

# Planning for an IPO: Compensation Considerations (Part 1 of 2)

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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 2018 Webinars

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- Upcoming 2018 webinars:
  - Compensation Changes Due to Loss of EGC Status (Part 2 of 2) (10/11/2018)
  - Taxation of Equity Awards: The 101 Training Course (11/8/2018)
  - How to Negotiate Executive Employment Contracts (12/13/2018)
  
- Upcoming 2019 webinars:
  - List will be created around September 2018
  
- Sign up here: <https://www.huntonak.com/en/insights/2018-executive-compensation-webinar-schedule.html>

## Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, 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

## Purpose of this Presentation

- The purpose of this presentation is to discuss various compensatory issues and designs that an issuer should consider in conjunction with the initial public offering (“*IPO*”) of its common stock
- To that end, keep in mind that there are two very different types of pre-IPO companies:
  - Privately-held companies that shared compensatory equity awards with its key employees while it was privately held, and
  - And those that did not (*i.e.*, all or substantially all of the issuer’s equity was owned by founders, family or a select few investors)

## Part 1: Understand Emerging Growth Company

- An issuer qualifying as an emerging growth company (“**EGC**”) at the time of its IPO is treated differently from other publicly-traded companies and enjoys limited compensation disclosure
  - Exempt from say-on-pay, say-on-frequency and say-on-golden parachute shareholder votes;
  - Exempt from pay ratio disclosure;
  - Exempt from having to file a CD&A within its proxy statement;
  - The NEO determination is limited to the CEO and two other executive officers;
  - Only required tabular disclosure is the Summary Compensation Table, the Outstanding Equity Awards Table, and the Director Compensation Table
- An issuer will retain EGC status until the earlier of:
  - The last day of the issuer’s fiscal year that contains the 5<sup>th</sup> anniversary of the issuer’s IPO,
  - The last day of the first fiscal year in which the issuer has annual gross revenues of \$1bb or more,
  - The date the issuer becomes a large accelerated filer, and
  - The date the issuer issued more than \$1bb in non-convertible debt during the preceding 3-year period
- The point of this slide is that EGC’s have more flexibility in their compensation design because they are subject to less compensatory disclosure when compared to non-EGC issuers (*i.e.*, disclosure drives compensatory design, more required disclosure equals less flexibility)

## Part 1: Determine the NEOs

- The Named Executive Officers (the “**NEOs**”) are the ones specifically disclosed in the S-1 Registration Statement and future proxy statements
- The determination of “who” are the NEOs begins with “who” are the executive officers. For this purpose, an “executive officer” means:
  - The president;
  - Any vice president in charge of a principal business unit, division or function; and
  - Any other officer who performs a policy-making function or any other person who performs similar policy making functions of the issuer
- Generally, NEOs include:
  - The PEO,
  - The PFO,
  - Each of the 3 most highly compensated executive officers (other than the PEO and PFO) who were serving at the end of the last completed fiscal year and whose compensation exceeds \$100,000, and
  - Up to 2 additional individuals for whom disclosure would have been required but for the fact they were not serving as an executive officer at the end of the last completed fiscal year
- In contrast to the above, the classification of NEOs for EGCs is limited to the PEO and the next 2 most highly compensated executive officers

## Part 1: Inform the Board

- It is important that the Board of Directors (the “**Board**”) have sufficient information so that it can make an informed decision with respect to the compensation of the key employees, and especially the compensation of the NEOs
  
- To help the Board make an informed decision, a Board-styled slide deck should be put together that covers the following compensatory elements:
  - The profile of the issuer’s proposed peer group;
  - The range of base salaries for the NEOs;
  - The incentive opportunity as a percent of base salary;
  - The incentive pay mix between cash and equity;
  - The vesting criteria used for the short-term incentive program and the long-term incentive program, including time-based vesting versus performance-based vesting criteria;
  - The equity vehicles used under the long-term incentive program;
  - The performance metrics used for short-term incentive and long-term incentive programs;
  - The share reserve for the equity incentive plan;
  - The prevalence of stock ownership and clawback policies; and
  - Employment contracts, severance agreements, and change-in-control provisions

