DORSEY
always ahead

Introduction to Executive Compensation

Presented by:

David Marx
Dorsey & Whitney LLP
www.dorsey.com

February 7, 2018

Executive Compensation Elements

- **Cash Compensation**
  - **Base salary**
  - **Short-term incentive compensation**
  - **Long-term incentive compensation**
  - **Excess benefit plans**
  - **Severance**
  - **Change in control severance**
- **Equity Compensation**

Why Equity Compensation?

- Employee ownership is often driven by recruiting and retention needs
- If your company's compensation consists only of cash you may discover that current or prospective employees may accept offers with competing companies that offer equity in addition to cash compensation
- Aside from retention, succession planning may also come into play
- While stock options used to be the most prevalent form of equity compensation for corporations, the trend has shifted toward performance awards for executives and a combination of stock options and restricted awards for directors
- Partnerships generally grant profits interests

3 Key Considerations

- Three key considerations private companies should consider before adopting an equity compensation program:

1. Impact on corporate governance
2. Tax considerations
3. Repurchase liability

1. Impact on Corporate Governance

- "Real" equity – e.g., stock in a corporation, or membership interest in a partnership, typically has participatory rights as well as economic rights.
  - Right to receive financial information
  - Voting and dissenters' rights (including limited statutory voting rights applicable to non-voting classes)
  - Fiduciary duties vis-à-vis treatment of terminated employees
- Buy-sell, repurchase, transfer and other contractual restrictions need to be thought out in advance

1. Impact on Corporate Governance (cont.)

- Securities law compliance (yes, even for private companies!):
  - Offers and sales of securities must be registered (or qualify for an exemption) under both federal and state law
  - Even grants of shares for no purchase price are treated as offers/sales for this purpose
  - Even if exemption from registration applies, disclosure requirements may still apply
  - Some state exemptions are self-effecting; some are not
- Re-sale limitations

2. Tax Considerations

- Ordinary income vs. capital gain
- Companies and their employees should weigh pros and cons of capital gain vs. income deferral opportunities
- Options and Stock Appreciation Rights (SARs) offer flexible exercise timing– allow holder to choose exercise date; exercise and income recognition can be tied to liquidity event
  - Option pricing at FMV is critical to avoid tax penalties
- In contrast, outright share grants are not so flexible – holder cannot choose when to recognize income

2. Tax Considerations (cont.)

- Tax withholding requirements should also be considered
- Withholding requirements often impose significant burdens on private companies and their employees if there is no corresponding liquidity upon income recognition event
- Loans and/or promissory notes may be used to address situations where income must be recognized prior to liquidity event

2. Tax Considerations (cont.)

- Partnerships and LLC structures raise significant tax issues for employee owners. Below are some key things employees should consider before taking membership interests:
  - Form K-1 reporting of the LLC's taxable income; no Form W-2 reporting
  - Members are responsible for making estimated tax payments; no federal income tax should be withheld
  - Members are responsible for reporting and paying self-employment taxes ("SECA"); no FICA tax should be withheld
  - Impact on certain employee benefits

2. Tax Considerations (cont.)

- Tax Reform eliminated deductions pursuant to Section 162(m) for public companies
- Tax Reform made changes to the individual alternative minimum tax
- Public companies may move away from performance-based compensation to incentive stock options or other forms of compensation

3. Repurchase Liability

- Generally no market exists for privately held shares absent sale or similar liquidity event
- Employees are often subjected to limitations on transfer to 3rd parties (both by operation of securities law and/or shareholder agreement)
- Company may be hesitant to offer employees put rights short of a sale situation unless legally required to do so
- Company must assess the retentive/incentive value of an equity award in terms of its exit opportunity versus the company's exposure to repurchase liability

Issues for Public Companies to Consider

Shareholders given a greater say:

- Say on pay (approval of compensation set out in proxy).
- Say on frequency of pay (approval of frequency of say on pay vote).
- Say on golden parachutes (approval of transaction-related compensation).

Issues for Public Companies to Consider (cont.)

- Clawbacks – Must provide for recoupment of incentive compensation if accounting restatement due to material noncompliance with financial reporting requirements.
- Compensation Committee & Advisors
  - Independence
  - Funding for advisors.
  - New NYSE & NASDAQ listing standards
- Pay ratio disclosure – CEO vs. median employee.
- Pay vs. performance – Compensation paid vs. company's financial performance.
- Director limitations on compensation

Long-Term Incentive Plan Design

Real Equity
- Full-Value Shares (Restricted Stock, Performance Shares, Capital Interests)
- Appreciation Rights (Stock Options, SARS, Profits Interests)

Phantom Equity
- Full-Value (Cash-settled share units)
- Appreciation Rights (Cash-settled SARS)

Long-Term Cash
- Multi-Year Bonus
- Sale Bonus

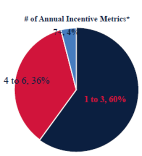
Design Considerations

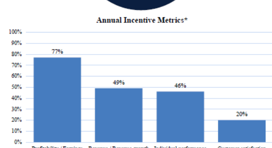
Shareholder Issues
- Minority Shareholders
- Participation in Shareholder Value Creation/Alignment with Shareholder Interests
- Tag/Drag

