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EXECUTIVE COMPENSATION

Executive Compensation Planning for Pre-IPO Companies



BY DOREEN E. LILIENFELD AND VERONICA M. WISSEL

Companies considering going public will likely review their compensation programs in connection with their initial public offerings. Public companies are able to make broader use of equity-based compensation, and are required to follow more formal decision-making processes, than their private counterparts. Many executive compensation rules and regulations under the federal tax code and securities laws are applicable to public companies but not private companies. Moreover, there have been significant legal developments in recent years:

Doreen Lilienfeld is a New York-based partner in the Executive Compensation & Employee Benefits Group at global law firm Shearman & Sterling LLP. She has been involved in a wide variety of compensation-related matters and has primary responsibility for compensation and benefits issues relating to corporate finance, private equity and other mergers and acquisitions transactions. Veronica Wissel is a New York-based associate at Shearman & Sterling and a member of the firm's Executive Compensation & Employee Benefits Group.

- The Sarbanes-Oxley Act of 2002 has expanded the liability of CEOs and CFOs for inaccurate disclosure and resulted in complex internal control requirements for public companies;
- The SEC has rewritten a number of times the rules that govern compensation disclosure of named executive officers and requires a narrative in each proxy statement covering the “hows” and “whys” of executive pay;
- New tax rules put significant pressure on issuers to assure that pre-IPO option grants have an exercise price at least equal to the fair market value of the underlying stock at the time of grant;
- “Risk” and “risk assessments” have become the new mantras in assessing the efficacy of compensation arrangements; and
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has added new substantive disclosure requirements and given investors the right to cast say-on-pay votes.

Shareholder advisory groups and institutional shareholders have also become more active in policing executive compensation policies and voting against pay practices and directors at companies that do not measure up to their standards.

With this in mind, companies preparing for an IPO should take steps as early as possible to ensure their compensation programs are in order. The following is an overview of several key issues to consider when preparing for an IPO.

1. Change-in-Control Provisions Take on New Importance

Protecting senior management in a change in control is a common practice in public and private companies. After an IPO, with a company's securities freely transferable on a public exchange, companies are more vulnerable to unplanned takeovers and other change-in-control transactions. And in the event of an uninvented change in ownership, a new owner may be more likely

to terminate senior management. As a result, when companies go public, many revisit their severance and change in control provisions for senior management to ensure that key executives are adequately protected.

Pre-IPO companies should determine which key executives need special change-in-control protection under employment agreements, severance plans, equity plans or other compensation programs, and whether these payments should be “single trigger” or “double trigger.” Single-trigger payments are made upon a change in control of the company, regardless of whether the executive remains employed after the transaction, and double-trigger payments are made only if there is a change in control and the executive’s employment is terminated as a result. Because shareholder advisory groups and corporate watchdogs generally frown upon single-trigger payments, many public companies have moved to double-trigger arrangements.

Public companies have less flexibility to avoid severe tax penalties on certain change-in-control payments to senior management under Section 280G of the Internal Revenue Code of 1986, as amended (the “Code”). Section 280G of the Code and its companion, Section 4999, impose a 20 percent excise tax on “excess parachute payments” and limit the employer’s tax deduction for these payments.¹ Private companies can avoid these adverse tax consequences if, contemporaneously with a transaction, the payments are voluntarily put at risk by the executives and approved by 75 percent of the company’s shareholders. Since this exception is not available to public companies, pre-IPO companies must consider the tax and cost implications of their new and existing change-in-control arrangements.

Companies take different approaches to planning for potential Code Section 280G issues. Some companies incorporate 280G “cutbacks” into their compensation arrangements, such that change-in-control payments to any individual will be reduced to the extent necessary to avoid triggering Section 280G. Section 280G “gross-ups” that make executives whole for the excise tax liability incurred in connection with an excess parachute payment have come under pressure in recent years due to the strong disfavor of gross ups by shareholder advisory firms.

Regardless of which approach is taken, companies should identify their change-in-control compensation strategy when preparing for an IPO and ensure all compensation plans and agreements work together and are aligned with the strategy. Companies’ compensation disclosure should also provide a rationale for their approach to change-in-control payments and Section 280G issues.

¹ Section 280G of the Code is implicated when the aggregate amount of change-in-control payments made to a “disqualified individual,” which includes directors, officers, highly compensated individuals and certain significant shareholders, equals or exceeds three times such individual’s “base amount,” which is the individual’s five-year average W-2 compensation. If Section 280G of the Code is triggered, then any amount that exceeds one times the “base amount” is considered an “excess parachute payment” and is subject to the 20 percent excise tax on the individual receiving the payments and loss of deductibility for the paying company.

