Equity Plans and Award Agreements: The Training Course

Presentation for:
Executive Compensation Webinar Series
February 9, 2017

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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.)

- At Andrews Kurth Kenyon LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:

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- Upcoming 2017 webinars:
  - Compensation Committees: A Look at Liability & Fiduciary Issues (3/9/2017)
  - Compensatory Arrangements within Partnerships and LLC (4/13/2017)
  - Designing Equity Compensation Abroad (5/11/2017)
  - Expatriate & Secondment Agreements: Top 10 Issues to Consider (6/8/2017)
  - Pay Ratio Disclosure Rules: The A-Z Training Course (7/13/2017)
  - Trends in Designing Performance-Based Equity Awards (8/10/2017)
  - 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!

Purpose of this Presentation

- The purpose of this presentation is to discuss certain provisions of an equity incentive plan and its award agreements, with a focus on design considerations that could ease plan administration or optimize flexibility for the employer

Equity Plan: Types of Awards

- The typical equity plan will provide for a variety of awards, examples of which are the following:
  - Options (ISOs and NSOs),
  - Stock appreciation rights,
  - Restricted stock,
  - Restricted stock units,
  - Performance shares and units, and
  - Other stock-based awards

- Our thoughts:
  - We typically provide the form of award agreements with any new rollout of an equity incentive plan
  - The idea is that such form of award agreements will be attached to the Company's Form S-1 or Form 10-K, even if such award agreement is not currently in use
  - Then later, when the Company decides to utilize a different award to reflect a change in compensation design or philosophy, such change should not trigger a Form 8-K because the new award would be materially consistent with a previously-filed form award agreement

Equity Plan: Issues Raised with Certain Defined Terms

- Cause
  - Consider whether to have a Company-favorable defined term of Cause that, if triggered, would require a forfeiture of both vested and unvested awards
  - However, if the Participant has an employment agreement with the Company under which Cause is a defined term, then we typically require that definition to apply in lieu of the definition found in the equity plan
- Consultant
  - It is common for consultants to be an eligible recipient under an equity plan
  - Keep in mind that for purposes of rules applicable to Form S-8 and Rule 701 (the applicable securities exemptions for public and private companies), only a natural person may be a recipient
  - This means that, in order to effectuate a grant of equity to a consultant that is an entity and have such grant covered by the S-8 or Rule 701, the grant should be designated to an identified individual on behalf of the entity
  - Under applicable U.S. federal income tax laws, it is recognized that the individual took the award in name only, and that for tax purposes, the entity is the recipient
- Plan
  - This is just a quick note that the term "Plan" could include any prior plans that are being rolled up into the current amended and restated plan
  - Such is a strategy when there is either a remaining share reserve under those prior plans, or if there are outstanding awards subject to forfeiture and the desire is for any lapsed awards to replenish the share reserve of the amended and restated plan

Equity Plan: Share Reserve

- Do not forget to specifically state how many shares within the share reserve are eligible for incentive stock option treatment (*e.g.*, ". . ., all of which may be subject to Incentive Stock Option treatment.")

- Consider whether it makes sense to have an evergreen provision
  - Example: "The maximum aggregate number of Shares that may be issued pursuant to all Awards under the Plan shall increase annually on the first day of each fiscal year following the adoption of the Plan by the number of Shares equal to the lesser of: (i) [____] percent of the total issued and outstanding common shares of the Company on the first day of such fiscal year, (ii) [____] Shares, or (iii) such lesser amount determined by the Board."
  - According to ISS, evergreen clauses are not an acceptable practice. Therefore, this concept is only applicable to IPO companies and privately-held companies

Equity Plan: Share Reserve and 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)

<u>Equity Plan: Delegations of Authority to Grant Equity</u>

- Absent a valid delegation, only the Board of Directors (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

- <u>Structural note</u>: 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

Equity Plan: 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)
  - [See next Slide for a continuation of the list]

Equity Plan: Delegations of Authority to Grant Equity (cont.)

- [Continued from prior Slide]
  - 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 should exclude grants to those who would or could be "covered employees" as of the exercise date (if a stock option) or vesting date (if a stock grant)
    - Compliance with the performance-based exemption under Section 162(m) requires such grants to be approved in advance solely by two or more outside directors

Equity Plan: 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

Equity Plan: Inducement Grants

- Under applicable NYSE and NASDAQ listing rules, shareholder approval is not required for "inducement grants"

- To qualify as an inducement grant, the grant of restricted stock or stock options must act as a material inducement to the person being hired as an employee (or such person being rehired following a bona fide period of interruption of employment)
  - Inducement awards include grants to new employees in connection with an M&A transaction

- Inducement grants must be approved by the Compensation Committee or a majority of the Company's independent directors

- An additional qualification requirement is that promptly (generally within 4 business days) following the grant of an inducement award, the Company must disclose in a press release the material terms of the award, including the identity of the recipient(s) and the number of shares involved, and make certain other filings with the applicable listing agency

Equity Plan: Inducement Grants (cont.)

