# Primer on Executive Compensation

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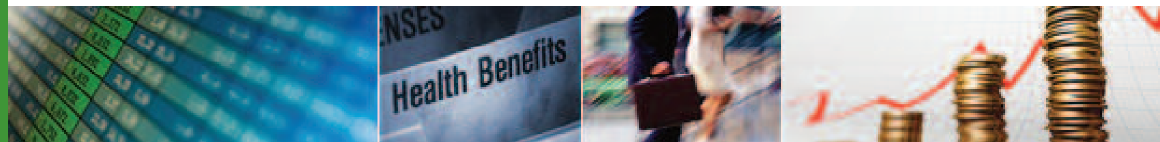

# Primer on Executive Compensation

- Types of Programs
- Laws Applicable to Executive Compensation Programs

Executive compensation is an interdisciplinary practice involving tax, corporate, benefits and securities law, stock exchange rules and corporate governance. The design and negotiation of employment agreements, severance agreements and cash and equity-based incentive programs come under the rubric of an executive compensation practice. This primer will focus on these items and describe how they fit into the executive compensation universe.

## Types of Programs

### Stock Options

A stock option represents a grant to a service provider of a right to acquire a specific number of shares of company stock at a future date, but at an exercise price fixed on the grant date. The exercise price is virtually always equal to or greater than the stock's fair market value on the grant date. Basically, there are two types of stock options: incentive stock options (ISOs) and nonqualified stock options (non ISOs). As described below, there are certain tax advantages to employees who receive ISOs, however certain restrictions apply to these grants. First, ISOs can only be granted to employees (not to non-employee directors or consultants), and the option exercise price for the ISO must be at least equal to 100 percent of the fair market value of a share of the company's stock underlying the ISO determined on the date the option is granted (110 percent in the case of an individual who is a 10 percent owner of the company). Secondly, an ISO may not be exercised later than 10 years after the grant date (five years in the case of 10 percent owners of the company). ISOs may not be exercised later than three months (one year in the case of a termination of employment due to disability) after the option holder's termination of employment other than due to his or her death. Lastly, common stock will be deemed to be acquired under an ISO only with respect to the first $100,000 of common stock (valued on the date of grant) first exercisable in any one calendar year. Thus, if under an ISO the participant vests in the right to acquire more than $100,000 shares of common stock in any one calendar year, the excess number of shares will not be deemed to have been acquired under an ISO.

The grant and exercise of an ISO will not be taxable events to either the employee or the company. If the stock acquired by exercising the ISO is held for the longer of two years from the grant date or one year from the exercise date, any increase in stock value over the exercise price will be treated as a long-term capital gain on the date the stock is sold. It should be noted, however, that the exercise of an ISO is an item of tax preference for alternative minimum tax purposes.

The grant of a non-ISO is not a taxable event. However, on the exercise date, the excess of fair market value over the exercise price is treated as ordinary income to the option holder and is, therefore, deductible by the company. Any subsequent sale of the stock acquired by exercising a non-ISO will be a capital transaction, resulting in either short-term or long-term capital gain or loss depending upon the circumstances.

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### Stock Appreciation Rights

Upon the exercise of a stock appreciation right (SAR), a participant will receive the difference between the common stock's fair market value and the base value multiplied by the number of shares with respect to which the SAR is exercised. Payment may be in cash, in shares of the company's stock (with a fair market value equal to such cash amount), or in a combination of cash and shares. SARs may be in the form of freestanding SARs, tandem SARs or a combination of the two. The base value of a freestanding SAR shall be equal to the fair market value of a share of the company's stock on the grant date. The base value of a tandem SAR shall be equal to the exercise price of the related option. The term of any SAR can be determined by the company, provided that the term of any tandem SAR that is linked to an ISO may not exceed 10 years.

Freestanding SARs may be exercised upon such terms and conditions as are imposed by the company and set forth under the SAR award agreement. A tandem SAR may only be exercised with respect to the stock to which its related option is exercisable. Tandem SARs granted in connection with an option will expire no later than the option expiration date and may only be exercised when the share's fair market value exceeds the option exercise price. Furthermore, the number of shares that may be acquired under the related option will be reduced by the number of shares to which the tandem SAR is exercised.

