Topics in Corporate Governance: Techniques in Equity Compensation

Class 2: Overview of Techniques Continued: Non-Qualified Plans and Synthetic Equity

August 6, 2018
6:30 to 9:30 PM

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What is a “Non-Qualified Plan”?

An Employer Sponsored Plan that is not a “Qualified” Plan is a Non-Qualified Plan.

Legal Factors Affecting Non-Qualified Stock Plans

- Broad Exemptions exist with regard to ERISA, Securities and corporate law for non-qualified plans.
- Coverage can be very selective
- Primary Restrictions relate to tax treatment - limiting deferral of income and tracking deductions to the sponsor (New IRC Section 409A)
- Federal and State Securities Laws may apply (subject to exemptions)
- No Real Fiduciary Considerations in Non-Qualified area – generally in the framework of settlor functions

What Are the Basic Types?

- Stock Grants (Direct)
  - Stock Bonuses
  - Restricted Stock Bonuses
- Stock Purchase Programs (Direct)
  - Section 423 Plans
  - Limited Stock Offerings
- Stock Option Plans (Indirect)
  - Incentive Stock Options (ISOs)
  - Non-statutory Stock Options (NSOs)
- Synthetic Equity

Direct Ownership Tools

- Non-qualified Stock Bonus Plans
  - Gifts of Stock
  - Tax implications For Co. and Participant

- Restricted Stock Plans
  - Add Transfer Restrictions
  - Add Forfeitability
  - Control Tax Impact
  - Section 83(b) election

Direct Ownership Tools

- Stock Purchase (Section 423) Plans
  - Can Provide up to 15% Discounts Without Tax (accounting issues remain)
  - Must Be Broadly Available
  - Generally Limited to Public Companies
    - *Securities Registration Likely Required

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Section 83(b) Election

- If a Participant elects to take value of equity incentives into income in the year they are granted, the gain on eventual exercise and sale will be treated as long term capital gains.

•Reward:

  - Potentially Lower Taxes
  - Potentially Greater Benefit to Participant

•Risk:

  - Stock doesn't appreciate (or worse declines in value)
    - Taxes paid on value that is never received
  - No mechanism to recapture taxes previously paid

Indirect Ownership – Stock Options

- An option is an agreement to buy or sell a specific security (shares of stock) at a specific time in the future (the term) for a pre-set amount of money (the strike price).

  - An Option:
    - Obligates the seller (optionor) to sell
    - And creates a right for the buyer (optionee) to buy.

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Incentive Stock Options

- **ISO (Incentive Stock Options)**
  - Very Selective
  - Must be granted at FMV (or 110% of FMV if granted to 10% shareholders)
  - Potentially Capital Gains For Recipient
  - Shares must be held 1 year from exercise and 2 years from date of grant.
  - No Deductions for Company.
  - Must be a Plan approved by shareholders.
  - May not exceed 10 year term (5 years for 10% Shareholders).
  - Cause Alternative Minimum Tax issues for holders when exercised.

Non-statutory Stock Options

- **NSO (Non-Statutory Stock Options)**
  - Very Selective.
  - Can be Granted at Discounts (with tax to participants and deductions to the company equal to the discount).
  - Generally, Cause Ordinary Income for Participants equal to difference between the exercise price and the fair market value at the time of exercise.
  - Deductions for the Company for Excess of Value at Exercise over the Exercise Price.
  - Can be Designed to Virtually any Specifications.

An Intriguing Alternative…

- **Stock Settled Stock Appreciation Rights (SSARs)**
  - Somewhat Less Restrictive Accounting Issues
  - Same General Economic outcome as NSOs
  - Generally, Cause Ordinary Income for Participants at Time they are converted to stock.
  - Cause Less Dilution because they cause the issuance of fewer shares.
  - Can be Designed to Virtually any Specifications.

