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Breaking Up Can Be Hard To Do: Practical Advice on How to Use Carrots and Sticks in Executive Compensation Arrangements to Recruit and Retain Top Talent During Good Times and Protect the Company When the Relationship Falters

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Why Carrots and Sticks?

- Difficult to attract and retain key management personnel.
- Executive talent often lured away by publicly held companies offering company stock (equity) as a key component of total compensation.
- While equity in private companies cannot be traded on a stock exchange, there are many ways private companies can provide long-term equity or equity-type incentives.

When is executive compensation an effective carrot?

- Understand and use motivation of individual executives to create effective retention tool.
- Best talent may look for other opportunities if long term prospects for future rewards seems uncertain.

How can executive compensation be an effective stick?

- Restrictive covenants in employment agreements are difficult to enforce at best, and unenforceable in some states.
- Forfeiture of deferred compensation for breach of restrictive covenant in executive compensation arrangement is usually enforceable.

What restrictive covenants to use?

- Breach of covenants results in forfeiture of some or all compensation.
- Typical covenants include:
  - Forfeiture for termination for cause or voluntary quit;
  - Violation of non-compete provision;
  - Violation of non-disclosure provision;
  - Violation of non-solicitation provision; and
  - Violation of non-disparagement provision.

When is the carrot effective for the employer?

- Aligns the executive compensation program with business and leadership objectives.
- Does not fall into the trap of "prevailing market practices" (unless they meet your objectives).
- External practices and viewpoints inform plan design, but internal objectives drive program design and delivery.

How to incent short-term performance?

- **Short term performance:** Can often be measured with "lag metrics" such as revenue, earnings growth and total shareholder return.
- These metrics often reflect successful performance of current products and services in existing markets and applications.

How to incent long-term performance?

- **Long term, future performance:** Is often best motivated and measured through "lead" or "driver metrics" such as revenue from new products or new markets, revenue mix.
- These metrics measure successful development of new products or services, different or complementary applications, and new markets.

How to manage risk?

- Make sure incentive plans do not create material adverse risks.
- Combine short and long-term incentives for balanced approach.
- Use multiple-performance measures.
- Use caps, clawbacks, anti-pledging and anti-hedging (if applicable to equity awards).

How to build the perfect carrot?

- Measure and reward performance that drives business plan achievement.
  - Identify performance measures that have greatest impact on long-term value creation.
  - Include a balanced set of measures (revenue growth is great, but earnings are necessary too!)
- Time performance expectations and reward payouts to your business cycle (do you need a longer performance period or vesting period?)

When is the carrot tasty to your employee?

- Reward must be aligned with employee's motivation.
- A senior executive who can influence company policy may be more motivated by stock options or SARs (she can impact growth and earnings).
- A mid-level manager who cannot influence policy may be better motivated and retained with restricted stock or phantom stock.

Other motivational considerations?

- How close to retirement is the executive?
- What percentage of executive/incentive compensation is vested/unvested?
- Is value of vested deferred compensation significantly higher than annual direct compensation?
- Does your company's performance make an equity-type award attractive (if not, try SERP)?

What makes an effective stick?

- Restrictive covenants are not enforceable without adequate consideration.
- Should be given in consideration for grant of executive compensation (not added later).
- Documentation should clearly state that company is giving compensation in consideration for employee giving restrictive covenants.

What else makes my stick effective?

- Add remedies that go beyond forfeiture of award.
- Specific performance of restrictive covenants with the right to pursue injunctive relief in addition to money damages.
- Add transfer restrictions; rights of repurchase or first-refusal.
- Require restricted stock to be escrowed together with stock-transfer powers.
- Add exclusive choice of law and venue provisions.

What carrots can we use?

- **Stock Options:** The right to purchase a share of stock at a set exercise price.
- **Restricted Stock:** A grant of stock which vests over some period of time or upon attainment of certain goals.
- **Phantom Stock:** A right to payment (usually in cash) based upon the value of the Company’s stock.
- **Stock Appreciation Rights (SAR):** A right to a payment (usually in cash) based on the appreciation in the value of the Company’s stock.
- **Other Deferred Compensation Programs:** Supplemental Executive Retirement Plans (SERPs), Incentive Bonus Plans, Split-Dollar Life Insurance Agreements.

