

Equity Compensation in Troubled Times

Richard E. Wood*
Kirkpatrick & Lockhart LLP

I. Introduction

Stock options were the currency of the “new economy.” Without stock options, it was widely believed, many companies simply could not have survived. A company’s ability to attract and retain highly skilled and motivated employees depended directly, and in some cases primarily, on the availability of a carefully designed stock option program.

Times have changed. Both the economy and the stock market are struggling after many years of steady growth. At the time this article is being written, it seems that the most pressing stock option question facing companies and employees is “What can be done about underwater options?” When markets are not rising, many begin to doubt the efficacy of stock options as an employee retention and motivation tool. While stock plan designers have been saying for decades that employees should view stock options as a long-term component of compensation, it seems that most individuals focus on the prospects of making a profit over the next twelve months.

There is little doubt that, in the wake of the recent spate of layoffs and downsizings, the labor market is not nearly as tight as it was a few years ago. For most companies, however, “human capital” is no less essential to business success than it was before the onset of our economic troubles. Companies need to understand how they can attract and retain talented employees in the current economic environment.

There are a number of different actions companies can take to shore up their compensation programs in the face of difficult business conditions. For example, enhancements to the non-equity portions of the compensation package can offset, at least partially, the negative effect of a decline in the perceived value of stock option programs. Also, the stock option programs can themselves be improved by changing the granting practices so that option grants occur more frequently than has been typical for most companies (e.g. making quarterly or monthly grants rather than making grants annually or even less frequently). By spreading out the grants over time, employees have a sort of “dollar cost averaging” benefit in that their weighted average exercise price will tend to be more reflective of the current market condition.

It is not the purpose of this article, however, to catalog all of the compensation-related actions companies should consider taking to address the current economic

* Richard E. Wood is a partner in the Pittsburgh office of the law firm Kirkpatrick & Lockhart LLP

situation. Instead, this article focuses on a particular type of equity compensation plan that is well suited to be a substitute for or a supplement to stock options, and that works effectively both in good markets and bad. Performance award plans have been around for many years, and have been used to great effect by many companies in lieu of or in combination with stock options. Perhaps it is time for companies that have not yet adopted such a plan to take a fresh look at performance awards and decide whether performance awards may have a role to play in their overall compensation strategies.

II. Performance Award Plans

Performance award plans, like stock options, are a form of long-term incentive compensation. These programs are intended to reward employees for the achievement of business goals over a period of time longer than one year. The long-term nature of the programs provides the employer with an opportunity to build “golden handcuffs” into the compensation program.

There is a key difference, however, between stock options and performance awards. Stock options provide financial benefits to employees primarily as a result of increases in the value of the employer’s stock. If the stock value is not rising, the option program will be of little or no benefit to employees. In contrast, a performance award plan does not depend entirely on stock value. In fact, in some performance award plans, the current stock price is entirely irrelevant.

It seems clear that the value of a company’s stock is poorly correlated to the company’s actual performance. It has been suggested that most of the volatility of a company’s stock value – usually about 80% of it -- reflects overall market trends rather than the individual company’s performance. Performance award plans have the flexibility to overcome such market distortion by tying the financial benefits of employees to the measures that best reflect the company’s own business success.

According to a 1999 survey by the consulting firm Frederic W. Cook, Inc., 49% of the 250 largest companies in the S&P 500 had adopted some type of performance award plan. The 2000 survey of the National Association of Stock Plan Professionals indicated that 29% of the companies surveyed had adopted such a plan. So performance award plans are certainly no secret in the business world.

Under a performance award program, each participant is granted a number of performance awards at the beginning of an award period. Each award has a value that can be fixed (*i.e.*, a specified dollar amount) or variable (*i.e.*, each award equals the per share value of the employer’s stock). Award plans using a fixed amount are sometimes called “performance unit” plans while plans using shares of stock are sometimes referred to as “performance share” plans.

The performance awards vest if pre-established financial targets are achieved over a multi-year award period. The company may set the duration of the award period as it chooses. Three years is a commonly used award period. If a plan uses shares of

stock as the basis for the awards, the plan may provide that any dividends on the stock during the award period will be added to amount otherwise payable to the employee if the performance goals are achieved.

The performance measures chosen depend on the employer's perception of the factors that best reflect employee achievement and whether the employer wants to base the evaluation upon overall corporate achievement, achievement within a particular division, or upon individual employee performance. Sometimes a combination of such factors is used. Typical performance standards include total shareholder return, net income, return on assets and attainment of divisional objectives. These performance targets may be stated in absolute terms or relative to a peer group or index. Peer group comparisons are particularly effective because they tend to "factor out" the influence of general market conditions, and enable companies to provide suitable rewards for superior performance even during bad economic times.

