Trends in Designing Performance-Based Equity Awards

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Housekeeping: 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

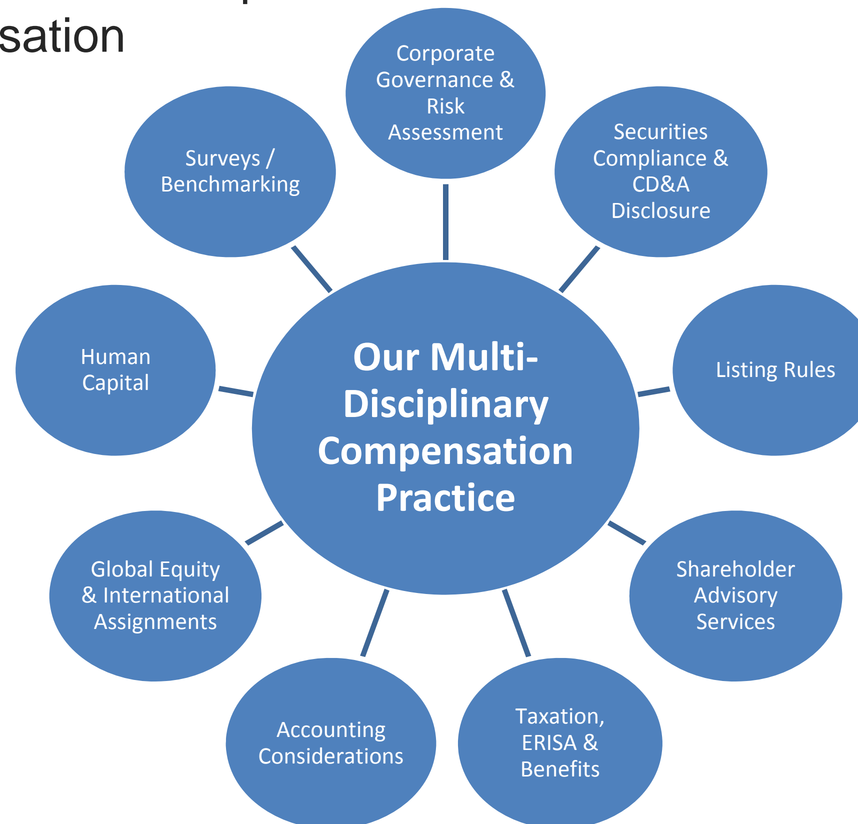
Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve the 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.)

- We are both unique and efficient in our approach to compensation matters. We are unique because the members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. We are efficient because, as multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



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- Upcoming 2017 webinars:
  - Preparing for Proxy Season: Start Now (Annual Program) (9/14/2017)
  - How to Properly Design a Nonqualified Deferred Compensation Plan (10/12/2017)
  - Navigating Employee v. Independent Contractor Classifications (11/9/2017)
  - Sharing the Dream: M&A Transactions & Retaining Key Employees (12/14/2017)

- Upcoming 2018 webinars
  - To be determined
  - Suggestions welcomed!

Typical Forms of Long-Term Equity Incentives

- The three primary equity vehicles most often used are:
  - Restricted stock units ("***RSUs***") and/or performance share units ("***PSUs***"),
  - Restricted stock awards ("***RSAs***"), and
  - Stock options (both incentive stock options and non-statutory stock options)

- Stock options
  - Due to the tax efficiency and the optionality inherent in the award, stock options continue to be the most prevalent equity incentive used by privately-held corporations
  - Stock options are still used by publicly-traded corporations, however, their usage as the sole equity vehicle continues to decline
    - The decline started with the implementation of FAS 123R (now ASC Topic 718)
    - Such decline continued, in part, due to the theory often shared by institutional shareholder advisory services that time-based stock options are not "performance-based"
  - However, stock options are still a primary equity vehicle for technology-based companies
  - The most standard vesting schedule for stock options is ratably over 3 years (*i.e.*, it vests pro rata over a 3-year period on the 1st, 2nd, and 3rd anniversaries of the Vesting Commencement Date)
    - Though monthly vesting after the 1st vesting tranche is common too (*i.e.*, it vests pro rata over a 3-year period, with 33% vesting on the 1st anniversary of the Vesting Commencement Date, and thereafter, the remainder shall vest pro rata on a monthly basis over the next 2-year period)

Typical Forms of Long-Term Equity Incentives (cont.)