- In terms of the “form” of award, some companies provide inducement grants as stand-alone awards, whereas others will have an inducement plan from which to make grants (the latter particularly prevalent in M&A transactions)

- Important to note is that inducement grants are “outside” of the shareholder approved equity incentive plan
  - Therefore, inducement grants are not covered by the equity plan’s S-8

- Our thoughts:
  - Every attempt should be made to cover the inducement grants under a Form S-8
  - In instances where a Form S-8 is not practical, and the award in question is a restricted stock award, then a Form S-8 may not be necessary given the analysis contained in the following two Slides

Equity Plan: Inducement Grants (cont.)

- Under the "bonus stock exemption," restricted stock held by a plan is treated as if it were registered stock (regardless of whether the plan is an affiliate) if certain conditions are satisfied
  - Authority is contained in Release No. 33-6188, Release No. 33-6281 and a series of no-action letters
  - Thus, registration of the securities under a Form S-8 would not be required

- Only applies where no consideration was paid (*i.e.,* no "sale")
  - Thus, exemption is not available for stock options
  - Query whether exemption is available if the employee pays par value for a restricted stock award

- Shares distributed would not be considered "restricted securities." This means that:
  - Resales by participants who are non-Affiliates could occur immediately, and
  - Resales by participants who are Affiliates would be subject to Rule 144, except that the Affiliate would not be subject to the "holding period" of Rule 144 since the securities would not be deemed "restricted" securities

Equity Plan: Inducement Grants (cont.)

- Conditions that must be satisfied for the bonus stock exemption to apply:
  - Issuer must be subject to periodic reporting requirements of Section 13 (*i.e.,* employers that have registered stock under the '34 Act) or Section 15(d) (*i.e.,* employers that have registered stock under the '33 Act) of the '34 Act,
  - Stock being distributed must be actively traded, and
  - Amount distributed must be "relatively small" in relation to the total number of that class issued and outstanding

- Release 33-6281 (Jan. 15, 1981) defining "relatively small"
  - Distribution is always relatively small if the total number of shares distributed during the fiscal year is less than 1% of the outstanding stock for that year
  - A larger distribution may be relatively small if it would not have a measurable impact on the trading market (according to a no-action letter concluding that 5% was "relatively small")

Equity Plan: Inducement Grants (cont.)

- Our thoughts generally:
  - Depending on the extent a Company grants equity to new hires, compliance with the inducement grant exception could substantially increase the life expectancy of the shareholder-approved equity plan's share reserve
  - Inducement grants could be used in the M&A context where a buyer offers equity to the employees of the target
  - Inducement grants could be a solution to a likely "against" recommendation from ISS if it were to ask its shareholders to increase the share reserve of its shareholder-approved equity incentive plan
  - However, burn rate and dilution profiles relative to industry peers could be negatively impacted, thus making it more likely that ISS will recommend "against" to any future request to increase the shareholder-approved equity plan's share reserve (i.e., an inducement plan essentially borrows from the share reserve of a future shareholder-approved equity incentive plan)

- Our thoughts on implementation:
  - Consider the structure of any inducement program
    - Create an inducement pool within the current shareholder-approved equity incentive plan (not recommended, but doable)
    - Draft an inducement plan (recommended if inducement grants will be frequent enough)
    - Approve stand-alone inducement grants on an ad hoc basis (recommended if inducement grants will be infrequent)
  - Have the inducement grant (or plan) be covered by a Form S-8, except in ad hoc situations involving restricted stock, then the bonus stock exemption might be applicable

Equity Plan: Post-Termination Exercise Period

- The post-termination exercise period for stock options is typically set forth in the equity 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:
  - 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 (though any amount of time not to exceed the 10-year life of the award is permitted)

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

Equity Plan: Change in Control Provisions

- The plan document typically sets forth the default provisions of what happens to the equity award upon a change in control if the award agreement is otherwise silent on the issue

- Under the default provision, the alternatives include:
  - No acceleration;
  - Accelerated vesting at the discretion of the Company;
  - Accelerated vesting upon the change in control;
  - Accelerated vesting upon the 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 with a certain period of time following such change in control

Equity Plan: Change in Control Provisions (cont.)

