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Checklist for Evaluating the Need for a New or Amended Stock Award Plan

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The ever-changing landscape for executive and director compensation places a premium on assuring that employers have suitable stock award plans at their disposal. For many employers, the need comes in the form of more shares, or broader flexibility in the types of available awards. There are many more subtle improvements that employers should consider with respect to their stock award programs, especially in view of escalating governance expectations across the globe.

Set forth below are 15 items that may improve the design or administration of compensatory stock plans. They reflect the broad spectrum of issues that employers have faced in recent years as the result of volatile stock prices, litigation relating to stock awards, and changes in applicable securities, tax, and accounting rules. Although employers may amend existing stock award plans in order to incorporate desired improvements, it is usually preferable to seek shareholder approval for a new stock plan whose design reflects changed laws, increased workforce globalization, e-delivery, and governance practices responsive to the concerns of shareholders and proxy advisory firms such as Institutional Shareholder Services (ISS).

If an employer chooses to amend an existing stock plan, it is worth noting that public companies may need to obtain shareholder approval for many of the possible changes listed below (due to applicable NYSE, AMEX, and NASDAQ rule revisions that took effect June 30, 2003). [1] In addition, an employer usually needs to obtain a plan participant's consent and provide contractual consideration in order to modify an outstanding award in a manner adverse to the participant. [2] The consideration for any or all of these changes could come in the form of a new stock award, if it is conditioned on an express consent of the participant to apply the changes to all outstanding awards.

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[1] *See* SEC Release No. 34-48108 (June 30, 2003).

[2] See, for example, # 4 regarding adding tax code §162(m) limits, # 6 regarding canceling underwater stock options, # 7 regarding eliminating net exercise rights, # 10 regarding adding a forfeiture for cause or clawback provisions, # 11 regarding forfeiture-for-competition, and # 12 regarding mandating arbitration of claims.

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1. Replenishing the Reserve Of Shares for Awards

• *Is your current reserve of shares for stock awards sufficient to cover a two to four year period?*

This should be a threshold consideration, and often justifies proposal of a new plan.

• *Does your plan provide for automatic annual increases in the reserve of shares available for awards, i.e., evergreen provisions?*

• *Do shares subject to cancellation, expiration, or forfeiture become available for new grants?*

Your plan could include any of these provision, but beware of possible stock exchange listing issues, unfavorable reactions from proxy advisory firms, tax code § 162(m) implications, and disqualifying your plan's ability to grant incentive stock options.

2. Expanding the Types of Awards Allowed Under the Plan

• *Does your plan limit itself to stock options?*

It is often preferable for a plan to permit any or all of the following types of awards in addition to stock options: restricted stock, restricted stock units (RSUs), deferred share units, phantom stock, stock appreciation rights, dividend equivalents, and performance awards (in cash or shares).

Note: *Does your company contemplate significant awards to non-U.S. employees?* If yes, consider structuring your plan as a global document that uses sub-plans to establish country-specific terms applicable to particular foreign entities or foreign personnel. For example, provisions that solely reflect U.S. tax laws (such as those applicable to incentive stock options, aka ISOs) can unnecessarily muddy a plan with few if any participants who are U.S. taxpayers.

Also Note: *Do institutional shareholders hold a significant percentage of your outstanding voting securities?* If yes, you should consider including plan terms, such as limits on "whole" share awards (notably restricted stock), in order to be more likely to receive a favorable voting recommendation from proxy advisory firms.

3. Delegating the Authority to Make Awards

• *Does your plan limit grant-making authority to the board or a committee of directors?*

Your plan could permit one or more executive officers to make awards to eligible individuals other than themselves. ***Caveat:*** Check the Securities Exchange Act of 1934 listing requirements and state corporate law. Note that Delaware law expressly authorizes a limited form of delegation.

Note: A delegation provision could help to avoid delays, and potential financial accounting problems, that arise when a company's process for making stock award grants does not result in prompt notice of awards to recipients.

4. I.R.C. §162(m) Exemption— For Public Companies

• *Does your plan include provisions sufficient to permit awards to satisfy the §162(m) exemption for "qualified performance-based compensation"?*

The plan should include provisions satisfying Treas. Reg. § 1.162-27(e), e.g., an annual per person limit on awards. This exemption also requires shareholder approval of the plan at least once every 10 years for plans that hard-wire their formula or number of shares for award. On the other hand, shareholder approval is required at least once every five years if the plan merely permits outside directors to make awards according to a formula that they determine within parameters set forth in the plan.

5. Lifetime Transfers of Awards

• *Does your plan permit a participant to transfer certain awards to family members?*

Lifetime transfers will not avoid income taxes, but offer significant estate planning opportunities for awards that have the potential to appreciate significantly after the date of their transfer. *See* Rev. Proc. 98-34. ***Caveat***: A stock option must be nontransferable in order to qualify as an incentive stock option (ISO). As a result, most plans exclude ISOs from plan provisions allowing lifetime transfers.