At the end of the award period, the vesting percentage is determined based on how the company, division, or individual employee performed against the predetermined performance standard. Once the vesting percentage is determined, it is applied against the number of performance awards initially granted to an employee to determine the number of vested performance awards. The value of the vested performance awards is then paid to the employee in cash, shares of stock, or a combination. Payments may be made in a lump sum or in installments over a period of months or years. Some plans permit employees to elect to defer payment of earned performance awards.

Employees must generally remain employed for the entire performance period in order to be entitled to a payout with respect to earned performance awards. Some plans provide for the payment of a pro rata award if employment ends during the performance period due to special circumstances, such as the employee's death, disability or retirement. A plan may provide for the full vesting and accelerated payout of performance awards in the event of a change in control of the employer.

The retention effect of a performance award plan can be strengthened by the use of overlapping performance periods. For example, a company could use four-year performance periods and begin a new performance period in the second year of the initial period. This would encourage employees to remain with the company after the completion of the first performance period because they would at that time be in the middle of the next performance period and would have to be concerned about losing that interest by quitting. If overlapping performance periods are used, payouts are more frequent and the potential award amounts for each period tend to be smaller than under plans having non-overlapping periods.

Take the example of an employer that has a performance award plan under which each unit is valued at a fixed amount of \$50. If an employee who was granted 1,000 units is determined, based on attainment of pre-established performance goals, to be 75% vested, then the employee would receive a payment of \$37,500 (1,000 x \$50

x .75). Instead of valuing units as a fixed dollar amount, the employer could have used its own shares as the measuring stick for the awards. If the employer's stock has a value of \$20 per share at the end of the award period, the employee would be entitled to \$15,000 (1,000 x \$20 x .75). In any case, the amount earned would be paid in cash, shares of stock or a combination of the two.

Companies have tended to limit participation in performance award plans to executive officers and other high-ranking employees. Due to the fact that variable accounting applies to these plans (discussed below), significant compensation expense, a non-cash accounting charge, can accrue if participation in a performance award plan is offered to large numbers of employees.

III. Regulatory and Accounting Compliance

A. Taxation

Employees are not subject to income taxation with respect to their performance awards unless and until payments of cash and/or stock are received. The amount of cash and the fair market value of stock paid under a performance award plan are taxable to the employee as ordinary income. Thus, unlike incentive stock options, performance awards offer employees no opportunity for capital gains taxation of income. The employer is entitled to take a tax deduction for any ordinary income recognized by employees. Also, the employer must withhold taxes from the amounts paid to employees as ordinary income.

Section 162(m) of the U.S. Internal Revenue Code limit to \$1 million per executive the annual tax deduction that a public company can claim from the payment of compensation to certain key employees. Performance awards can be designed to be completely exempt from this limitation.

B. ERISA

In general, like stock option programs, performance award plans are not subject to the burdens of compliance with the Employee Retirement Income Security Act of 1974, as amended (ERISA).

C. Securities Laws

Federal and state securities laws generally impose a requirement that offers or sale of stock or other securities must be registered unless an exemption from registration is available. Performance award plans that are entirely cash-based do not generally have to be registered. Plans under which shares of stock may be issued may, under certain circumstances, avoid registration on a "no sale" theory, but resale restrictions may be applicable if the shares are not registered. Most public companies register their performance share plans using the relatively simple Form S-8 registration statement. In many cases, private companies can rely on the exemption from

registration afforded by Rule 701 of the Securities and Exchange Commission. The possible impact of state securities laws should also be considered when a performance award plan is being implemented.

For purposes of the reporting and short-swing profit rules of Section 16 of the Securities Exchange Act of 1934 which are, applicable to insiders of public companies, an exemption will in most instances be available for interests in, and acquisitions of stock under, performance award plans.

Public companies must also be concerned about proxy disclosure of performance awards. There is a separate table in which awards made in the last fiscal year under all long-term incentive plans must be disclosed. The material terms of the awards, including the criteria for determining the amounts payable, must be disclosed in a footnote or in a separate narrative.

D. Accounting

Companies must use variable plan accounting for performance award plans rather than the more favorable fixed plan accounting. This means that the initial value of the performance awards plus any appreciation in value during the award period must be accrued as a compensation expense ratably over the award period even though no amount is actually paid until the end of the period. One advantage of a performance unit plan as compared to a performance share plan is that the compensation charge associated with performance units is known in advance while the compensation charge applicable to a performance share plan is open-ended (because the value of performance shares fluctuates as the value of the underlying stock changes).

IV. Conclusion

Performance award plans have been widely used for many years by companies desiring to provide employees with a long-term incentive and reward based on achievements that may not be fully reflected in stock values. While such plans may not give employees the same degree of upside potential that is often associated with stock option programs, they can remove the vagaries of the stock market from the compensation equation and more accurately align long-term pay with demonstrable company achievements.