- RSUs and PSUs are the classic equity vehicles used to contain performance-based metrics (though such could be designed as time-based)
  - These awards are contractual promises to pay cash or equity in the future (*i.e.*, the settlement date)
  - A design opportunity often utilized with these awards (by both public and private companies) is to defer the recipient's tax event until the settlement date (*i.e.*, a date that coincides with the last vesting tranche or some later date)
    - Since private companies lack a market for its common stock, these awards are often designed to become settled on a date that coincides with a liquidity event for the company's shareholders
    - For publicly-held companies, the award is often deferred until the settlement date for administrative ease (though FICA is owed at vesting – which generally will save the employer and the recipient tax dollars if the fair market value of the underlying stock increases throughout the vesting schedule)

- In contrast, RSAs are typically time-based awards
  - With an RSA, a corporate transfer occurs on the date of grant
  - As a result, and due to the lack of liquidity and the inability to implement a deferral mechanism, RSAs are typically not used by private companies unless the value of the shares is low on the date of grant and the recipient makes an 83(b) election
  - Due to a public market for the trading of its stock, RSAs are still a common equity vehicle for public companies
  - For public companies, the most common vesting schedule is ratably over a 3-4 year period

Most Common Performance Metrics

- Stock options and RSAs are typically time-based awards

- For private companies, performance metrics within RSU and PSU awards are generally designed to align with the dream shared by its shareholders, that is, to increase shareholder value and work towards the dream of a high valued liquidity event (*e.g.*, M&A event, financing transaction, monetization of the company's intellectual property)
  - Stock options are typically time-based awards
  - RSAs are typically time-based awards
  - For RSUs and PSUs containing performance-based metrics, the metrics are typically design towards increasing the return to shareholders at the liquidity event
    - For example, with respect to an executive the performance metrics include change in control sale price, EBITDA, net sale proceeds, etc.
    - And with respect to an award geared towards a leader of a division, the performance metric is sometimes tailored to the performance goals of his/her division (*e.g.*, a sales metric for a sales person)

Most Common Performance Metrics (cont.)

- For publicly-traded companies, performance-based equity awards such as RSUs and PSUs tend to focus on financial performance measures that drives stock price, such as:
  - Total shareholder return ("***TSRs***");
  - Operating income, earnings per share, EBITDA and net income;
  - ROE, ROA, ROIC; and
  - Revenue, sales growth, cash flow

- In addition, common performance metrics chosen by energy companies that we surveyed tend to include:
  - Return on average capital employed,
  - Reserve replacement ratio,
  - Production per debt adjusted share, and
  - Reserve adds per debt adjusted share

Most Common Performance Metrics (cont.)

- TSR is most common performance metric used by publicly-traded companies
  - This is mostly the result of pay-for-performance methodologies adopted by institutional shareholder advisory services such as ISS
  - However, this may change going forward given the addition of performance metrics by ISS (discussed in a below slide)
  - And too, companies are beginning to realize that TSR should not be the sole performance metric
    - TSRs do not have direct line of sight to the business goal for the executive
    - Depending upon the TSR design and the selection of the peer group, an unintended consequence is that TSRs can payout even though the stock price didn't perform (and not payout even though the stock price did perform)
    - Perhaps TSRs will be used in the future as a modifier to another performance-based award

- TSRs are discussed in greater detail below

Most Common Performance Metrics (cont.)