### Restricted Stock (Performance Shares)

Shares of stock transferred to a participant that are subject to forfeiture if certain employment requirements or other vesting requirements are not met are referred to as Restricted Stock. The period during which such requirements are in effect is hereinafter referred to as the "restriction period." Restricted stock may be granted in such amounts and subject to such terms and conditions as determined by the company.

Generally, restricted stock may not be sold, transferred, pledged, assigned or otherwise alienated or hypothecated until the end of the applicable restriction period or upon earlier satisfaction of such other conditions specified by the company.

Individuals holding restricted stock usually exercise full voting rights during the restriction period but do not typically receive regular cash or stock dividends. Dividends otherwise payable during the restricted period are credited to the individual's "dividend account" and are subject to the same restrictions on transferability and forfeitability as the restricted stock shares to which they relate (i.e., the dividends will be distributed from the dividend account as the underlying stock vests).

Performance shares are similar to restricted stock shares except that the performance shares vest upon the attainment of certain company-wide or individual performance goals and targets and not solely upon the passage of time.

### Restricted Stock Units (Performance Units)

A restricted stock unit (RSU) represents a promise to deliver one share of stock at a predetermined future date. RSUs are subject to forfeiture in the event certain employment requirements or other vesting requirements are not met. RSUs may be granted in such amounts and subject to such terms and conditions as determined by the company.

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**Cash-Based Incentives**

Under the terms of a cash incentive grant, certain individual, financial or other company-related performance goals and targets must be met in order to determine (1) the amount of cash payable to the participant and (2) the vesting of the cash incentives. The company sets performance goals, which depending on the extent to which they are met during the performance periods, will determine the value of cash incentives paid to participants.

Participants will generally receive payments of the cash incentives at the end of the applicable performance period. In certain situations, prior to the beginning of each performance period, participants may elect, or the company may determine, to defer receipt of payout on such terms as the company deems appropriate.

**Deferred Compensation**

Generally, deferred compensation is composed of any amount, whether cash, stock or other property that is paid to a service provider (generally, an employee or consultant) in a year subsequent to the year in which the amount is earned. For many years, the Treasury Department has tried to rein in how deferred compensation programs were designed and, in 2004, it successfully lobbied for the enactment of Section 409A of the Internal Revenue Code (see discussion below). Section 409A imposes very strict, detailed and often inconsistent rules as to how deferred compensation can be structured and when the deferred compensation can be paid. Nevertheless, deferred compensation programs continue to play a major role in benefiting many corporate executives.

**Employment Contracts / Severance Agreements**

Despite (or maybe in spite of) a nascent trend among compensation consultants and ISS to downplay the need for employment contracts, the vast majority of corporate executives still have certain written employment guarantees. Clearly, the most controversial and, accordingly, most important aspects of a written employment agreement are the provisions dealing with severance and payments upon a change in control of the company. In today's environment, severance payments are usually limited to 18 months to two years salary and bonus and are payable upon an involuntary termination in the absence of cause or a voluntary termination for good reason. "Golden parachute" arrangements (payments made upon a change in control of the company) are often "double trigger" in that both a change in company control and an involuntary termination of employment (or a termination for good reason) must occur in order for enhanced severance to be paid. Generally, golden parachute arrangements provide for up to three years of salary and bonus, usually payable in a lump sum upon termination.

Since the severance provisions call for a payment or payments on a date subsequent to the contract date, they can be subject to the provisions of Section 409A.

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Employment contract severance provisions (or in a stand-alone severance agreement) must be carefully drafted to avoid the application of 409A or, if such avoidance is not possible, ensure compliance with Section 409A requirements.

## Laws Applicable to Executive Compensation Programs

**Sarbanes-Oxley, Dodd-Frank and Executive Compensation**

Section 304 of Sarbanes-Oxley provides that the chief executive officer and chief financial officer of a publicly traded company shall reimburse the company for any bonus or other incentive-based or equity-based compensation as well as any profits from company stock sales received in the 12-month period following the filing of a financial report that is materially non-compliant with financial reporting requirements due to company misconduct, and that requires the company to prepare an accounting restatement.

