Equity Compensation Matters: Plan Design / ESPP

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Key Equity Compensation Plans Adopted in Connection with an IPO

- Omnibus IPO Equity Incentive Plan ("Omnibus Plan")
- Employee Stock Purchase Plan ("ESPP")

Reasons for an Omnibus Plan

- Flexibility - Private companies typically use stock options as the sole or primary equity compensation instrument. An Omnibus Plan introduces additional types awards (e.g., RSUs, restricted stock, stock appreciation rights, performance shares and performance units).

Key Decision Points for Omnibus Plans

- Share Reserve (Initial Share Pool & Evergreen)
- Treatment of Awards in a Change in Control
- Outside Director Compensation

Share Reserve – Initial Share Pool

- Most high-growth IPO companies will want to reserve enough shares to accommodate a growing workforce, needs for potential acquisitions, and focal grants for current executives and employees.
- When setting the share reserve and the evergreen, companies should reserve enough shares to meet forecasted needs for at least the next 3-4 years following the IPO to avoid having to go back to stockholders to increase the plan share reserve once public.
- Start the conversation about the share reserve (and evergreen) early with your Board and Compensation Committee.
- If the Omnibus Plan includes an evergreen, a reasonable range for the share reserve is 8-12% of the post-IPO outstanding shares.

Share Reserve – Evergreen

- Most companies going public include an “evergreen” or automatic share replenishment provision to avoid having to continually seek stockholder approval of share increases.
- A reasonable range for the evergreen is 4-5% of the then-outstanding shares.
- The evergreen will need a hard share cap as well to comply with tax rules.

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Treatment of Awards in a Change in Control

- An Omnibus Plan should give a company broad discretion to treat outstanding awards as it determines without consent from award holders, in order to maintain the company's flexibility to meet the terms of any proposed transaction.
- Most plans include a provision providing for acceleration of unvested awards that a buyer does not assume. This is not a single-trigger acceleration provision but a fairness provision that allows holders to receive value for their awards if a buyer refuses to honor the obligation to continue the awards.

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Outside Director Compensation

- Most public companies adopt a formal policy on outside director compensation, which typically provides for automatic, non-discretionary annual cash retainers and equity award grants in connection with each annual meeting of shareholders.
- A Delaware court recently found that the directors of a company did not have the protection of the business judgment rule with respect to an equity compensation plan because when setting their own compensation, there was no "meaningful limit" in the underlying plan.
- We recommend setting limits on the annual compensation that a director may receive and having shareholders approve the limits, which can be done through inclusion of the limits in an Omnibus Plan approved by stockholders.

Designing a Post-IPO Equity Compensation Program

- Whether to Introduce Full Value Awards (e.g., RSUs)
- Vesting Dates for RSUs
- Tax Withholding Alternatives for RSUs

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Whether to Introduce Full Value Awards

- With potential volatility in stock price post-IPO and high leverage from a dilution perspective, many public companies shift to RSUs for rank-and-file employees and a mix of options and RSUs for executives.
- RSUs will always have some value delivered because they do not have an exercise price and thus cannot go underwater.
- Less RSUs are needed to provide comparable “value” as a stock option, which minimizes dilution.

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RSU Vesting Dates

- Unlike stock options (where the tax event occurs on exercise), RSUs are subject to federal employment withholding at vesting and federal income tax withholding at settlement.
- To limit the number of times these tax events occur, most public companies limit RSU vesting dates to a few specific dates each year that occur in open trading windows.
- **Example:** RSUs vest only on the 2nd Wednesday in each of March, June, September and December.

Default Tax Withholding on RSUs

- **Net Share Withholding:** Company withholds shares to cover taxes and pays its own cash to the taxing authorities.
  - **Advantages:** Preserves the shares available under the Omnibus Plan, reduces dilution, and avoids Section 16 issues related to open-market sales.
  - **Disadvantages:** Uses company's cash reserves.
- **Sell-to-Cover:** A broker is instructed to sell shares on the open market to cover taxes.
  - **Advantages:** Preserves cash.
  - **Disadvantages:** Uses up the shares available under the Omnibus Plan, increases dilution, and could raise Section 16 and insider trading issues related to open-market sales.

Reasons for an ESPP

- The purpose of an ESPP is to provide employees with an opportunity to purchase common stock at a discount to the market price through accumulated payroll deductions.
- ESPPs generally have been viewed favorably because employees are able to participate on a relatively equal basis and the maximum payouts are limited such that senior managers cannot disproportionately benefit.

Key Decision Points for Employee Stock Purchase Plans

- Share Reserve (Initial Pool & Evergreen)
- Length of Offering Periods
- Purchase Price
- Contribution and Purchase Limits
- Whether to Include Non-U.S. Employees

Share Reserve – Initial Pool

- If the ESPP includes an evergreen, a reasonable range for the initial share reserve is between 1-2% of the post-IPO outstanding shares, depending on the projected rate of share usage.
- Modeling the potential needs for a multi-year period (based on the employee demographics and IRS limits) may be valuable in projecting share usage.

Share Reserve – Evergreen

- A reasonable evergreen is 1-2% of the outstanding shares.
- The evergreen will need a hard share cap as well to comply with tax rules.

Length of Offering Periods

- Predominantly, ESPP offering periods are 6 months, with the purchase price determined based on the lower of the stock price at the beginning of the period or the stock price on the purchase date (a “look-back”).
- Some companies have provided a longer look-back period of 12 to 24 months.
- Longer look-backs provide a greater employee retention benefit but also increase the stock-based accounting expense of the ESPP.

Purchase Price

- Most companies provide a discount of 15% on the applicable stock price (determined based on the look-back feature).
- The maximum discount permitted under applicable U.S. tax laws is 15%.
- For financial accounting purposes, if the discount is set at 5% on the purchase date (with no look-back), then the ESPP should not result in a compensation expense for the company.
  - However, most companies find that an ESPP that complies with the financial accounting safe-harbor does not provide sufficient incentive to employees.

Contribution and Purchase Limits

- **<u>Maximum Contribution Percentage</u>:** Companies typically set the maximum percentage of eligible “compensation” that employees may contribute at 10-20%.
- **<u>Definition of “Compensation”</u>:** Eligible “compensation” can include salary, bonuses, and any other elements of compensation, but including commissions may make administration more challenging.
- **<u>Purchase Limits</u>:** ESPP rules require a maximum share limit on shares purchasable during a purchase period. This number can be (1) arbitrarily high so that it does not serve a practical limit or (2) a meaningful limit to control share usage.

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Whether to Include Non-U.S. Employees

- ESPPs may not be tax qualified in non-US jurisdictions, but ESPPs still offer the benefit of purchasing stock at a discount.
- If non-US employees will be participating in an ESPP, then the list of non-US jurisdictions eligible to participate must be determined, and the company's non-U.S. equity counsel should create non-US appendices to the ESPP for legal compliance.

Thank you!

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