- During the 2017 proxy season, ISS released a new pay-for-performance methodology by adding the following financial metrics (in addition to the pre-existing TSR metric) to its qualitative pay-for-performance tests:
  - Return on equity,
  - Return on assets,
  - Return on invested capital,
  - Revenue growth,
  - EBITDA growth, and
  - Growth in cash flow from operations
- According to ISS, financial performance will be measured by a weighted average of the 7 financial metrics (*i.e.*, TSR plus the new 6 financial metrics)
  - Weightings will vary depending on the company's GICS code
- This means that for purposes of the ISS qualitative pay-for-performance tests (and probably for the quantitative pay-for-performance tests), the pay of a public company's CEO will be compared to the three-year financial performance of the weighted average of the 7 financial metrics

Payout Levels and the Performance Period

- Payout levels typically include:
  - A minimum level of performance (*i.e.*, a floor or threshold) that must be achieved before any of the award is earned
    - For example, 25% of target (though a typical range for a floor is 25%-50% of target)
  - A target level of performance (typically 100%, though sometimes TSRs have a lower target percentile)
  - A maximum level of performance (*i.e.*, a stretch goal)
    - For example, achieving performance at 150% of target (though a typical range is 150%-200% of target)
- The most common performance period with respect to RSUs and PSUs at publicly-traded companies is 3 years
  - Though some programs will allow an opportunity for the participant to "kick the can down the road" for an additional year (*i.e.*, an additional year for the participant to satisfy the performance metric before the award is otherwise forfeited)

Total Shareholder Return: Background

- Generally, TSR is defined as stock price appreciation/depreciation, plus reinvestment of dividends, over a measurement period.
  - Another way to look at it, is that TSR measures the return an investor would receive if he or she bought one share of common stock at the beginning of the measurement period, accumulated dividends during the measurement period, and then sold the common stock at the end of the measurement period

- There are two main formulas with respect to TSR programs
  - Absolute,
  - Relative, and
  - A combination of both

- An absolute TSR formula is calculated as follows:

$$TSR = \frac{\text{Ending Price} - \text{Beginning Price} + \text{Dividends}}{\text{Beginning Price}}$$

- The payout is then determined as a function of the company's TSR compared to predetermined goals (*i.e.*, it is not compared to the TSR of the peer group)

Total Shareholder Return: Background (cont.)

- A relative TSR program has the same math formula as an absolute TSR program; however, with a relative TSR program the payout is determined as a function of the company's TSR ranking/ratio compared to the TSR ranking/ratio of its peer group
  - For example, if the company's TSR percentile rank/ratio equals or exceeds x%, then the percentage of the target award that earned equals x%

- The following represents a hypothetical (though typical) relative TSR program:

	Relative TSR Rank	**Payout %**
Maximum:	75th percentile	200%
Target:	50th percentile	100%
Threshold:	25th percentile	50%
Below:	Less than 25th percentile	0%

- In the above example, if the company's TSR rank relative to its peer group is at the 80th percentile, then the payout would be 200% of the target shares

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Total Shareholder Return: Negative Returns

- What happens when there is no alignment between absolute TSR and relative TSR? For example:
  - Should management be rewarded when absolute TSR is high, but relative TSR is low (*i.e.*, a reward to reflect the gains realized by shareholders)?
  - Should management be rewarded when absolute TSR is low, but relative TSR is high (*i.e.*, a reward to reflect outperformance of the peer group)?

- Reason to address negative returns – Why should management be entitled to a payout for outperforming peers when shareholders lost money?

- Reason to ignore negative returns – Management should be paid for outperforming peers because shareholder loss could have been greater at a peer company
  - An additional negative is that the existence of a possible elimination of payout, a cap or a formula modifier would decrease the "fair value" of the award, thus possibly increasing the number of shares subject to the award

Total Shareholder Return: Negative Returns (cont.)