Stock Grant versus Option Grant

- **Restricted stock:** Permits employee to earn a share of stock over some period of time through continued service or accomplishment of stated goals.
- **Stock option:** Gives employee the right to purchase a share of stock.
- **Phantom Stock:** For employee -- similar economic incentive to restricted stock.
- **Stock Appreciation Right (SAR):** For employee -- similar economic incentive to stock option.

Restricted Stock/Options versus Phantom Stock/SARs

- **Phantom stock and SARs:**
  - Employee never becomes a stockholder.
  - Provide an economic incentive if the company's stock performs well without giving all the rights of a stockholder.
  - Subject to liability accounting (as opposed to equity accounting) and remeasurement of fair value is required at each reporting date until all award units are settled.

Restricted Stock/Options versus Phantom Stock/SARs

- **Restricted Stock and Options (once exercised):**
  - Employee becomes stockholder with voting rights and records inspection rights.
  - Management will have a fiduciary duty to stockholder-employees which it did not previously have.
  - Value of the award at the date of grant will be recognized over the vesting period with partial offsets for compensation deductions (except ISOs).

Restricted Stock/Phantom Stock

- 1,000 shares of restricted stock are granted.
- A share is worth $10 on date of grant.
- Employee has received stock worth $10,000 on the date of grant.
- If the stock increases to $20 per share, then employee has received $20,000 in value.
- If the stock decreases to $5 per share, then employee has received value of $5,000.

Options/SARs

- Option to purchase 1,000 shares of stock issued to employee at exercise price of $10 per share (the fair market value of a share on the date of grant).
- Option has no value on date of grant because it would cost employee $10,000 to buy stock worth $10,000.
- If stock doubles to $20 per share, then employee could purchase $20,000 of stock for $10,000, for $10,000 profit.
- If stock decreases to $5 per share, then employee has received no value (an “underwater option”).

SERPs/Bonus Plans/Split-Dollar Life

- **SERPs:** A long term cash incentive plan payable at retirement age, and often at death, disability, or on certain other severance events.
- **Incentive Bonus Plans:** Typically structured to provide short or medium-term incentives.
- **Split-Dollar Life Insurance:** A death benefit which can be structured to provide disability and lifetime retirement benefits.

Other planning considerations?

- **Tax consequences to employer:** Can employer take compensation deduction (ISO) and if so, when?
- **Tax consequences to employee:** When is compensation recognized, and is it ordinary income or long or short-term capital gain?
- **Other regulatory considerations:** IRC 409A, IRC 162(m), ERISA, banking regulations, Dodd-Franks.
- **Expense to company:** How much, how to calculate and when is it incurred?
- **Federal and state securities laws:** Is it a security?

Considerations for Multinationals?

- Under final regulations now in effect under the Foreign Account Tax Compliance Act (FATCA), multi-national employers that sponsor non-US retirement plans may be required to register those plans with the IRS as Foreign Financial Institutions (FFIs) and comply with certain FATCA withholding and reporting obligations unless exempt.
- Not all non-US retirement plans will qualify as FFIs, as there are several useful exemptions available. To use any exemption, the plan must affirmatively claim it through the filing of a Form W-8BEN-E
- Implementation delayed!

UK carrots?

- Methods of incentivising employees:
  - Overview of Share Plans;
  - EMI;
  - unapproved share options;
  - equity incentivisation; and
  - ‘phantom’ schemes
- Entrepreneurs’ relief
- SEIS and EIS

Type of Share Plans

	Share options	Share ownership
Discretionary	EMI, CSOP, Unapproved	LTIP, PSP, Split ownership
All-employee	Sharesave	SIP

Enterprise Management Incentives

- Share options
- Right to buy in the future on specific events:
  - Sale of company
  - Listing
  - Employee performance targets
  - End of vesting period
- Scheme qualifies for tax relief under Schedule 5 of The Income Tax (Earnings and Pensions) Act 2003
- Option exercise price fixed at date of grant
- No minimum period between grant and exercise