6. Canceling Underwater Stock Options, Or Replacing Other Awards

• *Does your plan require that participants consent to the cancellation of stock options whose exercise price is above current fair market value?*

Your plan, or individual award agreements, could include a mechanism for this, and thereby enable you to avoid expensive and time-consuming SEC tender offer filings, which are required if participants must consent to the cancellation. Just be careful to consider the views of proxy advisory firms.

• *Does your plan broadly permit the cancellation and replacement of other awards?*

This provision is generally desirable in order to maximize company discretion over the handling of outstanding awards (either as to individuals, such as when their employment terminates, or as to particular groups). Plan provisions reserving this discretion should be carefully crafted to assure that they do not inadvertently authorize repricings or other replacements that could cause adverse reactions from shareholders, stock exchanges, or proxy advisory firms.

7. Net Exercise Provisions

• *Do participants have "net settlement" rights for taxes and/or for paying the exercise price for stock options?*

It has become commonplace for plans to authorize the net settlement of awards. For participants, net settlements are easier to understand and avoid out-of-pocket cost. Employers benefit from simplifications in the administration of their stock award plans. While the example below focuses on stock options, note that net settlements are just as effective for all other awards (e.g., RSUs).

> EXAMPLE: Suppose a participant holds a non-ISO to buy 100 shares of stock for $20 per share, and desires to exercise when the fair market value is $50 per share. At the time of exercise, the participant will owe the employer cash in the amount of $2,000, representing the $20 per share purchase price for the 100 shares. Assuming a 25 percent tax withholding rate on income from the award, the participant will owe the employer an additional $750, which equals 25 percent of the in-the-money value of the shares at the time of exercise (i.e., $30 per share times 100 shares).
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> A net settlement would enable the participant to avoid paying $2,750 to the employer at the time of exercise. Instead, the employer would "net" shares having a fair market value equal to $2,750 (i.e., 55 shares, at $50 per share). Overall, the participant who exercises a stock option for 100 shares would receive 45 shares, with the employer retaining the other 55 shares — and paying $750 in cash to the IRS to cover the withholding taxes that are due.
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> ***Caveat #1***: A net settlement program for taxes involves having the employer, rather than the participant, provide the cash that is needed in order to pay applicable withholding taxes to the IRS. This is because the employer is basically redeeming the shares needed to pay those taxes. Employers should consequently be careful to consider the cash-flow impact of a net settlement program.
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> ***Caveat #2***: A net exercise provision could also violate the Sarbanes-Oxley Act with respect to participants who are executive officers and directors.

8. Repurchase Rights and Put Options

• *Do your plan or any award agreements reserve repurchase rights for you, or provide participants with put option rights?*

In order to preserve favorable stock-based accounting treatment, you may need to amend these rights, or carefully monitor your exercise of these rights. In a nutshell, a practice of cashing-out awards could trigger liability-based accounting, which essentially involves ongoing 'mark-to-market' adjustments to reflect the potential cost of redeeming outstanding awards.

9. Extending the Post-Termination Exercise Period for Awards

• *Do you wait until someone terminates employment to decide whether or not to extend the exercise period for stock options?*

You may be able to avoid future financial expense and violations of tax code §409A by addressing this issue in the plan or award agreements, either at the time of grant, or when the stock option is not in-the-money.

10. Forfeitures for Cause and Clawbacks

• *Does your plan expressly provide for the forfeiture of awards if a participant's employment* *terminates for "cause"? What about "clawback" rights?*

You may be in for an unpleasant surprise if your plan omits a forfeiture-for-cause provision, and you later seek to enforce one. [3] Clawback rights commonly relate to the recovery of stock award gains in cases that involve a financial restatement arising from executive fraud or misconduct. Nevertheless, the Dodd-Frank Act provides for a no-fault clawback from §16 insiders (though this is not effective until the SEC issues regulations), while the 2008 TARP legislation triggered clawbacks when any mistakes in the application of a performance-based formula resulted in the payment of excess incentives.

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[3] See *Thornton Oil Corp. v. Perconti*, 2003 WL 1340715, 29 EBC 2894 (Ky. Ct. App. Feb. 21, 2003) (unpublished), in which Kentucky's Court of Appeals ordered an employer to pay deferred compensation benefits in excess of $2.5 million to an executive (and board member!) whom a jury found to have committed conversion, fraud, and breach of fiduciary duties. The *Thornton* decision turned on (i) the absence of any forfeiture language in the award agreement, and (ii) accrual of the executive's benefits before his misconduct occurred.

For employers, the best practices involve—

1. designing clawbacks as a complement to forfeiture-for-cause provisions;

2. identifying the key employees whose awards will be affected;

3. deciding what awards will be affected — cash incentives? future stock awards? past awards?