## Part 1: Inform the Board (cont.)

- Consider using tally sheets and wealth accumulation analyses to help the Board make an informed decision
- Tally sheets lists each component of an executive's compensation and tallies it up (*i.e.*, also called a "placemat")
  - Tally sheets also include any potential payments that would occur under various termination scenarios (*e.g.*, for Good Reason, without Cause, Change in Control, etc.)
  - Tally sheets are a "best practice" and can be instrumental in preserving a director's business judgment rule defense to any shareholder derivative lawsuit (*i.e.*, the tally sheets helps to establish that the director made an "informed" decision)
- In contrast, a wealth accumulation analysis demonstrates the total equity holdings of an executive, projects into the future, and estimates at various points in time what an executive's wealth accumulation might be (using various assumptions, including future stock performance)

## Part 1: Compensation Committee

- The Compensation Committee must be comprised of at least two or more non-employee directors that satisfy applicable independence requirements under Rule 16b-3 and applicable listing rules
- The Compensation Committee is governed by a Charter. Pursuant to the Charter, should the Compensation Committee have the authority to effectuate grants of equity or should it instead only make “recommendations” to the full Board for the latter to effectuate grants of equity

## Part 1: Pre-IPO Equity Grants – Generally

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- There are a variety of issues that should be vetted if the issuer (or a shareholder of the issuer) is going to grant equity to one or more key employees prior to the IPO
  
- Such issues are discussed on the following slides and include:
  - Use of non-recourse debt by the key employee to finance the acquisition,
  - Equity grants from an existing shareholder,
  - Cheap stock issues, and
  - Section 409A issues

## Part 1: Pre-IPO Equity Grants – Non-Recourse Debt

- The issue of non-recourse debt often arises whenever the issuer or a shareholder desires to help a key employee finance an acquisition of equity with a promissory note
  - Should the note be 100% recourse?
  - Should the note be 100% non-recourse?
  - Should the note be partially recourse, and if yes, what percentage should be subject to recourse?
  
- A tax issue arises whenever the issuer or a shareholder finances the key employee's acquisition of equity by using a note that is partially or wholly non-recourse
  - In the typical scenario, the employee purchases the stock at FMV (*i.e.*, the tax transfer occurs at the date of grant). There is no compensatory element. Any later appreciation is captured at capital gains rates
  - However, if non-recourse debt is exclusively used to finance the purchase, then the purchase could be treated as an "option," and the tax transfer would then occur only as the debt instrument is paid. The result is that any appreciation in the underlying stock from the date of grant until the date the debt instrument is paid could be characterized by the IRS as compensatory income to the employee (subject to ordinary income tax treatment and wage withholding). The foregoing is not an issue if recourse debt is being exclusively used
  
- If instead part of the debt will be non-recourse, then consider structuring the note to be 50% recourse and 50% non-recourse. A number of practitioners believe that 50% recourse is sufficient for a tax transfer to occur at grant

## Part 1: Pre-IPO Equity Grants – Shareholder Grants

- Sometimes a shareholder of the issuer desires to transfer some of his or her equity in the issuer to key employees of the issuer
  - Such could be a transfer of stock, restricted stock and/or an option to purchase stock from the shareholder
  - A problem to navigate is that under the tax laws the equity is treated as compensation in exchange for the key employee providing services to the issuer. As a result, the key employee could have compensation income, and the issuer could have a withholding obligation and a compensatory deduction
- To achieve the above, the Treasury regulations treat the shareholder-to-key employee transfer as though it were:
  - A transfer of the property by the shareholder to the issuer in the form of a contribution to capital,
  - Followed by a transfer of compensatory property from the issuer to the key employee
- Issues to clarify in the above transaction include:
  - Whether the shareholders basis in the contributed stock is reallocated to his or her remaining ownership in the issuer
  - Whether the issuer has a withholding obligation (depends upon whether the transfer had a discount element to the price)
  - And too, the analysis becomes a little more dense if the shareholder is transferring parent stock to a key employee of a subsidiary (*i.e.*, whether non-recognition treatment under Section 1032 applies on the deemed transfer of stock from the parent to its subsidiary)

## Part 1: Pre-IPO Equity Grants – Cheap Stock

- The issue of “cheap stock” arises any time the issuer grants pre-IPO equity awards at valuations substantially lower than the IPO price
  - The concept of cheap stock is primarily an accounting issue, and arises with respect to equity granted within the 12-month window immediately preceding the IPO
  - The SEC’s concern is whether the issuer correctly accounted for the awards, and whether the issuer included disclosure within the Form S-1 as to the process and substance that was undertaken to value such awards
  
- Ways to avoid cheap stock issues include:
  - Have a contemporaneous valuation of the equity awards in question, and
  - Provide robust disclosure in the Form S-1 as to the process and substance the issuer undertook to value such awards (whether independent appraiser or otherwise)
  