EMI 2 – HMRC Requirements

- Employee working 25 hours or, if less, 75% of working time per week
- No material interest in the company (30%)
- Qualifying company:
  - Qualifying trade
  - Companies with UK presence
  - Not an excluded activity
  - £30m gross assets test
  - Fewer than 250 employees
- Fully paid ordinary shares
- Shares in a company not under the control of another company
- Individual limit: up to £250,000 worth of shares under option (increased in June 2012
- Company limit: £3m worth of shares

Unapproved Share Options

- Higher limits
- More flexibility re. shares (such as shares in a subsidiary) or treatment of leavers (exercise at director’s discretion)
- Subject to income tax and NIC on exercise
- Ability to transfer employer’s NIC to employee
- PAYE to be collected within 90 days of exercise

Tax Treatment

	EMI	Unapproved options
Option price	£10,000	£10,000
Value on exercise and sale	£50,000	£50,000
Gain	£40,000	£40,000
Income tax and NIC	Nil	£20,112 or £23,560
Subject to CGT	£40,000	Nil
Annual exemption	£10,600	N/A
Taxable capital gain	£29,400	Nil
CGT (assume 28% or 10%*)	£8,232 £2,940	Nil
Net gain (40% taxpayer)	£31,768 £37,060	£19,888
Net gain (45% taxpayer)	£31,768 £37,060	£16,440
Corporation tax saving (24%)	£9,600	£9,600

*10% CGT rate available for options exercised on or after 6 April 2013, subject to 12 month holding period since date of grant

Phantom Share Schemes

- A real hybrid
- No allotment of shares needed
- No changes to constitution needed
- No dilution of voting, income or capital of existing shareholders
- Taxed as income not capital – less advantageous for the employee

Equity: Objectives

- **Considerations for the Board:**
  - *"Let's incentivise our key executives via a share scheme, we will all benefit from them having some skin in the game…"*
  - General objective is to ensure any increase in the value of the shares whilst held is taxed as capital and not income – minimising tax charges over life of ownership of the shares
  - The benefit: current rates of tax:
    - **income tax:** 45% for higher rate from 6 April 2013
    - **CGT:** 28% - subject to Entrepreneurs' Relief too

Equity: Growth Shares

- *"What kind of shares can we allot to our executives…?"*
- New class of share – issued at market value applicable to those shares
- Only participate in future growth of the company
- Little or no right to dividend – usually only pay out on an Exit Event
- The aim is to deliver the economic and tax benefits of an option structure for both the company and the executive, outside an option scheme

Equity: Growth Shares

- **Advantages:**
  - Aim to secure capital gains tax treatment (28%), rather than income tax liability (45%) on growth value of the shares
  - Executive will usually only pay nominal value to acquire the shares
  - No limit on number of shares that can be awarded
  - No requirement to offer to all employees
  - Shares are owned by the executive on day one
  - Can be implemented back to back with option scheme

Equity: Growth Shares

- **Downside:**
  - Prior valuation of the company
  - Degree of risk on the tax treatment – changes to tax legislation – anti-avoidance targeting tax planning
  - Amendments to the constitutional documents of the company – new class, voting, income, capital rights and leaver mechanisms
  - Amendments must be registered with Companies House – unlike option schemes which are private agreements
  - New class of shares must be established if further round of growth shares to be allotted
  - Professional advice needed – new class/allotment

Equity: Flowering Shares

- **Difference :**
  - **Growth Shares** holder only benefits from growth in value of company
  - **Flowering** – holders participate in value of the company if and when specified performance condition is met "*Flowering Event*":
    - the company exceeding a specified profit target
    - minimum exit price on disposal of the company's business or the company itself
- Possible risk of tax charge on flowering shares if the flowering event is interpreted as a taxable conversion of securities

Equity – Tax anti-avoidance Rules

- Anti-avoidance rules catch:
  - Restricted securities
  - convertible securities
  - securities with artificially depressed market value
  - securities with artificially enhanced market value
  - securities* acquired for less than market value
  - securities* disposed of for more than market value

Entrepreneurs' Relief

- 10% tax rate on gains made by individuals (and certain trustees) of the following:
  - **Shares or securities in a trading company**;
  - The whole or part of a business;
  - Certain assets used in a business which has ceased; and
  - Certain personal assets used in a business.