4. broadly authorizing all types of clawbacks, with award agreements to detail what applies; and

5. assuring proper notice to affected participants (through prospectus delivery for public companies).

Caveat: If you are amending outstanding grants to add a forfeiture-for-cause or clawback provision, the amendment probably requires both the participant's consent and lawful consideration.

11. Forfeiture-for-Competition Provisions

• *Does state law pose a threat to the enforceability of your forfeiture-for-competition provisions?*

Employers should expect courts to be reluctant to enforce boilerplate provisions that apply the same noncompetition, nonsolicitation, and confidentiality requirements to all plan participants. Some degree of customization of promises, with attention to applicable state law, will pay huge dividends from an enforcement perspective.

Because Delaware law so frequently controls with precedential sway for other states, be aware of a recent decision stating that judicial enforcement of overly broad noncompetes would put employers in a no-lose situation, and consequently warning that overly broad contract terms will not be blue-penciled (modified) for enforcement. [4] For geographically organized information about various noncompete rules, see http://www.executiveloyalty.org/By_Geographic_Area.html.

ERISA Preemption: Note that your plan and award agreements could position you to argue that ERISA preempts state law. Employers should consider using ERISA to drive stock-related litigation into the federal courts, for resolution under federal common law. This may enable an employer to rely on federal law to enforce forfeiture-for-competition provisions that might otherwise be susceptible to challenge under variant state laws. [5]

Caveat: If you are amending outstanding grants to add a forfeiture-for-cause or clawback provision, the amendment probably requires both the participant's consent and lawful consideration.

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[4] *Delaware Elevator, Inc. v. Williams* (Del. Ch. March 16, 2011) ("a court should not save a facially valid provision by rewriting it and enforcing only what the court deems reasonable. .

. . If an employer knows that a court will enforce a reasonable covenant as a fallback, the employer has every reason to start with an overbroad provision").

[5] See *Tatom v. Ameritech Corp.,* 305 F.3d 737, 744, 28 EBC 2860 (7th Cir. 2002), holding that "Federal cases draw a distinction between provisions that prevent an employee from working for a competitor and those that call for a forfeiture of certain benefits should he do so."

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12. Compelling Arbitration Of Plan-Related Claim

• *Is it your preference to arbitrate stock plan claims?*

Your stock award agreements could condition the award on the participant's consent to mandatory arbitration. ***Caveat***: An employer's employment counsel should assure that any litigation strategy involving arbitration complements the employer's general approach to employment litigation.

13. Maximizing Judicial Deference To Plan Decisions

• *Does your plan secure a deferential standard of review for your decisions, and the broadest possible interpretive powers for plan administration?*

The courts will generally enforce the terms set forth in your plan and award agreements, including a highly deferential standard of review if that is what the plan or award agreement requires. There is recent and convincing Seventh Circuit precedent for applying *Firestone* [6] deference to top hat plans, but only to the extent set forth in the plan. [7] Note that an ERISA plan requires compliance with its claims procedures.

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[6] *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 10 EBC 1873 (1989).

[7] *Comrie v. IPSCO Inc.*, No. 10-2393, 50 EBC 2473 (7th Cir. Feb. 18, 2011).

Caveat: Employers should be careful to follow proper procedures and to develop records showing reasonable determinations whenever plan participants question determinations. Even if an employer has reserved to itself broad discretion to interpret the terms of an employee benefit plans, be aware of the following limitations on that discretion:

(1) the employer's discretion is often "subject to the implied duty of good faith and fair dealing" (*Goldstein v. Johnson & Johnson*, 251 F.3d 433, 442, 26 EBC 1193 (3d Cir. 2001); and

(2) the employer's discretion to construe does not give the employer the authority to redefine terms or undermine an employee's "justified expectations as to what those terms [i.e., cause and without cause] meant" (*Scribner v. Worldcom Inc.*, 249 F.3d 902, 26 EBC 1860 (E.D. Wash. 2001).

14. Amending Awards Without A Participant's Consent

• *Does your plan require that participants consent to any potentially adverse change to outstanding awards?*

Your plan could instead permit the amendment of outstanding awards without the consent of participants, provided your board of directors or the plan's administrative committee determines that the amendment is in the best interest of affected participants.

This subtle change has significance in part because of the SEC's tender offer rules, which could require a Schedule TO filing and full prospectus disclosure if more than a few participants must consent to a particular change in the terms of their awards.

15. Amending Plans Without Shareholder Approval

• *Does your plan require shareholder approval for material changes?*

This type of provision typically derives from a pre-1992 version of the SEC's short-swing profit rule, and is not required. Your plan could consequently reserve broad discretion for the board of directors, with shareholder approval being sought only when required by law or through the board's decision to seek it (e.g., to satisfy stock exchange listing requirements).

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