Dodd-Frank imposed new requirements on the securities law aspects of executive compensation, including: (1) say on pay and say on parachute; (2) independence of members of compensation committees, compensation consultants, legal counsel and other advisers; (3) rules regarding disclosure of pay for performance and pay ratios (i.e., the ratio of an executive's pay to the average of the pay received by all employees); (4) rules requiring clawbacks of executive compensation in certain situations; and (5) hedging by directors and executives to protect against a decrease in market value of employer stock.

**IRC Section 83**

Section 83 of the Internal Revenue Code (IRC) governs the taxation of property transferred for the provision of services. Generally, Section 83 provides that the property will be taxable to the service provider (and a related deduction will be allowed to the payor) when the property becomes transferrable or free from a substantial risk of forfeiture.

A classic example of Section 83 property is restricted stock (see page 3). Under a restricted stock program, company stock is transferred to an employee or other service provider subject to forfeiture if employment (or other service provider's relationship with the payor) is terminated prior to a specific date.

Section 83(b) allows individuals who receive restricted property to take the property into gross income on the grant date, not the vesting date. Therefore, a Section 83(b) election will be useful only if (1) the service provider expects significant growth in the property value during the restriction period and (2) he or she reasonably expects to remain employed by the company (or maintain a consulting relationship with the company) through the end of the restriction period.

**IRC Section 162(m)**

Applicable to publicly traded corporations, Code Section 162(m) places a $1 million annual tax deduction limit on certain corporate officers' and highly compensated employees' compensation. Exceptions apply to this limitation, the most important being the "performance-based compensation" exception. Generally, performance-based compensation includes a bonus to which payment is subject to the satisfaction of certain pre-established and objective performance goals and targets. Stock options and stock appreciation rights automatically satisfy the performance-based

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compensation exception if (1) the exercise price of the option or SAR is no less than the fair market value of the underlying shares of stock on the grant date and (2) the plan under which the options/SARs are granted specifically limit the number of options or SARs that can be granted to any one executive in any one year. The rules governing the exceptions to the deduction limitation are quite detailed and should be carefully addressed in the event that any publicly traded corporation executive is expected to receive salary, bonus and equity and/or cash incentive compensation in excess of the $1 million limitation on an annual basis.

**IRC Sections 280G and 4999**

Section 280G of the IRC sets forth the "golden parachute" provisions applicable to publicly traded and certain privately held corporations. If parachute payments are conditioned upon, or are related to, the change in control of the employer (and if such payments equal or exceed 300 percent of the executive's "base compensation amount"), the amount of the parachute payments in excess of 100 percent of the executive's base compensation will not be deductible and will be subject to a 20 percent excise tax under Code Section 4999. Very detailed rules govern (1) how practitioners are to determine which amounts are conditioned upon or are related to the change in control and (2) how these amounts are valued. The 280G rules do not apply to privately held corporations if the holders of at least 75 percent of the corporation's voting stock approve the parachute payments. However, the rules governing how the vote must be taken, and the identification of those stockholders who must receive notice and voting rights, are very complicated and must be handled in a deft manner.

**IRC Section 409A**

For the last few years, compliance with the requirements of Section 409A of the IRC has been one of the most vexing problems with which executive compensation practitioners have had to deal. Section 409A provides that "nonqualified deferred compensation" (generally, compensation paid in a taxable year beginning after the taxable year in which the executive obtains a legal right to the compensation) can only be paid upon specific events, including: separation from service, disability, death, vesting, a specific time (or pursuant to a fixed schedule), the occurrence of an unforeseeable emergency or upon the change in control of the employer. A failure of an employment agreement or other plan or program providing for deferred compensation to follow the Section 409A rules will result in severe tax penalties being imposed upon the service provider (i.e., the executive). These penalties include the immediate taxation of amounts that may not be transferred to the executive until a point in time in the future, an additional 20 percent penalty tax and certain interest penalties. The Section 409A rules are very complex and, in some cases, counterintuitive. Great care should be taken when drafting any type of deferred compensation arrangement, including employment contracts, severance agreements, and equity and non-equity incentive plans, to ensure adherence to these rules in order to avoid the draconian tax impact resulting from a failure to adhere to section 409A's requirements.