- Conditions:
  - Company must be a trading company;
  - Individual must own at lease 5% of ord. share capital* allowing him to at least 5% of the voting rights;
  - Individual must be an officer or an employee (full or part-time);
  - Shares must have been held for the requisite holding period (1 year)*
- Lifetime cap – currently £10,000,000

* Law has changed for EMI shares

Seed Enterprise Investment Scheme

- Attractive to equity investors
- Income tax relief:
  - Subject to an annual investment limit of £100,000, the investor's income tax liability for the year is reduced by reference to the SEIS investment
  - An investor investing £100,000 would look to reduce his or her tax liability in that year by £50,000
- Reflects the higher risk when compared with EIS

Seed Enterprise Investment Scheme

- Capital gains tax (CGT) relief:
  - Disposal of the SEIS shares *should* be CGT-free
  - Resulting losses *may* still be available
  - CGT deferral also available

Seed Enterprise Investment Scheme

- Conditions in summary (investor):
  - Investment needs to be for commercial reasons and monies must be raised for the purposes of the trade or the company preparing to trade
  - SEIS shares must be held for at least 3 years
  - Investor (and associates) cannot hold more than 30% of shares/voting rights (NB period runs from incorporation to end of the holding period)
  - Investor should not be an employee (or associated with one) during the holding period, but can be a director (subject to specific rules if paid)
  - No linked loans (nb the Company does not have to be the lender)

Seed Enterprise Investment Scheme

- Conditions in summary (company):
  - Gross assets must not exceed £200,000
  - Must be unquoted and independent* from another company (from incorporation) with no arrangements to become so
  - Cannot raise more than £150,000 in any three-year period
  - Must be carrying on a qualifying *trade*, which does not include:
    - Property development
    - Dealing in shares/commodities
    - Operation of hotels/nursing homes
    - Financial activities/leasing
  - Trade must be less than two years old
  - Must not be in financial difficulties
  - Fewer than 25 full-time employees (i.e. 35 hours per week)

*law changed for shares issued after 6 April 2013

Seed Enterprise Investment Scheme

- Conditions in summary (company):
  - No EIS or VCT investment can have been made prior to the SEIS share issue
  - EIS is permissible within the SEIS period if 70% of SEIS monies have been spent
  - SEIS monies should be spent within three years of the SEIS share issue

Seed Enterprise Investment Scheme

- What can go wrong for the investor (examples)?

- Tax reliefs withdrawn if:
  - Investor becomes an employee when not a director during the holding period
  - Investor exceeds the 30% test
  - Company ceases to meet the qualifying conditions (e.g. if it lists or ceases trading*)
  - Company fails to spend the SEIS monies in time

- Tax reliefs withdrawn/reduced if:
  - Investor sells shares early
  - Investor receives 'value' from the Company

Enterprise Investment Scheme

- Attractive to equity investors
- Pre-dates SEIS

- Income tax relief:

  – Subject to an annual investment limit of £1m, the investor's income tax liability for the year is reduced by reference to the EIS investment

  – An investor investing £500,000 would look to reduce his or her <u>tax liability</u> in that year by £150,000

Enterprise Investment Scheme

- Capital gains tax (CGT) relief:
  - Disposal of the EIS shares *should* be CGT-free
  - Resulting losses *may* still be available
  - CGT deferral also available

Enterprise Investment Scheme

- Conditions in summary (investor):
  - EIS shares must be held for at least 3 years
  - Investor cannot hold more than 30% of shares/voting rights
  - Investor cannot be ‘connected’ with the company in ‘Period A’, which starts before the EIS issue as well as the 3-year holding period:
    - An issue where the investor has been or is an employee or director
    - director ok, subject to specific rules if payment is made
  - No linked loans (nb the Company does not have to be the lender)

Enterprise Investment Scheme

- Conditions in summary (company):
  - Gross assets must not exceed £15m
  - Must be unquoted and independent from any other company
  - Cannot raise more than £5m over a 12-month period (including SEIS)
  - Must be carrying on a qualifying trade, which does not include:
    - Property development
    - Dealing in shares/commodities
    - Operation of hotels/nursing homes
    - Financial activities/leasing
- Must not be in financial difficulties
- Must have fewer than 250 employees
- Monies must be spent within two years (generally)

Enterprise Investment Scheme

- What can go wrong for the investor (examples)?