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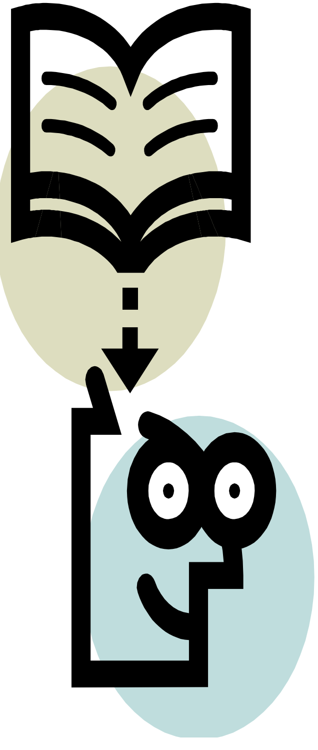
Stock Option Plan Design Decisions

- **Business Objectives – Why Offer Options?**
  - **Compensation Substitute (aka Merit)**
  - **Performance Incentive**
  - **Performance Reward**
  - **Other?**



- **Population Target – Who will Benefit?**
  - **Key Employees? (Define…)**
  - **Management/Supervisory**
  - **Broad Based**

Basic Option Design Decisions

- **Pricing – What Will Employees Pay?**
  - **FMV**
  - **Discount**
  - **Premium**
  - **Indexed Price**

- **Vesting – When Will Benefits Be Non-Forfeitable?**
  - **Immediate**
  - **Graduated**
  - **Cliff**
  - **Class year**

Basic Option Design Objectives

- **Events of Liquidity**
  - **Sale of Business**
  - **Achievement of Specific Goals**
  - **Time Sensitive**

- **Liquidity Vehicles**
  - **Company Earnings**
  - **Internal Market**
  - **Sale Proceeds**
  - **IPO**

Common Settlement Choices

- **Cash Proceeds**
  - Options are exercised; stock is sold; strike price is paid to optionor; tax withholding is deducted; cash proceeds are paid to optionee.

- **Sell to cover (aka Cashless Exercise)**
  - Optionee directs the optionor to exercise all options and immediately sell enough shares to allow it to receive the strike price and to cover tax withholding. Excess shares are issued to Optionee.
-

Other Less Common Settlement Choices

- **Exercise and Hold**
  - Optionee pays cash to optionor to acquire specified shares. All shares are issued to optionee.
    - ISO – No automatic income tax to optionee; AMT calculation may create alternative minimum tax at time of exercise; if held one year or more the entire gain over strike price is Capital Gains.
    - NSO – Ordinary income tax on gain at time of exercise; no AMT issues; if held one year or more, Capital Gains treatment on gains over exercise price.

- **Stock Swap**
  - Optionee surrenders shares already held as payment for strike price; option shares are issued to optionee.

- **Reload Rights**
  - As Options are exercised, some plans provide that new options will be issued.

Case Study for Discussion

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Infinite Multiple Corporation

Skeleton: Public company. 20,000 employees. Technology industry. Multinational locations.

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Skeleton: Public company. 20,000 employees. Technology industry. Multinational locations.

Flesh: Company has proprietary technology in R & D. Project is behind schedule by 3 months. Stock value is severely depressed. Key employees are beginning to flee to competitors.

Overview of Techniques: Synthetic Equity

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What is Synthetic Equity?

- Programs that compute current, deferred or incentive compensation with reference to the value of employer stock are generally called synthetic equity plans.
- These may fall in the category of "non-qualified deferred compensation" plans subject to IRC Section 409A

"Maybe synthetics will do!"

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Statutory and Regulatory Factors

- Broad Exemptions exist with regard to ERISA, Securities and corporate law for non-qualified plans.
- Coverage can be very selective
- Primary Restrictions relate to tax treatment - limiting deferral of income and tracking deductions to the sponsor (New IRC Section 409A)
- Federal and State Securities Laws may apply (subject to exemptions)
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Why Use Synthetic Equity?