- And if the equity in question is a stock option, then the discount that triggers the above cheap stock issue will also trigger a Section 409A issue

## Part 2 – Design IPO Equity Plan

- The equity plan should be approved by the pre-IPO Board and the issuer’s pre-IPO shareholders, and it should become effective immediately prior to the effectiveness of the issuer’s Form S-1 Registration Statement
  
- Form award agreements
  - Privately-held companies tend to avoid the costs associated with drafting form of award agreements they won’t use in the near future (makes sense!)
  - But for purposes of the S-1, consider attaching all possible form of award agreements that could be used under the equity incentive plan
    - Reason is to avoid triggering Form 8-K disclosures each time a new award agreement is later used
    - These form of award agreements would be carried forward each year as an Exhibit to the issuer’s Form 10-K
  
- Defining “Change in Control”
  - The definition is typically used within an equity incentive plan to cause the accelerated vesting of awards under such plan
  - Consider whether the definition should be triggered if the founders’ equity ownership ever falls below a certain threshold

## Part 2 – Design IPO Equity Plan (cont.)

- Protect the share reserve with a share replenishment evergreen provision
  - An evergreen provision is common in pre-IPO equity plans. A typical evergreen provision is comparable to:
    - “Subject to the provisions of Section [section addressing adjustments] of the Plan, the maximum aggregate number of Shares that may be issued pursuant to all Awards under the Plan is [ ] Shares, all of which may be subject to Incentive Stock Option treatment. 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.”
  - After the issuer becomes publicly traded, any increase to the share reserve will require approval by the issuer’s shareholders. Seeking such approval from the shareholders is likely to trigger thoughts from ISS and other institutional shareholder advisory services. Prolonging their “thoughts” as long as possible is a goal of having an evergreen provision
  - Consider too that immediately following an IPO an issuer is likely to be in a high growth stage, will need to conserve cash, and equity awards will likely be used to make up the spread. And since the form of equity used is often stock options or other appreciation-type awards, a greater number of shares will likely be needed to provide requisite retention value
- Protect the share reserve with liberal share counting
  - This provision of the equity plan provides that any terminated, expired, lapsed, canceled or repurchased shares subject to outstanding grants would revert back to, and replenish, the equity plan’s share reserve

## Part 2 – Design IPO Equity Plan (cont.)

- With respect to the question of whether the vesting of outstanding equity awards should fully accelerate if the issuer consummates a Change in Control, the alternatives are:
  - No acceleration,
  - Discretionary acceleration,
  - Double trigger acceleration (*i.e.*, both a Change in Control and termination of employment occur within a certain time period following such Change in Control),
  - Single trigger acceleration only if the acquiror does not assume or replace the outstanding equity awards, and
  - Single trigger acceleration
  
- The foregoing is inserted in the equity plan ONLY AS the default provision, to apply when the equity award agreement is otherwise silent on the issue
  
- A Form S-8 registration statement (used in connection with grants of equity to employees) will be filed in connection with the issuer's IPO
  - Due to a share counting provision within the Form S-8 rules (*i.e.*, Form S-8 counts "gross" grants, and the share counting provisions of the equity plan count "net" grants), and due to the evergreen provision within the equity plan (assuming such was elected), more shares will be registered than then are otherwise available under the share reserve

## Part 3 – Design Executive Compensation (cont.)

- An executive's total compensation is likely to be weighted towards long-term equity awards once the issuer becomes publicly traded
  - What type of equity awards should be used (stock options tend to make up a majority of IPO grants by issuers)
  - What should be the split between time-based vesting and performance-based vesting criteria
  - What should be the performance metric?
    - TSR is most common
    - However, common return-based metrics include return on equity, return on assets, and return on invested capital
    - And common growth-based metrics include revenue growth, EBITDA growth, and cash flow (from operations) growth
    - And too, ISS highly supports the use of the above 3 categories of metrics
  
- Severance
  - What should be the multiple? 2x base + bonus? 3x base + bonus?
  - Should a different multiple apply between the CEO and the other NEOs?
  - Should the foregoing multiple be enhanced if the termination is in connection with a change in control of the issuer?
  - Any accelerated vesting of equity if severance is due to Good Reason or instigated by the issuer without Cause?
  - Any continuation of benefits such as health care, certain perquisites, etc?

## Don't Forget Next Month's Webinar

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- Title:
  - Compensation Changes Due to Loss of EGC Status (Part 2 of 2)
  
- When:
  - 10:00 am to 11:00 am Central
  - October 11, 2018