2. Corporate Governance Rules Require a More Formalized Compensation Process

Public companies are subject to many corporate governance rules that are not applicable to private companies. Accordingly, the procedures relating to executive compensation and equity programs will likely change significantly after an IPO. The company’s compensation committee will have to be comprised of independent members, and the committee will be required to take on a more active role in designing and administering the company’s compensation programs.

Many private companies make executive and equity compensation decisions at the level of the full board of directors. However, because of public companies’ broader use of equity compensation and the enhanced duties and responsibilities of a public board of directors, public companies often delegate most compensation decisions to their compensation committees. In addition, several rules relating to compensation applicable to public companies require a committee of independent directors to make certain compensation decisions for the company:

- Under the Nasdaq and New York Stock Exchange listing rules, a committee of independent directors must take certain actions regarding executive compensation.
- Section 162(m) of the Code (described further below) requires a committee of independent directors to administer certain performance-based compensation, and specifically to set the performance goals at the start of the fiscal year and certify whether those goals have been met at the end of the fiscal year.
- Under Section 16 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), equity grants may be exempt from the short-swing profits liability if they are approved by a committee comprised solely of “outside directors.”

For these reasons, companies preparing for an IPO should take the following steps to ensure that their compensation committees are appropriately organized and prepared for their role in the public company:

- Analyze compensation committee members under all of the relevant independence standards. Each of these independence standards is different, and the Section 162(m) and Section 16 rules are generally more restrictive than the Nasdaq and NYSE rules.
- Brief compensation committee members about the various rules and requirements under Section 162(m) of the Code and Section 16 of the Exchange Act.
- Reconsider the decision-making processes to ensure that the compensation committee has the authority to make all decisions required to be made by independent directors.

3. Compensation Consultants and Peer Groups Should Be Examined

Many (but not all) companies use a compensation consultant to advise on post-IPO compensation matters. Compensation consultants can provide market data and

assist the compensation committee in determining what changes should be made to the company's executive compensation structure and levels in light of peer practices. Consultants can also assist in analyzing executives' current equity ownership levels and any recommended adjustments to those levels. To the extent a pre-IPO company chooses to use a compensation consultant, it should keep in mind the following disclosure requirements:

- If compensation consultants provide services other than executive or director compensation services for an annual fee of more than \$120,000, then the company must disclose the aggregate fees paid to the consultant for compensation consulting and other services.
- The company must also disclose whether the decision to engage the consultant was made or recommended by management and whether the board approved those services. For this reason, companies should consider having the compensation committee decide whether to engage a consultant, and which consultant to engage.
- The Dodd-Frank Act requires additional disclosure on potential conflicts of interests raised by compensation consultants' work.

A secondary issue raised in the context of a compensation consultant's services is that the SEC's disclosure rules also require companies to disclose any benchmarks used or peer groups analyzed to determine executive compensation. If a company uses a peer group to analyze executive compensation, the peer group members must also be disclosed. Pre-IPO companies should keep in mind that any future changes to the peer group will have to be disclosed and explained.

4. Named Executive Officer Compensation Will Be Publicly Disclosed

The Form S-1 Registration Statement requires disclosure of the compensation for the last completed fiscal year for the issuer's named executive officers ("NEOs"). NEOs include anyone who served as the CEO or CFO during the last fiscal year and the three next-most highly compensated executive officers.² While this point may seem obvious for those familiar with the SEC disclosure rules, it is worth pointing out for several reasons:

- An individual must be an executive officer in order to end up in the tables. As part of the pre-IPO planning exercise, issuers must determine which individuals are executive officers. Highly paid professionals may be vital to an enterprise, but if they do not have an executive officer title or perform significant policy-making functions for the issuer, they will not have their compensation reported in the tables.³

² Up to two additional individuals may also be included to the extent the individual would have been one of the three next most highly compensated executive officers, had the individual been an executive officer as of the end of the last fiscal year. See Item 402(a)(3) of Regulation S-K under the Exchange Act.

³ The term "executive officer" means the company's president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance),

- Hiring bonuses, one-off equity grants and any other special or out-of-the-ordinary bonuses or incentive payments may unexpectedly push an individual executive officer into the "named executive officer" category.
- All payments and compensation arrangements will have to be publicly disclosed and any underlying contracts must be publicly filed, even if the company intended for the arrangements to be confidential. For some issuers, this might create sensitive employee relations issues.

5. Annual Bonus and Incentive Plans Must Be Disclosed in Detail With Targets

The SEC rules require issuers to disclose the corporate and individual performance factors used to determine bonuses. These typically include performance targets, the weighting of each target, the actual results achieved for each target and how the results were used to determine the amount of the bonus.⁴

The SEC's bonus disclosure rules can create some issues for newly minted public companies. Some private companies have very informal bonus-setting processes and may find it difficult to describe how they determine bonuses. Other companies may use a formal process but may consider highly specific factors that they may feel uncomfortable disclosing.