- Tax reliefs withdrawn if:
  - Investor no longer qualifies (e.g. exceeds 30% test or is connected)
  - Company no longer qualifies (e.g. if it lists, ceases trading* or the trade does not qualify)
  - Company fails to spend the EIS monies in time

- Tax reliefs withdrawn/reduced if:
  - Investor sells shares early
  - Investor receives 'value' from the Company

SEIS and EIS

- Apply to HMRC for advance clearance – investors will take great comfort if they know the company meets the qualifying conditions
- Be in a position to issue the relevant tax certificates at the appropriate time

Considerations for Multinationals in Germany?

- Legal Developments / Discussions in Public
- Treatment of stock options / SAR‘s
- Trends concerning type and content of incentives

Statutory law developments concerning achievement-oriented compensation in Germany

Amendment of statutory German Stock Corporation Act (“GSCA”) by implementation of

- 2002 – transparency and publicity act “Transparenz- und Publizitätsgesetz” – TransPuG)
- 2005 – Act for Disclosure of executive compensation („Vorstandsvergütungs-Offenlegungsgesetz“ – VorstOG)
- 2009 – Act on appropriateness of executive compensation (Gesetz zur Angemessenheit der Vorstandsvergütung - VorstAG)
  - Extensive public discussion about models / scope of executive compensation
  - Reflects sensitivity about executive compensation and its mechanisms
  - Lead to significant changes also for non-listed stock corporations

Current Opportunities for Privately Held Companies

1. **Stock Corporations ("AG")**
   - achievement-oriented compensation permitted (explicitly mentioned in GSCA, sec. 87)
   - equity / non-equity based
   - limits: appropriateness, time-related (4 year standby period), transparency only for publicly listed corporations
   - competence with respect to appropriateness: supervisory board
   - in case of stock options: resolution of shareholders/general assembly (3/4 vote)
   - SAR's: no resolution of shareholders/general assembly necessary

2. **Private limited liability company ("GmbH")**
   - non-equity based: permitted based upon shareholder resolution
   - equity based: highly unusual due to formal "obstacles" (notarization required)

Treatment of stock-options vs. SAR's

SAR (including phantom stocks)

- accrued liability
- balance sheet date: intrinsic value (prevailing view; minority: fair value), carry forward principle

Stock-Options

- company stock: treatment as SAR's
- stock to be issued by conditional capital increase: no reflection in balance sheet (argument: economically born by shareholders)
- at time of execution: equity

Tax treatment of SAR’s vs. stock-options

- share-based compensation is tax deductible for company if regarded as labor costs
- to be taxed by executive as income (independent contractor) at time of execution (actual income)
- consequently: stock-options based on conditional capital increase: due to lack of qualification as labor costs not tax deductible (company)

→ lower thresholds for SAR’s due to
  - no upfront taxation for executive
  - avoidance of requirement of shareholder resolution
  - avoidance of standby period

Trends regarding type/content of incentives

Appropriateness

Components to be considered in respect of appropriateness:

- statutory law (sec. 87 I 1 of GSCA): particular duties of executive; situation of company;
- additional factors scrutinized by courts: qualification, market value, particular situation of negotiation, duration of affiliation with company
- potential consequences if "inappropriate": application of supervisory board for decrease of compensation (filed with competent court), provided
  - fundamental deterioration of company situation
  - severe inequity

