Legal and Practical Challenges Inherent in Offering Executive Compensation Plans by Privately Held Employers

Don Delves, Director, Willis Towers Watson
Joseph S. Adams, Winston & Strawn LLP
The continuum of private companies

<table>
<thead>
<tr>
<th>Ownership</th>
<th>Diffuse / wide</th>
<th>Widely held by ‘members’</th>
<th>Concentrated</th>
<th>Concentrated</th>
<th>Concentrated</th>
<th>Concentrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time horizon</td>
<td>Long term</td>
<td>Long term</td>
<td>Long term</td>
<td>Long term</td>
<td>Medium term</td>
<td>Medium term</td>
</tr>
<tr>
<td>Employee participation</td>
<td>High</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Financial Leveraging</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>High</td>
</tr>
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</table>
Privately owned businesses are the future

- The total number of US companies is increasing
  - Approximately 5 million companies

- While the number of publicly traded companies has fallen
  - 6,000 to 7,000 in 2000
  - 4,300 today (and holding)

- Uninvested PE and VC funds: $1.3 trillion

- Private companies staying private
Privately owned businesses are the future (con’t)

- Private (family owned or controlled) businesses
  - 80% of companies worldwide
  - 60% of workers in U.S.
  - Create 78% of new jobs in U.S.

- However:
  - 30% of family businesses survive to 2G
  - 12% to 3G
  - 3% to 4G

- And:
  - 10% of family business boards say they are effective at attracting, retaining, hiring, diversity
Privately owned businesses are the future (con’t)

Successful private (family) businesses:

- Establish good governance as a baseline

- Preserve “family gravity”
  - Values
  - Vision
  - Long term focus
  - Customers and employees first
  - Social responsibility

- Develop of future leaders
  - Emphasis on values and cultural fit

- Disciplined CEO succession
Wide differences in executive pay practices in private companies

- Compensation policies are driven by ownership structure

- However, private companies are competitive with publicly-traded companies for talent
  - Cash compensation tends to play a larger role in the pay mix
  - Salary and bonuses are typically comparable to what public companies pay, though private companies often have a bias to somewhat larger bonus levels
  - Total compensation is typically lower because private companies use less equity

- While less prominent, private companies increasingly offer some form of long-term incentive (LTI)
  - LTI grants are often lower, but payouts are more consistent
Alignment of business objectives and LTI design

Company State Spectrum

Perpetual Private
- Sustained Long-Term Performance
  - Performance Cash
  - Phantom Stock

Transaction
- Value creation to max out deal price
  - Stock and Options

Perpetual Public
- Pay for performance, shareholder alignment, long-term holdings, retention
  - Stock Options, Performance Shares, Restricted Shares

Objective
- Pay for performance, shareholder alignment, long-term holdings, retention

Design
- Sustained Long-Term Performance
- Value creation to max out deal price
- Stock and Options
- Stock Options, Performance Shares, Restricted Shares
Emerging best practices in private companies

- Although not required to do so, more private companies today are adopting governance practices common in public companies

- Formal advisory and fiduciary boards with independent directors

- Independent compensation committees

- Formal compensation philosophies to guide decisions

- Greater use of benchmarking and annual pay reviews

- Tailored ongoing LTI plans

In short, leading private companies today are taking a more thoughtful and structured approach to how they target and design their executive pay programs than was common a decade ago
Direct influence of shareholders on incentive design

- Private company stakeholders present several key variables in the design of LTIs
  - Who the owners / investors are
  - End game
  - Importance of value
  - Cash flow needs
  - Risk tolerance
  - Appetite for growth / investment
  - Purpose / mission / values
Pay mix observations

- Pay components are typically similar in both private and public companies; however, for private companies, cash compensation tends to play a larger role in the pay mix than in publicly owned companies.

![Pie charts showing pay mix for private and public companies](chart.png)

- Private Companies:
  - Base Salary: 14%
  - Annual Incentives: 23%
  - Long-Term Incentives: 64%

- Public Companies:
  - Base Salary: 24%
  - Annual Incentives: 19%
  - Long-Term Incentives: 56%
Pay level observations
Private companies with LTI

Private Companies with LTI as a Percent of Public

- **Average**: 85% Base Salary, 95% Target Total Annual Cash, 85% Target Total Direct Comp
- **Chief Executive Officer**: 69% Base Salary, 88% Target Total Annual Cash, 88% Target Total Direct Comp
- **C-Suite/Top Tier**: 78% Base Salary, 91% Target Total Annual Cash, 91% Target Total Direct Comp
- **All Other Executives**: 88% Base Salary, 97% Target Total Annual Cash, 97% Target Total Direct Comp
Pay level observations
Private companies without LTI

Private Companies **without** LTI as a Percent of Public

<table>
<thead>
<tr>
<th>Position</th>
<th>Base Salary</th>
<th>Target Total Annual Cash</th>
<th>Target Total Direct Comp</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Other Executives</td>
<td>67%</td>
<td>95%</td>
<td>93%</td>
</tr>
<tr>
<td>C-Suite/Top Tier</td>
<td>56%</td>
<td>102%</td>
<td>106%</td>
</tr>
<tr>
<td>Chief Executive Officer</td>
<td>36%</td>
<td>92%</td>
<td>91%</td>
</tr>
<tr>
<td>Average</td>
<td>64%</td>
<td>100%</td>
<td>99%</td>
</tr>
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Private companies without LTI as a Percent of Public