Incentive Objectives
- Line of Sight to Operating Performance
- Retention

Annual Incentive Plan Design Design Features*

- Nearly all companies have annual incentive plans (94%)
- Discretionary plans are relatively prevalent as well (40%)
- Majority of companies use 1-3 metrics in their AIPs
- Most prevalent metrics are earnings (e.g., profit, income) and revenue
- Almost half of companies also use individual performance measures

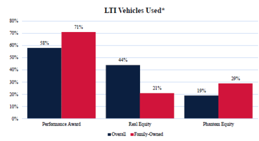


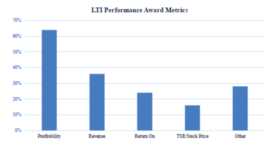


*Source: Word@Work 2016 Private Company incentive Practices Survey (n≈200 private for-profit companies)

Long-Term Incentive Plan Design
Design Features*

- Approximately 50% granted LTI awards in 2015
- Family-owned companies are much less likely to use real equity
- Performance awards typically linked to profitability or revenue goals over a multi-year period
- Participation is typically limited to CEO and top executives, with minimal usage at lower levels





*Source: Word@Work 2016 Private Company incentive Practices Survey (n≈160 private for-profit companies; design features based on companies with an LTI Program n≈80))

Private Equity Funds
Teaming up with Management

A Private Equity Fund ("PE Fund") invests in portfolio companies typically for 5-7 years.

- PE Funds typically use a mix of annual cash bonus and long-term equity.
- The principal purpose of the equity is to retain the management team through exit.

Due Diligence of Compensation Arrangements

- The PE Fund will diligence the compensation arrangements of management prior to the execution of the purchase agreement. Diligence includes reviewing the following:
  - Employment agreements
  - Equity grants
  - Bonus plans
  - Severance arrangements

Compensation Elements

- **Base Salary** – Generally, a PE Fund will want to keep the base salary in the same range unless there is a material change in duties of the executive or the salary range is not market.
- **Cash Bonus Plan** – Payouts are tied to performance metrics such as EBITDA
  - Bonus levels for the CEO and direct reports will be a higher percentage of base compensation than lower level employees.
  - Individual goals may be more heavily factored in the bonus targets for lower level employees, whereas the financial performance of the portfolio company predominates the criteria for senior management.

Compensation Elements (cont'd)

- **Long-Term Equity Incentive Compensation** – Used to align interest of management with PE Fund.
  - There will typically be a large one-time grant to management of a portfolio company upon initial acquisition of the portfolio company
  - Equity grants to management of a portfolio company typically have no liquidity until IPO or other exit

The Top Management Equity Issues

1. Size of incentive equity pool and type of equity awards (typically 5%-12%)
2. Allocation of time vesting v. performance vesting performance metrics
3. Cashless exercise of options
4. Accelerated vesting on termination of employment
5. Existence/extent of puts and calls
6. Fair market value determinations; ability to dispute
7. Restrictive Covenants

Vesting Criteria

- Awards are often a mix of time vesting and performance vesting. Typically, management employees receive both.
- Time-based vesting is typically four to five years.
- Vesting may occur upon certain terminations of employment and typically will occur on an exit/change in control.
- Performance-based formulas will depend on purpose and will closely align the objectives of management with that of the PE Fund

Liquidity Issues

- Upon exercise of options or vesting of restricted stock, employee will enter into a shareholder agreement or subscription agreement with the company containing provisions regarding the treatment of the shares, including:
  - Calls – provides the company with the right to call stock upon any termination of employment
  - Puts – may provide the employee or his or her estate the right to put the stock to the company in the event of retirement, death or disability
  - Tags, drags and rights of first refusal; and
  - Transfer restrictions, voting proxies.

Importance of Restrictive Covenants

- Restrictive Covenants are important to protect business value. Restrictive covenants are often requested of an executive in consideration for equity awards, in connection with an employment agreement or simply as a condition to employment. These include:
  - Non-Compete (appropriate scope and duration);
  - Non-Solicitation (employees, customer and/or suppliers);
  - Confidential Information;
  - Non-Disparagement; and
  - Rights to inventions and developments made while an employee.

Protections to Rank and File Employees

- Rand and File Employees:
  - Generally do not participate in equity arrangements.
  - May participate in annual cash bonus plans where goals may be more individualized.
  - May be afforded severance protection through a severance plan
  - Generally receive past service credit for vesting and participation (but not benefit service under a defined benefit plan) for new plans instituted by the portfolio company after acquisition.

Mechanics in Implementing Equity Plan

- Board action to adopt the plan.
- Shareholder approval of plan, if necessary
- Board or compensation committee action to approve awards.
- Use of deal price, internal and external valuations.
- Prepare offering documents – including plan agreements, loan agreements, if any, subscription agreements and disclosure documents.
- Obtain tax elections (Section 83(b) elections for restricted stock and partnership profits interests).
- Confirm securities law approach – Rule 701 and other exemptions.
- Coordinate Blue Sky filings.
- Maintain share certificates and registry.

Questions?

David Marx
(801) 933-7363
marx.david@dorsey.com