- Consider other provisions within this section of the equity plan that could provide the Company with flexibility
- For equity plans that require the optionee to exercise immediately prior to the Change in Control or else the stock option is automatically terminated, careful 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 prepared to tell all optionees of the upcoming Change in Control (which is not a "sure thing" until the transaction closes)
- Consider adding a cashout provision to ensure Company-favorable flexibility:
  - For example, consider having a provisions that provides: "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

- In lieu of one document used to document an award, consider having both a Notice document and an Award Agreement document, with each incorporating the other by reference
  - All of the tailored provisions could be in the Notice, with the Award Agreement being the longer document with no provisions that would change on a grant-by-grant basis

- Consider having “Date of Grant” and “Vesting Commencement Date” as separately defined terms. Such allows the Company to provide credit towards the vesting schedule

- Common triggers that accelerate vesting include any combination of the following:
  - 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 death of the Participant,
  - The Disability of the Participant, and
  - A certain performance hurdle

Award Agreements (cont.)

- Consider whether to allow for electronic acceptance of equity awards
  - First verify such is permitted under applicable law
  - An example of such a 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

- For grants of restricted stock awards, consider eliminating any requirement to pay par value. As background, under the Delaware constitution and under Delaware corporate law, the provision of future services by an employee was not considered adequate consideration for a grant of equity, and therefore, companies required the payment of par value
  - However, a number of years ago, the Delaware constitution and the corresponding corporate law provisions were revised to eliminate such a requirement. Thus, the promise of future services is now sufficient consideration for the granting of restricted stock

- Though the historic practice of requiring par value continues to exist, many companies have eliminated the requirement because they want to (i) have more administrative ease, and/or (ii) rely upon the bonus stock theory (*i.e.*, no value can be paid in order to rely upon the bonus stock theory)
  - However, before eliminating the requirement, first verify whether par value is required under the Company's corporate organization documents

Award Agreements (cont.)

- 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's status as a Service Provider is terminated by the Company for Cause;
  - The Participant breaches any provision of the Notice or this Award Agreement;
  - The Participant fails or refuses to timely execute any exhibit to this Award Agreement, examples of which include:
    - Restrictive covenants and confidentiality agreements,
    - Waiver and release, and
    - Voting proxies;
  - The Participant fails to satisfy any withholding obligation of the Company
- With respect to restricted stock awards, it is common for the stock certificates to be held by the CFO/Treasurer (in escrow) during the vesting period. And any dividends paid on unvested shares would also be subject to the escrow
  - This requirement is expressed in the award agreement
  - There would be an exhibit to the award agreement that contains the participant's escrow instructions to the escrow agent, and such is signed in conjunction with receiving the award

Award Agreements: Certain Governance Provisions

- 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
  - 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 they buyer won't buy unless all the shareholders participate, and there is a minority shareholder who doesn't want to sell? Or vice versa?
  - A drag-along provision could be a 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)
  - A tag-along provision could be incorporated into the award agreement. A tag-along provision allows a minority shareholder to join in the sale with the majority shareholder on the same terms and conditions (*i.e.*, the minority shareholder tags along with the majority shareholder in the transaction)

- The Company's right of first refusal and repurchase right are common provisions

Restricted Stock Grants

- Generally, the grant of restricted shares would constitute a corporate transfer but not a tax transfer
  - A corporate transfer means the recipient is entitled to voting and dividend rights even if the award is subject to forfeiture
  - If the award is subject to forfeiture, then the tax transfer typically coincides with vesting

- Tax treatment to the participant assuming no 83(b) election was timely filed:
  - Unless an 83(b) election is timely filed, the participant would generally recognize ordinary taxable income equal to the FMV of the award (less any amount paid) as of the earlier of: (i) the date the shares become transferable, or (ii) the date the forfeiture restrictions lapse (*i.e.*, the date of vesting)
  - Until such time, any dividends received by the participant would be treated as compensation, not dividends
  - After such time, any sale of the underlying stock would be treated as capital gain or loss equal to the difference between the sale price and the tax basis

Restricted Stock Grants (cont.)