-10% 10% 30% 50% 70% 90% 110%
Annual incentive design
Private company annual incentives
Private companies without LTI

Annual Incentive Plan Measure Prevalence

- Bottom Line Pre-Tax: 59% Private, 58% Public
- Other Financial: 17% Private, 31% Public
- Top Line: 22% Private, 39% Public
- Return Metrics: 14% Private, 19% Public
- Bottom Line Post-Tax: 19% Private, 33% Public
- Cash Flow: 16% Private, 22% Public
- Economic Value/Profit: 6% Private, 4% Public
Long-term incentive design
Private company long-term incentives
Vehicle prevalence

**Number of LTI Vehicles**

- One: 82%
- Two: 13%
- Three: 5%

**Vehicle Prevalence**

- Stock Options/SARs: 29%
- Performance Plans: 77%
- Restricted Stock/RSUs: 18%
Private company long-term incentives
Restricted stock / RSUs

Eligibility & Receivership

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<thead>
<tr>
<th>% of Employees Eligible</th>
<th>% of Employees Receiving</th>
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<tbody>
<tr>
<td>3.5%</td>
<td>2.8%</td>
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<tr>
<td>0.4%</td>
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Salary Levels

<table>
<thead>
<tr>
<th>Salary Level of Lowest Eligible</th>
<th>100% Participation Level</th>
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<tr>
<td>$174</td>
<td>$200</td>
</tr>
<tr>
<td>$127</td>
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Private Company 50th  Public Company 50th
Private company long-term incentives
Performance plans

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<td>$230</td>
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<tr>
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Private Company 50th  Public Company 50th
Private company long-term incentives
Performance plans

Grant Frequency

- 93% Granted Annually
- 3% Every 2 years
- 2% Every 3 years
- 2% Every 4 years or more

Performance Period

- 83% 3-Year Performance Period
- 8% 1 year
- 2% 2 years
- 7% 4 years or more

Number of Performance Measures

- 46% One or Two Measures
- 31% One measure
- 15% Two measures
- 9% Three measures
- 9% More than 3 measures

Performance Period

- 83% Paid in Cash
- 10% All cash
- 7% All shares
- 2% All units
Private company long-term incentives
Performance plans

Long-Term Performance Plan Measure Prevalence

- Revenue / Profit Measures
  - Revenue: 27%
  - Other: 25%
  - EBITDA: 22%
  - Net Income: 20%
  - EBIT/Op. Inc.: 12%

- Shareholder Value Performance Metrics
  - Free Cash Flow: 9%
  - Other: 2%
  - Working Capital: 2%
  - Op. Cash Flow: 2%
  - EVA: 2%
  - TSR: 2%

- Strategic Performance Metrics
  - Other: 10%
  - Employee Metrics: 7%
  - Strategic Milestones: 5%
  - Cust. Satisfaction: 5%
  - Quality: 2%

- Return / Margin Performance Measures
  - ROIC/RONA: 10%
  - ROE: 9%
  - Operating Margin: 7%
  - Other: 3%
  - 0% 5% 10% 15% 20% 25% 30%

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Summary

- The approach to executive compensation in private companies differs in several important ways from public companies

- Private companies generally:
  - Provide cash-based performance plans
  - Use value based plans (a lot) less frequently than public companies
  - Have lower grants
  - Otherwise follow public company practices fairly closely

- Not reflected in the survey — private company LTIPs tend to be more steady, consistent and predictable over time
Legal Issues in Designing Long-Term Incentive Plans
Summary

- Objectives
- Goals/Considerations
- Design
  - Eligibility
  - Types of Awards
  - Valuation
  - Vesting
  - Exercise/Liquidity
- Other Issues
  - General
  - Tax
  - Securities
  - Corporate
Objectives

- Attract, retain, and motivate key employees

- Structure a program that preserves all possible exit strategies, e.g., sale of the company, transition to other family members, IPO

- Structure a program that will please (or at least not surprise) the venture capital folks, investment bankers and possible acquirors
Goals/Considerations

- Tax impact on the Company
- Tax and economic impact on the controlling shareholder
- Tax impact on the employee/award recipients
- Shareholder dilution
- Accounting impact
- Federal and state securities laws
Design – Eligibility

- Who should be eligible for awards under the Plan:
  - employees,
  - non-employee board members,
  - independent contractors, advisors, and other independent service providers?

- Should the Company be using the same types of equity compensation for all recipients?
Design – Types of Award

- **Initial Question:**
  - Are we sure we want to base awards and/or compensation on equity? Are we trying to incent some other type of growth or performance?

- What types of equity awards should the Plan provide for:
  - tax-qualified (*i.e.*, "incentive") stock options,
  - non-qualified stock options,
  - restricted stock or restricted stock units (RSUs),
  - performance shares,
  - stock appreciation rights (SARs),
  - phantom equity,
  - all of the above?

- Profits Interests?
Design – Types of Award

- **Key Question #1**: “Appreciation–only” Award or “Full Value” Award?

- **Key Question #2**: Actual equity or phantom equity?

<table>
<thead>
<tr>
<th></th>
<th>Actual Equity</th>
<th>Phantom Equity</th>
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</thead>
<tbody>
<tr>
<td><strong>Appreciation Only</strong></td>
<td>Stock Options (ISOs or NSOs)</td>
<td>Stock Appreciation Rights (SARs)</td>
</tr>
<tr>
<td><strong>Full Value</strong></td>
<td>Restricted stock or RSUs</td>
<td>Phantom Stock</td>
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- **Key Question #3**: Should the Company be using the same types of equity compensation for all recipients?
Design – Types of Award

- **Profits Interests.** A profits interest represents an actual interest in the profits of the partnership.
- **However,** holder cannot share in any profits realized prior to an issuance or in any appreciation in the value of the assets (whether realized or unrealized) of the partnership that occurs prior to the grant.

- **Employee Treatment**
  - No taxable income to the employee at the time of the award, provided that the employee will be treated as a partner and receive allocations (and appropriate tax distributions).
  - Generally, recommended to make an 83(b) election.
  - Appreciation is generally taxed to the employee at favorable long-term capital gain rates

- **Employer Treatment:** No deduction
Design – Valuation

How should the plan define Fair Market Value?

- Board discretion or a formula?
  - Board of Directors' resolution may need to justify the options' exercise price as fair market value for Section 409A purposes

- Considering adding definition of FMV that clearly backs-out the value delivered by the Plans’ awards. For example:
  - For the avoidance of doubt, the Fair Market Value of the Common Equity shall be determined after taking account of what would be the Company’s obligation pursuant to all benefits authorized under this plan. . . .
Design – Vesting

- When should the awards vest?
  - Time-based, performance-based, or a combination?
  - Should vesting accelerate on death, disability, or a change in control?

- Forfeiture for cause or breach of restrictive covenants?
  - Clawbacks: Should the Plan provide that the Company may clawback any Incentive Award if it is discovered that the basis for the accumulation and payout of the Award was incorrect (e.g., in the event of a financial restatement)?

- Should employees be permitted to hold vested award after termination of employment?
  - Can company have discretion?
  - Are the awards subject to IRC Section 409A?
Design – Exercise/Liquidity

- When should award recipients have be able to receive/exercise their awards?
  - Specified period of years?
  - Employment termination?
  - Sale of Company or IPO only?
    - For 409A awards, IPO technically cannot be a payment event?
    - Try “Valley” approach

- If actual shares delivered, what if there is no liquidity:
  - Can the exercise price of an award be paid via net settlement?
    - Or utilize stock settled SARs
  - What about payment of income and employment tax withholding?
Other Issues – General

- Any existing equity award programs that need to be replaced?

- Effective Date of Program?
  - Were promises made for earlier grants?
  - Any 409A issues with backdating?

- Administration: Will the Board, a Board Compensation Committee, or some other individuals or committee review and approve these matters?
Other Issues – Tax

- Section 409A imposes a variety of restrictions and limits on deferred compensation plans and a violation of Section 409A can have extremely negative tax consequences for plan participants.
  - Incentive plans must be designed carefully to be exempt from Code Section 409A or, in the alternative, to comply with Section 409A.
  - Often, there is a tradeoff between valuation issues and ease of exercise

- 83(b) elections
  - Benefits vs. risks
  - Strict timeline
  - Model form

- ISO rules
  - Employee perspective
  - Employer perspective

- 280G
  - Private companies often use shareholder vote to avoid 280G issues
  - Where that approach is not available, consider desired approach, and how/where to document the approach

- 409(p) – A potential issue for private ESOP companies
Other Issues – Securities

- Upon what securities law exemption the Plan will rely until the Company's equity is registered in a public offering?

- Review the state securities laws (so-called "blue sky" laws) in the state where award recipients work.
Other Issues – Corporate

- Shareholder approval requirements for plan?
- How much of the company's outstanding equity should be authorized for issuance of awards under the Plan?
  - How many classes of equity/units does the Company have? What class should award recipients receive? What rights should that class include?
  - Has the founder made any promises of ownership percentage and, if so, were these percentages promised on a fully diluted basis?
- If actual equity, consider:
  - The Company must have:
    - Call Rights
    - Drag-Along Rights
    - Right of First Refusal
- Should award recipients have any of the following:
  - Put Rights
  - Tag-Along Rights
  - Registration rights
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Questions?

Donald Delves
Managing Director
Executive Compensation Practice Leader, North America
Willis Towers Watson
233 South Wacker Drive
Chicago, IL 60606
D+1 312 873 5054
M+1 312 543 3045
donald.delves@willistowerswatson.com
willistowerswatson.com

Joseph S. Adams
Partner
Winston & Strawn LLP
35 W. Wacker Drive
Chicago, IL 60601-9703
D: +1 312-558-3723
M: +1 847-809-5947
JSAdams@winston.com