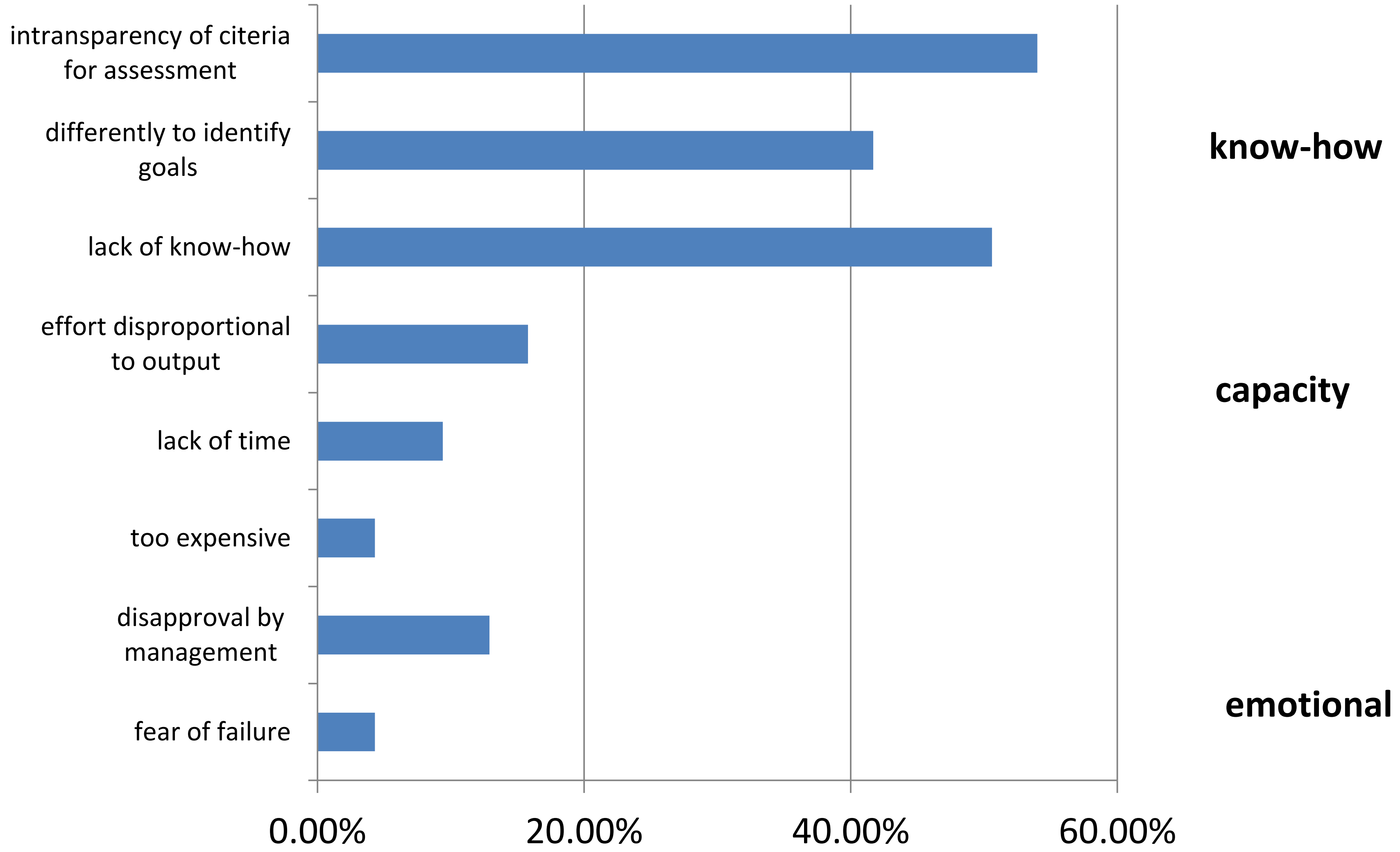
Trends regarding type/content of incentives (Part II)

Keyfindings (study of Milz&Comp*):

- main concern / aspect of dissatisfaction regarding incentives is identification of transparent goals/parameters;
- dissatisfaction increased if substantial part or entirety of components based upon qualitative "soft" criteria;
- unsufficient implementation of classic components (profit, marginal income) has negative impact upon satisfaction of executives;
- variable component below 10% of income has negative effect upon company

* Study of Milz&Comp GmbH, "Leistungsorientierte Vergütung im produzierenden Mittelstand", Präsentation Auszug Ergebnisse, 2011