- Operational Form – LLC, LLP, S-Corporation, Partnership, Sole Proprietorship (No Stock), Non Profit, Governmental Entity
- Organizational Issues – Division, Department, subsidiary or affiliate
- Ownership Concerns – Family Business, Ownership Restrictions, Licensing/Bonding Issues
- Control/Governance Issues – Synthetic Equity Interests generally do not carry voting rights
- Selective Participant Group
- Flexibility

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Synthetic Equity: Equivalent Ownership

- Phantom Stock – Cash bonus predicated on the value of stock
- SAR (Stock Appreciation Rights) – Cash bonus predicated on the growth in the value of stock
- Performance Units – Cash bonus predicated on the achievement of a specific performance target
- Restricted Phantom Stock Units – Cash bonus predicated on the value of stock earned by the occurrence of specific events

Other (Potentially) Synthetic Equity Interests

- Warrants – earned or purchased right to acquire stock at a future date for a predetermined amount – often attached to stock purchases or investments

- Deferred issuance stock rights – earned right to shares at a future date or upon achievement of future objective.

- Deferred Compensation Plans of an almost infinite variety (but the common objective is to channel some of the equity of the company to specific individuals, usually with favorable tax treatment).

Synthetic Equity Design Decisions

- What is the objective of the plan?
- Who are you trying to benefit?
- How much equity are you willing to make available for the purpose?
- Do you intend for employees to benefit from the current value of stock? The future growth in stock value? Some other performance measure?
- What is the long-term commitment to fund? Cost considerations?
- Liquidity Events?

Key Plan Features

- **Objective of awards:** ___________________________________

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- **Holding Period/Vesting/Forfeiture:** _______________________

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- **Liquidity Features:** _____________________________________

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- **Voting and Governance Rights (if any):** ____________________

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- **Dividend Rights (if any):** _________________________________

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Funding Non-Qualified Synthetic Equity

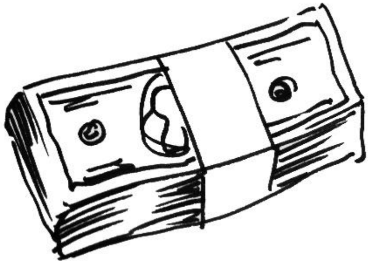
- Cash Flow: Simply fund benefits as they become due out of corporate income and cash-flow

- Allocated Account in Treasury: Save cash in an investment account held in the name of the company

- Rabbi Trust: Create a separate trust within the company treasury allocated for the purpose of funding benefits but subject to the company's creditors – not taxable to employee

- Secular Trust: Create a separate trust off the books of the company not subject to the claims of the company's creditors – taxable to the employee

- Insurance: Tax sheltered investment vehicle



Section 409A – Deferred Compensation Rules

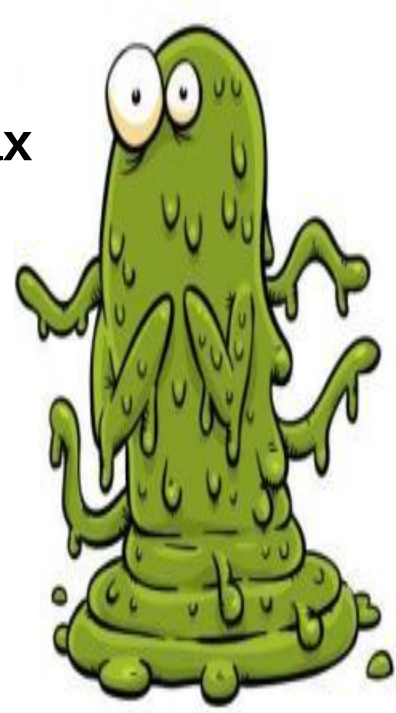
- **Compensation that is earned may only be deferred to a specific point in the future under the terms of a written plan:**
  - Death, disability, change in control, unforeseen emergency, fixed (or definitely determinable) date as specified in the plan

- **Elections for deferral may only be made prior to the tax year in which the compensation would otherwise be taxable (or within 30 days of the date the award is made if in the first year of deferral**

- **For performance based incentives, the election must be made earlier than 6 months before the end of the performance period**