Companies preparing for an IPO should consider how they will describe their annual bonus program and its associated performance measures. To the extent a company might not feel comfortable disclosing its historical approach, it will have to find a way to describe the factors and procedures with enough detail to inform investors about the manner in which bonuses were determined and articulate a logical and clear rationale for both the bonus-setting process and the payout decisions.

If feasible, it may be advisable for some companies to develop bonus programs for the year preceding the initial filing to be more consistent with programs used by public companies. This may entail, at a minimum, utilizing common, GAAP-consistent or reconcilable measures of corporate performance, like net profits or EBITDA, so that the company will be able to disclose specific performance targets, payout formulas, target bonus amounts and actual payout amounts.

6. Section 162(m) of the Code

Section 162(m) of the Code applies to public companies and limits the tax deductibility of compensation

any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the companies. See Rule 3b-7 of the Exchange Act.

⁴ The SEC has indicated that issuers are required only to disclose performance targets relating to prior fiscal years and are not required to disclose future or ongoing performance targets. In addition, under the SEC rules, there is a very narrow exception to the requirement to disclose performance targets and measures to the extent they constitute confidential information. Whether bonus targets are confidential is measured using the same tests utilized for determining confidential treatment of trade secrets or commercial or financial information under Rule 406 of the Securities Act of 1933, as amended (the "Securities Act") and Rule 24b-2 of the Exchange Act. See Instruction 4 to Item 402(b) of Regulation S-K under the Exchange Act and 5 U.S.C. 552(b)(4).

paid to top executives (similar to the group of named executive officers) to \$1 million, unless certain exceptions apply. The most important exception is for “qualified performance-based compensation.”

In order for compensation to be considered performance-based, it must meet several criteria. The compensation must be subject to the achievement of pre-established performance goals set by the compensation committee at the beginning of the applicable performance period, and the compensation committee must certify after the end of the performance period whether and the extent to which the goals have been achieved. Shareholders must approve the material terms of the plan, including the menu of performance goals from which the compensation committee may establish performance targets, and the limit on the maximum amount of any payout that may be made to any individual in any year (or in the case of equity awards, the maximum number of shares subject to any one or more awards that may be granted to any individual in any performance period).

For newly public companies, the rules provide a temporary exemption from the \$1 million limit for payments that are made pursuant to a plan or agreement that existed while the company was private, but only to the extent that the company provides all required disclosure of the plan or agreement in its prospectus.⁵ This transition period lasts until the earliest of:

- The expiration of the plan or agreement;
- The material modification of the plan or agreement;
- The issuance of all employer stock and other compensation that has been allocated under the plan; or
- The first meeting of shareholders at which director elections will occur that takes place after the end of the third calendar year following the calendar year in which the IPO transpires.

Companies should consider using the IPO transition period to the maximum extent possible for any compensation arrangements that will be used after the IPO. In order to benefit from the transition period, the company’s Form S-1 must disclose “information concerning those plans or agreements that satisfie[s] all applicable securities laws then in effect.”⁶ While the IRS has never elaborated on what level of disclosure is necessary to satisfy the transition period disclosure requirement described above, many practitioners have taken the position that this means all of the following disclosure required under Item 10 of Schedule 14A when public companies seek to obtain shareholder approval of a compensation plan:

- A description of the material features of the plan, each class of persons eligible to participate and the approximate number of persons in each class;
- Tabular disclosure of the new plan benefits determinable under the plan; and
- The federal income tax consequences of the issuance of any options, warrants or rights.

⁵ See Treas. Reg. § 1.162-27(f).

⁶ Treas. Reg. § 1.162-27(f)(1).

Section 162(m) also provides an important transition rule for options, stock appreciation rights and restricted property. Stock options, stock appreciation rights or restricted property granted under a plan that is exempt during the transition period will continue to be exempt from Section 162(m), even if these awards vest or are paid after the end of the transition period. The IRS recently clarified that this special transition rule does not apply to any other equity-based compensation awards, like restricted stock units or phantom stock awards.⁷

7. Stock Option Grants Prior to IPO Will Be Scrutinized

Due to the deferred compensation rules of Section 409A of the Code, accounting rules regarding stock options, and the requirements for incentive stock options, it is substantially universal practice to grant stock options with an exercise price at or above the fair market value of the underlying common stock on the date of grant. Under Section 409A of the Code, the board of directors must determine the fair market value in good faith using a reasonable valuation method that takes into consideration all available information. As a company gets closer to an IPO, the potential IPO would be a material factor to consider in determining the fair market value of the company’s stock. In addition, the SEC is likely to scrutinize any stock option grants made in the 18-month period prior to an IPO to ensure compliance with all tax and accounting rules.