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### IRC Section 422

Section 422 sets forth the rules described above for incentive stock options.

### SEC Filing Requirements

A corporation subject to SEC registration requirements may register securities offered under any employee benefit plan or "interests" in these plans by use of Form S-8. The transactions covered by a Form S-8 filing are offers and sales to the registrant's employees or employees of a subsidiary or parent. For these purposes, an individual is considered to be an "employee" if he or she is a common law employee, director, officer, general partner, consultant or adviser of or to the corporation (or parent or subsidiary). Certain offerings are exempt from the SEC registration requirements. The most useful of these is the Rule 701 exemption, which allows privately held corporations to sell securities to their employees without registration if the following rules are satisfied: (1) during any 12-month period the aggregate sales price cannot exceed the greatest of (A) $1 million, (B) 15 percent of the total assets of the issuer or (C) 15 percent of the outstanding amount of the class of securities being offered and (2) if the aggregate sales price exceeds $5 million during any 12-month period, certain disclosures must be made to the purchasers.

### SEC Disclosure Requirements

Regulation S-K governs compensation disclosure requirements. These disclosure requirements include (1) information regarding the compensation paid to "Named Executive Officers" (including the CEO, CFO, the next three most highly compensated officers and up to two additional individuals with respect to whom disclosure would have been required had they been executive officers at the end of the last completed year) and directors, (2) the "Compensation Disclosure and Analysis" and (3) say on pay (say on golden parachute) provisions. New contracts and plans are described on Form 8-K, which is immediately filed with the SEC. Copies of such new contracts and plans are attached as exhibits to the next following Form 10-Q or 10-K.

### SEC Rule 16b-3

Generally, Section 16 of the Securities and Exchange Act requires that the profits earned by an officer, director or more than 10 percent owner of a publicly traded corporation from purchases and sales, or sales and purchases within a six-month period, must be disgorged to the corporation (the so-called "short-swing profits rule"). However, compensatory awards made to corporate directors and officers will be exempt from this rule if the grants are made by a committee composed solely of two or more "non-employee directors" or by the full board (Rule 16b-3).

### Accounting Issues

ASC 718 (issued by the FASB in December 2004) provides that stock awards will generally be governed by "equity accounting" rules (i.e., that stock grants, stock options, restricted stock, RSUs, stock settled SARs, and cash-settled SARs will be

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expensed based on the value of the underlying stock on the grant date). The expense will be computed using a "fair-value-based" method. For stock options, this generally requires the use of a Black Scholes or binomial method. Certain rules apply in determining whether equity or liability accounting (where the expense is measured at the grant date and remeasured at fair value at the end of each reporting period until the award is settled or expires) is applied. The most common factors that require liability accounting are (1) the use of "immature" stock (i.e., stock held for less than six months) for the exercise of an option or (2) allowing an employee to "put" the shares back to the company within six months of vesting or delivery.

**Exchange Listing Standards**

The NYSE and NASDAQ, among other exchanges, have adopted exchange listing standards that set forth the rules that each company listed on the applicable exchange must satisfy. Among the rules are requirements of director independence and equity grant restrictions (i.e., that stock options, etc., must be granted by a committee composed of independent directors). Each exchange's specific rules should be reviewed to ensure compliance. It is important to note that Section 952 of Dodd-Frank requires, in part, that the exchanges must adopt certain rules regarding director independence and the independence of compensation committee consultants, attorneys and other advisers.

**ISS Recommendations**

Many institutional advisers rely on ISS, Glass Lewis and other proxy advisory firms for advice as to whether to vote in favor of directors, executive compensation (via the advisory "say on pay" vote") or for the approval of new equity and non-equity compensation plans for directors and officers. These firms have established their own standards and requirements for issuing "vote for" recommendations; thus, it is incumbent for each public company to initiate a dialog with ISS and the other firms to help avoid recommended votes "against" a director or directors or a compensation program.

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As previously mentioned, this is only a basic primer on executive compensation matters. It is important to consult an experienced attorney before entering into any employment contract or severance agreement and before designing and implementing any cash or equity based bonus or incentive program.

For more information, please contact:

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