00 am Central
 - June 11, 2020

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