- Possible ways to address negative returns:

- 1st – Eliminate any payouts when absolute TSR is negative over the performance period
  - Consider too whether this should work in the reverse, to provide a payout when absolute TSR is high but relative TSR is low (*i.e.*, a reward to reflect the gains realized by shareholders)

- 2nd – cap the payout opportunity when absolute TSR is negative over the performance period
  - Such caps typically limit the payout to the target level
  - If applicable, the cap would apply irrespective of whether the relative TSR formula would have otherwise required a higher payout opportunity
  - Consider whether the cap should work in the reverse, to protect management in instances where absolute TSR is high but relative TSR is low (*i.e*, a reward to reflect the gains realized by shareholders)

- 3rd – have a formula modifier that downward adjusts the payout when the company has a negative return (*i.e.*, similar in formula to an upward adjustment that would apply if the company had positive TSR)

Share Counting and Equity Settled Performance Awards

- Equity-based performance awards that have maximum payout modifiers (*e.g.*, 200% of target) will draw from the share reserve of the equity incentive plan at such maximum amount at the time the award is granted
  - This can create issues with respect to how many shares are available for other issuances, especially with respect to awards containing maximum payout opportunities that are in reality only stretch goals
  - A typical 3 year performance period can add to the problem of an insufficient share reserve
  - For these reasons, some companies are only granting cash-settled awards
  - And an alternative would be to have the award settled in equity up to the target level, and everything exceeding the target level would be settled in cash
  - Any portion not achieved at the applicable performance metric would revert to, and replenish, the share reserve of the equity incentive plan ONLY IF the plan document supports such replenishment (*i.e.*, liberal share counting)

Share Counting and Equity Settled Performance Awards (cont.)

- Equity incentive plans with liberal share counting are counted/depleted on a net basis
  - For example, if 100 shares are subject to the award and only 60% of the award becomes vested, then 40 shares would return to, and replenish, the share reserve of the equity incentive plan
- In contrast, shares registered pursuant to a Form S-8 are counted/depleted on a gross basis
  - Using the above example, all 100 shares would count towards and deplete the remaining share reserve subject to the Form S-8
- This means!
  - Do not rely upon your equity incentive plan capitalization table to determine how many shares remain available under the Form S-8
  - When determining how many shares to register under a Form S-8, always register more than are then available under the equity incentive plan

Accelerated Vesting Due to Retirement

- There are two types of vesting schedules that contain "retirement" provisions that act to accelerate vesting:
  - Those with performance-based vesting provisions, and
  - Those with time-based vesting provisions

- For agreements with performance-based vesting provisions that provide for accelerated vesting upon retirement:
  - The continued application of the performance-based metrics within the award agreement should act as a substantial risk of forfeiture under Section 83 of the Code. Such is the answer even though the employee has a "contractual" right to benefits (to the extent the performance condition is satisfied) due to his or her attaining retirement age
  - For the above reasons, there is no taxation to the employee due to his or her attaining retirement age. This means no withholding obligation and no FICA/FUTA is triggered at retirement age or upon a termination of employment on or after attaining retirement age
  - Instead, taxation (both withholding and FICA/FUTA) would be triggered when the performance condition becomes satisfied

Accelerated Vesting Due to Retirement (cont.)

- For agreements with only time-based vesting provisions that provide for accelerated vesting upon retirement but payout upon separation from service:
  - The substantial risk of forfeiture under Section 83 is eliminated when the employee attains retirement age
  - Absent the agreement being designed to comply with Section 409A, the employee would have taxable income when he or she attains retirement age (subject employment taxes, withholding, etc.)

- If the agreement is designed to comply with Section 409A, *e.g.*, having the award payout upon his or her separation from service even though he or she previously attained retirement age, then:
  - FICA/FUTA is triggered upon the employee attaining retirement age, and
  - Income tax withholding would be deferred until the employee incurred a separation from service

- If retirement provisions are going to be used within equity awards, then consider:
  - Only using RSU and PSU awards because it is easier to facilitate deferral opportunities within these types of awards

Attempt to Maximize Capital Gains: 83(b) Elections

- The primary objective of an 83(b) election is to maximize capital gains treatment for the participant