- **Benefit payments may never be accelerated once the election is made**

- **May only make one election in any 12 months and must defer income for at least 5 years**



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Section 409A – Programs Covered

- ESOPs and other qualified plans are NOT covered by 409A
- Incentive and Non-Statutory Stock Option Plans are NOT covered by 409A
- SARs are NOT covered by 409A if they are granted at current fair market value
- Restricted stock that does not contain any compensation deferral feature is NOT covered by 409A
- Phantom Stock, restricted stock units, performance units and any other deferred compensation programs ARE covered by Section 409A
- Violation could result in retroactive taxability

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Valuing Equity Interests – Available Guidance

Gold Standard – Independent Professional Valuation

- Asset Value (Liquidation Value)
- Capitalize Historical Earnings
- Comparable Public Companies' Trading Value
- Known Transactions
- Discounted Future Cash Flow

Good Faith Valuation by Board

- Reasonable Formula
  - EBITDA Multiples
  - Multiples of Adjusted Book Value
  - Industry Conventions

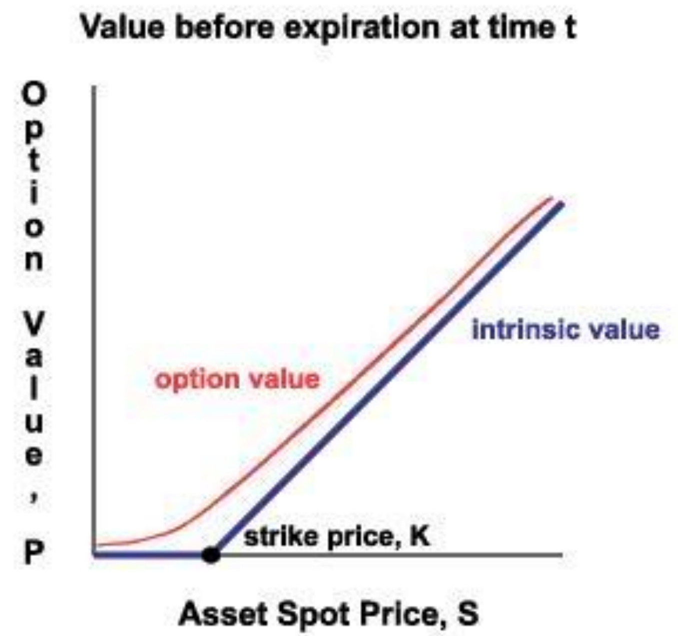
Rev. Rul. 59-60 "Willing Buyer and Willing Seller"

Valuing Equity Compensation – Corporate Issues

- In Public Companies, the market sets the value.
  - Restrictions or preferences alter

- In Closely held companies, the Board of Directors may set value.
  - Formulae for setting value
    - Independent appraisal
    - Accepted Methodologies
      - Black-Scholes
      - Binomial Models
      - “Reasonable Standard”
        - (IRC Section 409A)

- Unreasonable standards
  - Folklore
  - Book Value



Valuing Equity Incentives - Employee Issues

- How Many Options Granted?
- Vesting Period?
- Strike Price (Cost)?
- Capitalization (How Many Shares Outstanding)?
- Market Value?
- Term to Liquidity?
- Liquidity Options?
- Risk?

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Case Study for Discussion

Case Study - Benefit Gurus Incorporated

Skeleton: Small regional employee benefit plan administrator; 1 principal owner in his 40s; 15 years of decent profitability; $3 million in revenue; 35 employees; very high turnover.

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Skeleton: Small regional employee benefit plan administrator; 1 principal owner in his 40s; 15 years of decent profitability; $3 million in revenue; 35 employees; very high turnover.

Flesh: Owner wants to grow the business in order to sell to larger company; Owner has political aspirations and no real love for the pension administration business; more ????

Guidelines for Case Study Analyses

Stakeholder: ____________________

- Objectives:

- Strategy Alternatives:

- Tactics:

- Measurement: