

# Executive Compensation & Benefits in a Start-Up Environment

---

PANEL 3

MATT CLYDE



# Our Team

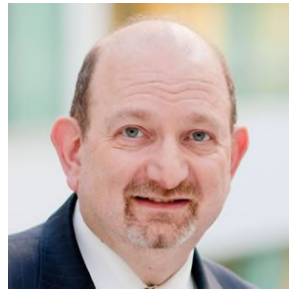
---



Matt Clyde  
(Pittsburgh)



Lynn Brehm  
(Charlotte)



Jay Dorsch  
(Philadelphia)



Jenna Schaffer  
(Philadelphia)



Rob Kaplan  
(Philadelphia)



Anne Greene  
(Pittsburgh)



# How Are Executives Compensated?

---

## Cash Compensation

- Base salary
- Short-term incentive compensation
- Long-term incentive compensation
- Excess benefit plans
- Severance
- Change in control payments / severance

# How Are Executives Compensated?

---

## Equity Compensation

- Stock options (non-qualified options and incentive stock options (ISOs))
- Stock appreciation rights (SARs)
- Restricted stock
- Restricted stock units (RSUs)
- Phantom stock
- Performance shares
- Performance share units (PSUs)

# How Are Executives Compensated?

---

- Benefits and Perquisites
    - Benefits and perquisites (“perks”) supplement the pay packages of many senior executives.
    - Executive perquisites may include:
      - Automobile allowance;
      - Relocation benefits;
      - Supplemental retirement benefits;
      - Tax gross-ups; and
      - Tax and financial planning services.
    - Significant NEO perks must be disclosed and excessive perks will be subject to scrutiny.
- REVIEW**

# What Laws Govern Executive Compensation?

---

- State laws are often preempted by federal law.
- Federal laws to watch out for:
  - Employee Retirement Income Security Act (ERISA)
  - Internal Revenue Code
    - Section 401(a) – “tax qualified” retirement plans
    - Section 162(m)
    - Section 280G
    - Section 409A

## Section 280G - Overview

---

- Potentially applies if a payment to an executive is triggered upon a change in control or sale of the company's assets (i.e. a "golden parachute").
- Imposes a 20% excise tax on "golden parachute" payments.
- Golden Parachute payments = payments greater than 3x executive's base compensation.
- Applies to both private and public companies – but does not always apply to partnerships, LLCs or S corporations.
- Excise tax can be avoided if there is special shareholder approval of the parachute payment.

# Section 409A - Overview

---

- Section 409A applies to compensation that is earned in one year but which is paid in a later year (i.e. “nonqualified deferred compensation”).
  - Applies to employees, directors, and independent contractors.
  - 409A failure results in 20% additional tax
- Covers a broad range of situations
  - Employment Agreements & post-employment payments
  - Severance Plans & Separation Plans
  - Reimbursement Arrangements
  - Deferred Compensation Plans
  - Short and Long-Term Incentive Plans
  - Nonqualified Stock Options Plans
  - Equity Plans & Phantom Equity Plans
  - Does not apply to tax-qualified plans (e.g. 401(k), 403(b), 457 plans)



## Section 409A - Basic Rules

---

- Restrictions on the timing of deferral elections
  - In general, prior to the year in which services are performed
  - For nondiscretionary performance-based bonuses, election may be made during the performance period, before the last 6 months in the period
  - Election must specify amount deferred, and time and form of payment
- Permissible Payment Events
  - Must be paid only upon certain events:
  - Separation from Service (not always the same as a termination of employment), including retirement or termination
  - Change in Control – Note: Does not include IPO
  - Specified Date, including a specified age
  - Disability/ Death/ Unforeseeable Financial Emergency - Note: Does not include college tuition

## Section 409A - Exemptions

---

- Short-term Deferral Exemption: Compensation must be paid no later than 2 ½ months after the end of the year in which the right to payment vests.
- Separation Pay Plan Exception: 2x base salary paid within 2 years of an involuntary separation from service can be exempted from 409A.
- Options: Stock options can be exempt from 409A if the exercise price is equal or greater to fair market value at issuance (i.e. the options are not “in the money” upon grant).

## Section 409A – Common Pitfalls

---

- Late deferral elections.
- Delay or acceleration of payment date.
- Company or employee discretion when to make or receive a payment.
- Impermissible definition of a payment event:
  - Change in control
  - Separation from service
- Payments to “specified employees” of publicly-traded companies – 6 month delay from separation from service.
- Consulting arrangements post employment.

# Overview of Common Types of Executive Compensation

---

- Each type of executive compensation has different pros and cons.
- Not all types of executive compensation are available or well-suited for all types of corporate structures.
- There is significant flexibility in designing an executive's compensation structure (not subject to rules that apply to tax-qualified retirement plans like 401(k) plans).

# Base Salary

---

- If a start-up Company cannot afford the executive's base salary, a portion of the salary can be deferred to a later date.
  - Watch out! deferring salary to a later date can easily trigger 409A coverage.
  - The deferred amount must be subject to a real risk of forfeiture.
  - The payment date for any deferred salary must be set with specificity and not subject to company or employee control.
- What if the company still cannot afford the deferred salary when it is due?
  - There are ways to make a subsequent deferral, but strict rules must be followed under 409A.

# Short-term & Long-term Incentive Compensation

---

- The company has enormous flexibility in setting vesting rules, performance metrics, service requirements and payment terms.
- Generally it is best to structure the arrangement so that payment is made shortly after the vesting occurs to take advantage of the short-term deferral exception to 409A.
- Payments can be made in cash or equity.
- It is important to have a good plan document.

# Excess Benefit Plans / SERPs

---

- Sometimes called a Supplemental Executive Retirement Plan (SERP).
- Usually structured so that employees can defer more than is otherwise allowed under a tax-qualified retirement plan (e.g. 401(k) plan).
  - 401(k) plans are limited to \$20,500 in employee deferrals and \$58,000 in total contributions (both employee and employer) in 2022.
- Excess Benefit Plans are generally “unfunded” and restricted to a “top hat” group of management or highly compensated employees – otherwise it will become an ERISA plan.

# Excess Benefit Plans / SERPs

---

- Pros:
  - Employee is not taxed until benefits are distributed.
  - Enormous flexibility establishing vesting rules and restrictions on payments.
  - The employer does not have to “fund” the benefit until it is due (Note: some executive employees negotiate a “Rabbi Trust”).
  - The benefit can be structured as a defined, monthly benefit that will be forfeited if the employee does not abide by restrictive covenants post-employment.
- Cons:
  - Cannot be offered to a broad group of employees or the arrangement will become an ERISA plan.
  - Usually creates a long-term company liability.
  - Company does not get a tax-deduction until benefits are paid to the employee.
  - Fairly cumbersome to administer.



# Change in Control Payments

---

- The benefit can be variable and determined based on the transaction price / share price.
- Can be structured as single-trigger or double-trigger vesting.
  - Single-trigger: right to payment vests upon a change in control
  - Double-trigger: right to payment vests upon a change in control AND the executive being terminated in connection with the change in control.

# Change in Control Payments

---

- Pros
  - Very useful in motivating executive employees to work to make the company marketable to a buyer.
  - Cost of plan is essentially bore by the buyer.
  - Can be used as a type of “poison pill” to help prevent hostile takeovers.
- Cons
  - Usually subject to 409A.
  - Uncertainty that benefit will actually be paid (i.e. a CIC may never occur).

# Stock Options

---

- Difference between non-qualified options and incentive stock options (ISOs).
  - Tax treatment
  - Non-qualified options: employee is taxed when options are exercised and the employee purchases the shares (ordinary tax rate)
  - ISOs: employee is taxed when the shares are sold by the participant (capital gains tax rate)
- Requirements for ISOs:
  - Shareholders approval – an ISO plan must be approved by the shareholders with within 12 months of the date the ISO plan is adopted by the board of directors.
  - Grant rules – ISOs must be granted within 10 years of the date the plan is adopted by the company or approved by the shareholders (whichever is earlier).
  - Holding rules - If an employee exercises an ISO, the shares must be held at least one year from the date of exercise AND two years from the grant date.
  - Exercise rules – exercise price cannot be more than FMV as of the grant date (i.e. the option cannot be “in the money” upon grant date) AND the exercise period cannot be more than 10 years.

# Stock Options

---

- Pros
  - Are cost-effective (the company gets a tax deduction when the holder exercises a non-qualified stock option).
  - Enables employees to participate in the company's growth and thereby align their interests with those of shareholders.
  - Can offer tax benefits to employees (especially ISOs).
- Cons
  - The tax treatment is complicated and can be difficult for employees to understand.
  - Tend to reward aggregate rather than individual performance (unless individual performance-based vesting criteria are added).
  - If the company's stock is not appreciating, options are not a strong retention tool.
  - The employee must come up with the money to pay the exercise price to receive the benefit.
  - Options can be difficult to value.
  - Company valuations can be cumbersome/expensive.
  - Shareholder dilution can occur.
  - ISOs cannot be issued by LLCs.