- If no 83(b) election is timely filed, then:
  - The participant would generally recognize ordinary taxable income equal to the fair market value ("***FMV***") of the award (less any amount paid) on the date the award becomes vested
  - Any dividends received by the participant prior to vesting would be treated as compensation (not dividends)
  - Any sale of the vested stock would be treated as capital gain or loss equal to the difference between the sale price and the participant's tax basis

- Tax treatment to participant assuming an 83(b) election was timely filed:
  - The participant could attempt to capture as much of the projected appreciation of the underlying stock at capital gains rates if the participant makes an "83(b) election" within 30 days from the date of grant
    - The purpose of an 83(b) election is to limit the ordinary income tax element to the value of the stock on the date of grant (which can be much lower than the amount of ordinary taxable income the participant would otherwise recognize at the time of vesting)
    - This means the participant would be taxed at the time of the initial transfer (at a time when the FMV of the stock may be low)
    - Thereafter, any increase in the FMV of the stock would be taxed at capital gains rates when the participant sells the underlying stock

Attempt to Maximize Capital Gains: 83(b) Elections (cont.)

- Tax treatment to the company:
  - If the participant is an employee, the company's withholding obligation and depositing of employment taxes would be triggered
  - Also, the company would have a corresponding compensation deduction

- The following slides are intended to show the tax impact of making (or failing to make) a timely 83(b) election AND assumes the award in question is a restricted stock grant

- Assume the following hypothetical facts:
  - An employee received 10,000 shares of restricted stock on February 1, 2017, when the FMV per share was $10
  - The award vests 100% on the two year anniversary of the date of grant (no interim vesting)
  - When 10,000 shares vest on January 31, 2019, the FMV per share is $30
  - The employee then sells the shares for $400,000 in May 2019, when the FMV per share is $40

- [The calculation on the following slide only addresses federal income tax]

Attempt to Maximize Capital Gains: 83(b) Elections (cont.)

- If an 83(b) election IS timely filed upon receipt of the award:

Ordinary income upon grant 2/1/17:	$100,000
Ordinary income tax 2/1/17 (40% x 100,000):	40,000
Ordinary income upon vesting 1/31/19:	-------
Capital gain at sale 5/19 ($400,000 - $100,000):	300,000
Capital gains tax 5/19 (23.85% x $300,000):	71,400
Aggregate Tax on Award:	**$ 111,400**

- If an 83(b) election IS NOT filed:

Ordinary income upon grant 2/1/17:	$ -------
Ordinary income upon vesting 1/31/19:	300,000
Ordinary income tax 1/31/17 (40% x $300,000):	120,000
Capital gain at sale 5/19 ($400,000 - $300,000):	100,000
Capital gains tax 5/19 (23.8% x $100,000):	23,800
Aggregate Tax on Award:	**$143,800**

- In this example, the tax cost to the employee for failing to make an 83(b) election is $32,400 ($143,800 less $111,400)

Attempt to Maximize Capital Gains: 83(b) Elections (cont.)

- The greater the increase in the value of the shares during the vesting schedule, the greater the tax cost to the employee for failing to make an 83(b) election

- When determining whether or not to make an 83(b) election, the employee generally must carefully consider the risk that the employee may terminate employment prior to full vesting of the award
  - Under the foregoing Example, if the employee files an 83(b) election but terminates employment prior to any vesting, the employee will forfeit all the shares and will have paid $32,400 in tax for which he/she generally cannot claim a refund
  - Whereas if the employee did NOT file an 83(b) election and terminated employment prior to any vesting, he/she would have forfeited all of the shares but would not have paid any tax

- Worth noting is that some companies negate the above economic risk by providing the employee with a gross-up at the time an 83(b) election is made. Such a formula could be:

$$\text{Total Gross Up} = \frac{\text{FMV of Stock on Date of Grant}}{\text{1 Minus Applicable Tax Rate}}$$

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Don’t Forget Next Month’s Webinar

- Title:
  - Preparing for Proxy Season: Start Now (Annual Program)

- When:
  - 10:00 am to 11:00 am Central
  - September 14, 2017

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