Reasons for non-implementation of achievement-oriented compensation

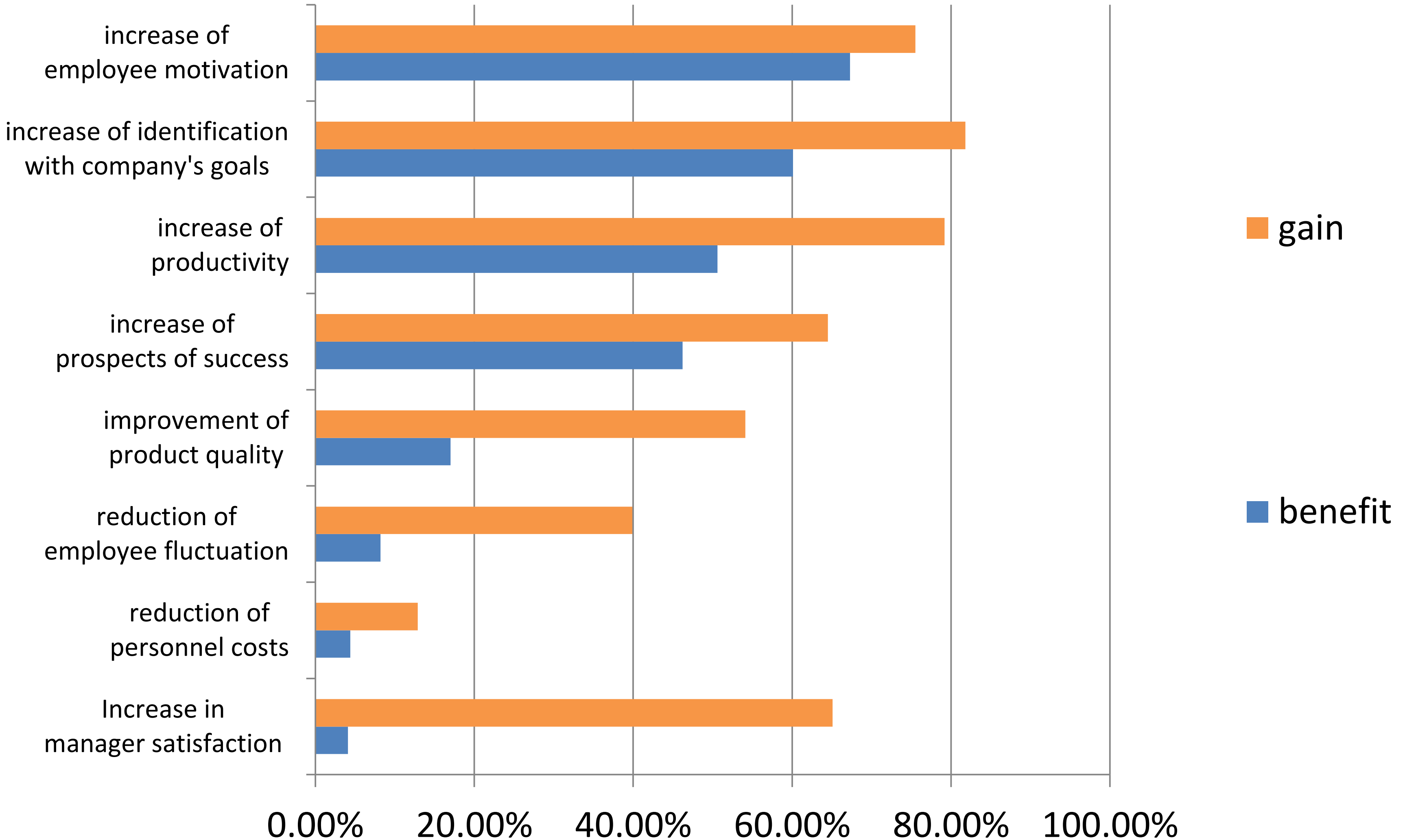


Source: Milz & Comp. GmbH

Balance of individual and board/team-oriented incentives

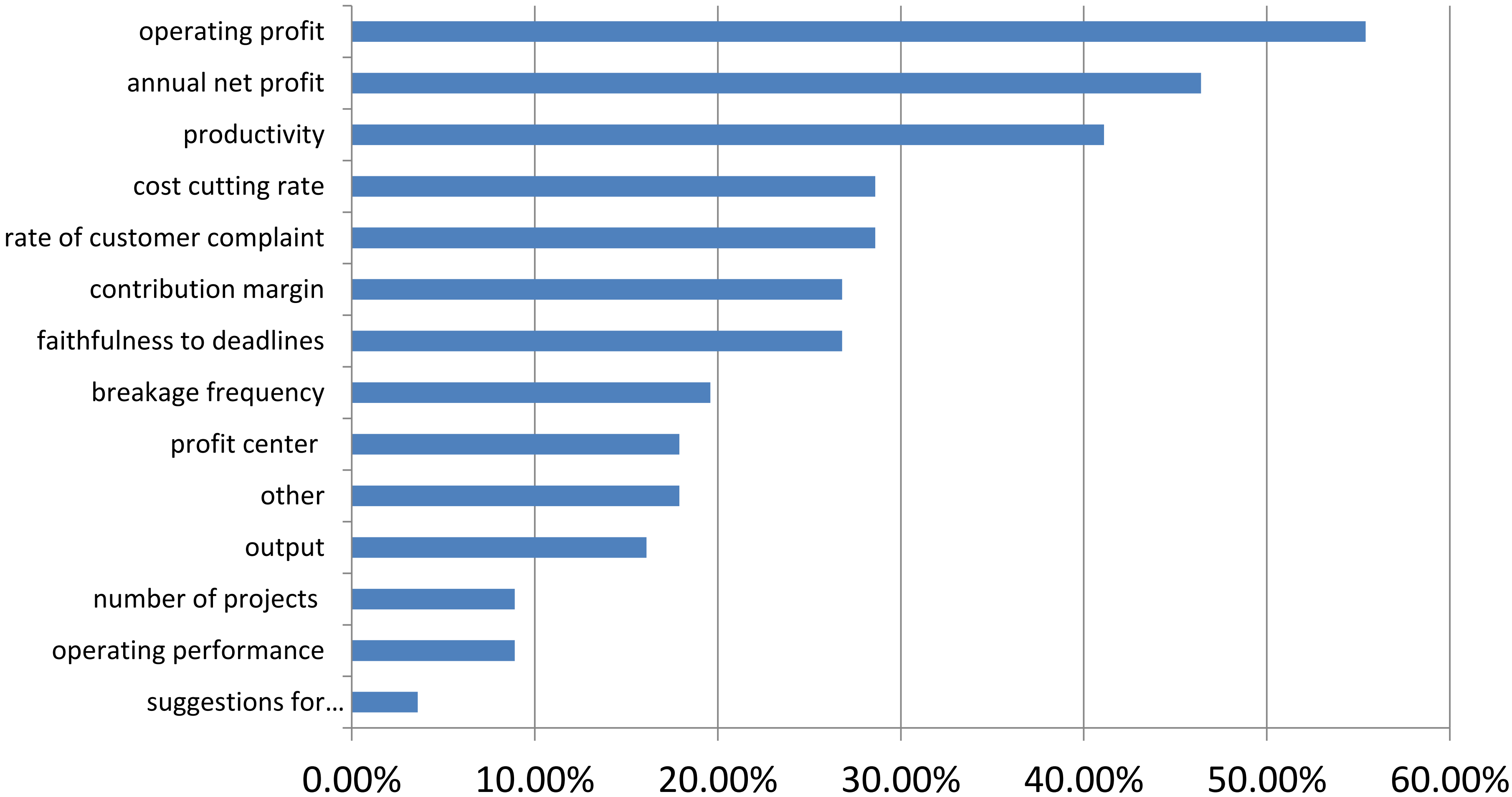
- individual incentives may encourage individual focus instead of milestones that require management board teamwork
- issue of loyalty towards company
- balance of benefits vs. risks involved

Goals and benefits of implementation for achievement – oriented compensation



Source: Milz & Comp. GmbH

Bases of assessment for manager (production industry)



Source: Milz & Comp. GmbH

Best practice for design of incentives

- Which corporate milestones are intended to be achieved?
- Which particular incentive serve best to reach these milestones of the company?
- Which achievement parameter serves best as the indicator:
  - to be calculated precisely?
  - only to be achieved by way of excellent performance?
  - any parts which are outside of control of executive?
- possible side effects?