- Tax treatment to participant assuming an 83(b) election was timely filed:
  - The participant could attempt to capture as much of the anticipated future appreciation of the underlying stock at capital gains rates by making an "83(b) election" within 30 days from the date of grant
    - The purpose of an 83(b) election is to limit the ordinary taxable income 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 subject to the 83(b) election would typically be taxed at capital gains rates when the participant later sells the stock

- Tax treatment to the Company:
  - If the participant is an employee, the Company would have a withholding obligation and employment taxes at the time the participant recognizes ordinary income
  - Additionally, the Company would have a corresponding compensation deduction at that time

Options v. Stock Grants: A Comparison

EVENT	ISO	NSO	Restricted Stock
Date of Grant (Employee)	No federal income tax consequence to the optionee or the company	No federal income tax consequence to the optionee or the company	No federal income tax consequence to the participant or the company unless the participant timely filed an 83(b) election If the participant timely filed an 83(b) election, then the participant would recognize ordinary taxable income equal to the difference between the FMV of the shares on the date of grant and the price paid. The company would have a corresponding withholding obligation and compensation deduction
Date of Vesting (Employee)	No federal income tax consequence to the optionee or the company	No federal income tax consequence to the optionee or the company	If no 83(b) election was filed, then the participant would have compensation income (taxed at ordinary rates) equal to the difference between the FMV of the shares on the date of vesting and the price paid, if any. The company would have a corresponding withholding obligation and compensation deduction If instead the participant timely filed an 83(b) election, then vesting would trigger no federal income tax consequence to the participant or the company

Options v. Stock Grants: A Comparison (cont.)

EVENT	ISO	NSO	Restricted Stock
Date of Exercise (Employee)	No federal income tax consequence to the optionee or the company However, the “spread” under an ISO – *i.e.*, the difference between the FMV of the shares at exercise and the exercise price – would be classified as an item of adjustment in the year of exercise for purposes of AMT. In order to avoid the application of AMT, the optionee would have to sell the shares within the same calendar year in which the ISOs were exercised. However, such a sale within the same calendar year would constitute a “disqualifying disposition” (see next slide) The company would have no withholding obligation and would not be entitled to any deduction	Optionee would have compensation income (taxed at ordinary rates) equal to the difference between the option’s exercise price and the FMV of the underlying shares on the date of exercise The company would have a corresponding withholding obligation The company would generally be entitled to a compensation deduction equal to the amount the optionee included as ordinary income	Not applicable

Options v. Stock Grants: A Comparison (cont.)

EVENT	ISO	NSO	Restricted Stock
Date of Sale (Employee)	The tax consequences depend on whether the sale is a "disqualifying disposition" (*i.e.,* no disqualifying disposition if the stock is held for at least: (i) 2 years from the date of grant AND (ii) 1 year from the date of exercise) If the sale is not a disqualifying disposition, then the optionee would recognize long-term capital gain (or loss) equal to the difference between the sale price of the shares and the exercise price. The company would be entitled to no corresponding deduction If instead the sale is a disqualifying disposition, the optionee generally would have compensation income (taxed at ordinary rates) equal to the difference between the exercise price and the FMV of the underlying stock at the time of exercise (the company would be entitled to a corresponding deduction). Such compensation income would be added to the stock's basis to determine any capital gain that would have to be recognized on the disqualifying disposition	Any gain or loss would be short- or long-term capital gain or loss, depending on whether the shares were held for one year following exercise The company would not receive a compensation deduction for any such gain or loss	Same as NSOs

Options v. Stock Grants: Stock Grant Example

- The following example compares the tax consequences of receiving restricted stock with and without an 83(b) election

- Assume the following facts:
  - An executive received 10,000 shares of restricted stock on February 1, 2017, when the fair market value 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 fair market value per share is $30
  - The executive then sells the shares for $400,000 in May 2019, when the fair market value per share is $40

Options v. Stock Grant: Stock Grant Example (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 (23.8% 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 1/31/19 (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 executive for failing to make an 83(b) election is $32,400 ($143,800 less $111,400)

Options v. Stock Grant: Stock Grant Example (cont.)

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

- When determining whether or not to make an 83(b) election, the executive generally must carefully consider the risk that the executive may terminate employment prior to full vesting of the award
  - Under Example 2, if the executive files an 83(b) election but terminates employment prior to any vesting, the executive 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 executive had NOT filed 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 employers negate the above economic risk by providing the executive with a gross-up at the time an 83(b) election is made. Such a formula could be:

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

Don’t Forget Next Month’s Webinar

- Title:
  - Compensation Committees: A Look at Liability & Fiduciary Issues

- When:
  - 10:00 am to 11:00 am Central
  - March 9, 2017

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