# Stock Appreciate Rights (SARs) / Phantom Stock Plan

---

- Basic Structure: the company promises to pay employees the appreciation in market value of shares (measured over a specific time period).
- SARs and Phantom Stock Plans are essentially bonus plans tied to the share price of the company.
- SARs and Phantom Stock plans are usually subject to a vesting schedule.
- The payout can be in cash (most common approach) or stock.

# Stock Appreciate Rights / Phantom Stock Plan

---

- Pros
  - Unlike an option plan, employees do not have to come up with cash to exercise stock options.
  - Can be paired in tandem with a stock option plan to provide employees cash needed.
  - Simple to administer.
  - Does not dilute outstanding share value.
- Cons
  - Tend to reward aggregate rather than individual performance (unless individual performance-based vesting criteria are added).
  - If the company's stock is not appreciating, SARs are not a strong retention tool.
  - Company valuations can be cumbersome/expensive.

# Restricted Stock

---

- Basic Structure: an award of company stock that is subject certain restrictions until it vests; once the restricted stock vests, the stock is no longer “restricted.”
- The most common restrictions during the vesting period are: (i) non-transferability and (ii) forfeiture if there is a separation from service.
- The shares are fully issued at the time of the grant and provide immediate value to the employee.
- The value of restricted stock is subject to taxation when the restricted stock vests (ordinary tax rate), unless an 83(b) election is made.

## Restricted Stock (cont'd)

---

- What is an 83(b) election?
  - It is an election to pay taxes (ordinary tax rate) on restricted stock when it is first granted (i.e. before it vests).
- Why would an employee want to make an 83(b) election to pay taxes on restricted stock before it vests?
  - It allows the employee to pay taxes when the value of the stock is low (i.e. when it is granted) and not owe any taxes when the stock vests (and the value of the stock is, presumably, higher).
- Are there risks to making 83(b) elections?
  - Yes. If an employee makes an 83(b) election and pays taxes when granted restricted stock, if the employee never vests and forfeits the restricted stock, the employee will have paid tax on stock that was forfeited (i.e. taxed on income that was never received). UGH!
- Are there timing rules for when an 83(b) election must be made?
  - Yes. An 83(b) election must be made (filed with the IRS) within 30 days of an employee being granted restricted stock.



# Restricted Stock

---

- Pros
  - There is no exercise price and therefore restricted stock has no risk of going "underwater." Unlike stock options, restricted stock continues to have value even if the stock price declines.
  - Provide a significant retention factor because restricted stock will almost always have value and will never be "underwater."
  - Do not require employees to come up with money to pay an exercise price.
  - Do not require a company valuation / appraisal.
- Cons
  - Reward only aggregate company growth and not individual performance.
  - If an 83(b) election is filed and the restricted stock never vests, the employee will have paid income tax on restricted stock that was never received.
  - Dilutive effect on other shareholders.

# Restricted Stock Units (RSUs)

---

- Basic Structure: the employee receives a right to receive a share of company stock at some later date after the RSU vests.
  - No shares are actually issued upon grant (this is the key difference between RSUs and Restricted Stock).
  - The award is essentially an unfunded and unsecured promise by the company to deliver shares in the future.
- Because there is no stock issued upon grant (just a promise of future stock), 83(b) elections are irrelevant;
- Employees are taxed upon vesting of the RSUs / receipt of the stock.

# Restricted Stock Units (RSUs)

---

- Pros
  - Provide a significant retention factor because the employee receives at least some value once the RSUs vest, even if the company's stock price declines during the vesting period.
  - Do not require employees to come up with money to pay an exercise price.
  - Do not require a company valuation / appraisal.
- Cons
  - Employees generally must pay tax on the award at a time when they cannot sell the shares to cover the tax.
  - Reward only aggregate company growth and not individual performance.
  - Dilutive effect on other shareholders.

# Performance Shares / Performance Share Units (PSUs)

---

- Performance Shares Basic Structure: shares are held in escrow and are subject to forfeiture and transferability restrictions until specified performance conditions are met.
- PSUs Basic Structure: the employee is granted a right to receive a specified number of shares in the future if specified performance conditions are met.
- Performance shares and PSUs are currently the most prevalent forms of performance awards granted to executives.

# Performance Shares / Performance Share Units (PSUs)

---

- Pros
  - Companies can tailor the award to incentivize and reward specific performance criteria.
  - Do not require employees to come up with money to pay an exercise price.
  - Do not require a company valuation / appraisal
- Cons
  - Performance awards will have somewhat less of a retentive effect if it becomes clear during the performance period that the performance criteria will not be met.
  - Employees generally must pay tax on the award at a time when they cannot sell the shares to cover the tax.
  - Dilutive effect on other shareholders.

Thank You

---

[www.cozen.com](http://www.cozen.com)