8. Disclosure of Material Risks Posed by Compensation Programs Is Required

Following the economic crisis of 2008 and the associated instability of financial institutions, corporate governance regulators began to focus on institutional risk created by compensation programs. The 2009 amendments to the SEC compensation disclosure rules require issuers to disclose any material risks arising from employee compensation policies and practices that are reasonably likely to have a material adverse effect on the company. To the extent that an issuer identifies these risks, the company must disclose its compensation policies and practices as they relate to risk management and risk-taking incentives. This disclosure requirement covers compensation programs for all employees, not just named executive officers.⁸

If a company has determined that its compensation policies and practices do not pose material risks, there is no obligation under the SEC rules to make an affirmative statement to this effect. However, making no statement at all about compensation risks arguably implies that the company has determined that its compensation arrangements do not pose material risks to the enterprise. Further, when a company does not include any statement about risk, the SEC will often ask the company to explain the omission and describe how it determined there were no material risks, as part of the comment process leading up to the effectiveness of the registration statement. Larger, well-established public

⁷ See Certain Employee Remuneration in Excess of \$1,000,000 Under Internal Revenue Code Section 162(m). 76 Fed. Reg. 37034 (June 24, 2011) (to be codified at 26 C.F.R. Part 1).

⁸ See Item 402(s) of Regulation S-K under the Exchange Act.

companies typically include affirmative language stating that they have considered the potential risks posed by their compensation programs.⁹

Companies use different approaches regarding to who conducts the compensation risk assessment. Some companies task their compensation committees with conducting the assessment in consultation with the company's risk officers. Others include the compensation risk assessment as part of the board and audit committee's overall risk oversight and analysis responsibilities, with input from the compensation committee.

9. Post-IPO, Say-on-Pay Votes Will Be Required

With the passage of the Dodd-Frank Act, all public companies are now required to hold a nonbinding shareholder vote on the company's executive compensation as disclosed under Item 402 (which includes the Compensation Discussion and Analysis (the "CD&A"), as well as the tables and narrative disclosure following the CD&A). While this vote is not required during the IPO process, it is important to take into account that shareholders will scrutinize and vote on the compensation programs and policies implemented by a newly public company in future years. Companies about to go public must consider corporate governance trends that did not apply to them when they were private. Among the "hot buttons" for shareholder advisory firms are the following:

- Investor groups disfavor tax gross-ups of any kind, including gross-up obligations to compensate executives for potential golden parachute tax liabilities, for taxes incurred on perquisites or personal benefits and for tax penalties due to violations of Section 409A of the Code.
- Shareholder advisory groups focus on the link between pay and performance, and favor incentive arrangements tied to concrete corporate and individual performance measures over guaranteed or time-based payments and benefits.

⁹ According to Shearman & Sterling's 2011 survey of director and executive compensation practices, 96 of the 100 largest public companies surveyed included some sort of risk disclosure in their annual proxy statement. The survey and the companion survey regarding general governance practices are available on the Shearman & Sterling LLP website at corp.gov.shearman.com, as well as details on how to download highlights of our survey in an App available from the iTunes Store® and the Android Market®.

- Shareholder advisory firms closely examine share-recycling provisions and equity burn rates and often have formulas to determine what is acceptable. These firms disfavor equity plan provisions allowing companies to re-issue shares or options or other awards covering shares that have previously been forfeited or sold back to the company. Shareholder advisory firms also look at the shares available for issuance under equity plans and the rate at which companies grant equity awards.¹⁰
- Shareholder advisory firms regularly criticize perquisites and personal benefits that are deemed "excessive." Benefits most often criticized are personal use of company aircraft, country club memberships and car services.

Conclusion

These are but a few of the many issues that must be addressed during the IPO process. Nonetheless, they illustrate the fact that strategic planning in the year or so leading up to a potential IPO can make the IPO process go more smoothly and allow the issuer to present its compensation programs in the best, most accurate light to its future public shareholders. A newly public company can examine the compensation disclosure regime and other regulations in a holistic manner and structure its programs accordingly.

A public company program may look significantly different from a pre-IPO compensation program, both in the actual levels and types of compensation offered, and in the processes used to set and oversee compensation. Pre-IPO companies, however, might use the IPO process as an opportunity to reconstitute its compensation programs and utilize an expanded array of compensation components in a manner that most effectively motivates and retains the company's key employees.

¹⁰ It should be noted that Institutional Shareholder Services Inc. ("ISS"), a shareholder advisory firm, has proposed a new policy update under which ISS will recommend that shareholders vote on a case-by-case basis with respect to shareholder approval of equity plans for companies that have recently undergone an IPO. In the past, ISS as a general rule recommended approval of equity plans of post-IPO companies when the approval was for purposes of Section 162(m) of the Code. Under the proposed new policy, ISS will conduct a full equity plan analysis, looking at total shareholder value transfer, re-pricing, burn rate, and change in control provisions, to determine whether to recommend voting in favor of plan approval.