Comp Talks
Section 162(m)
Tips and Traps

Kathy Morgan,
Iridium Communications

Keith Ranta, Cooley

***Moderated by* Amy Wood, Cooley**

Overview

- Technical overview
- Practical considerations regarding tax deduction
- Exceptions from coverage – performance-based compensation
- Special Section 162(m) committees
- Common compliance traps
- Best practice tips for granting performance-based compensation
- Shareholder approval

What is Section 162(m) and why do I care?

Cooley

IRC Section 162(m)

- Section 162(a): In general, a company may take as a tax deduction all the ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation
- Section 162(m): For publicly held companies, no tax deduction is allowed for certain compensation to any "covered employee" to the extent the compensation in that taxable year exceeds $1 million
  - Covered employees – CEO and the three highest paid officers (other than the CEO and CFO) as of the last day of the completed fiscal year
  - Smaller reporting company/EGC treatment differs – include CFO if one of two most highly compensated
- $1 million limit applies to the aggregate annual compensation
  - Salary, sign-on bonuses, annual and long-term incentives, equity grants and housing allowances are examples of compensation subject to 162(m)
- Deduction limitation applies in employer's tax year when amount is paid and included in employee's income

IPO exception for newly public companies

- Under the IPO exception, $1 million limit does not apply to any compensation “paid” pursuant to a plan or agreement that existed during the period in which a company was not publicly held and is adequately described in registration statement, until the earliest of:
  - The expiration or material modification of the plan or agreement
  - The issuance of all stock or other compensation allocated under the plan or agreement
  - First annual shareholders meeting at which directors are elected that occurs after the close of the *third* calendar year following the calendar year in which the IPO occurs
    - Assume IPO in 2017, the transition period would end on the annual shareholders meeting in 2021

Year	2017	2018	2019	2020	2021
Event	IPO				2021 Shareholders Meeting
					Transition Period Expires

- Cash bonuses – applies to compensation paid under plan during transition period if plan in place prior to IPO was adequately disclosed
- Equity awards – options granted during post-IPO transition period exempt regardless of when vest or exercised; RSUs only exempt if settled/paid during transition period

Do we need the tax deduction?

- Consider whether the company cares about the tax deduction
  - Do you pay cash compensation in excess of $1 million?
  - Structure of equity awards – options treated differently
  - Does the company have net operating losses?
- Consider implications of losing tax deduction
  - Proxy disclosure
  - Impact on financial statements due to loss of deduction
- Always discuss with finance team

What doesn't count?

Cooley

Section 162(m) excluded compensation

- Specified types of compensation are excluded from the $1 million limit
  - Retirement income from a qualified plan or annuity
  - Benefits that are excluded from the executive's gross income (e.g., welfare benefits)
  - Commission-based compensation
  - Qualified performance-based compensation
    - Includes most stock options
    - Includes most performance-based equity grants made under a shareholder approved plan

Qualified performance-based compensation (QPBC)

- **Performance Goals.** The compensation must be contingent solely on the attainment of one or more "pre-established," objective performance goals
  - Attainment must be substantially uncertain at time goals are established
  - Goals must be set forth in plan approved by shareholders
- **Compensation committee.** The performance goals must be set by the corporation's compensation committee
  - Must consist of 2 or more outside directors
  - "Outside director" definition different from listing standards, Section 16(b)(3), general independent standards and proxy advisory firm standards
  - Requirements are complex – should revisit every year
- **Shareholder approval.** Before payment, shareholders in a separate vote must approve the material terms of the compensation, including the applicable performance goals and the maximum amount payable to any covered employee

Qualified performance-based compensation (QPBC)

- **Compensation committee certification.** Before payment, the compensation committee must certify in writing that the performance goals and any other material terms were in fact satisfied
  - Either written resolutions attaching certification – OR – minutes of meeting approved by compensation committee before payment
  - Generally cannot adjust goals after set, unless adjustments set forth in plan and approved by shareholders
  - Special rule for options and stock appreciation rights (SARs)
- **Cannot provide discretion to increase awards.**
  - Cannot deem performance goals satisfied if not clearly met
  - Cannot provide for additional payments if performance goals are exceeded
  - Negative discretion permitted – may adjust awards down

QPBC – equity awards

- Stock options and SARs satisfy the “performance goal” requirements and treated as qualified performance-based compensation by default if:
  - Granted by compensation committee consisting of outside directors;
  - Equity plan includes a per employee limit on number of shares for which an award may be granted during a specified period (typically a year);
  - Per employee limit is approved by the shareholders; and
  - Exercise price is at least 100% of FMV on grant date.
- Vesting certification not required
- May vest solely based on time – performance-based vesting and certification of vesting not required
- Exception does not apply to restricted stock or RSUs

Isn’t that “special”.....

- Special committee – subcommittee of the compensation committee consisting solely of two or more outside directors to approve performance-based compensation
- Compensation for 162(m) covered employees must be separately approved by the subcommittee
- Practical considerations
  - Process for establishing subcommittee
    - Selection of directors
    - Compensation committee charter
  - Additional administrative steps for meetings
  - Written consents of both compensation committee and subcommittee

Common traps

Common QPBC compliance issues

- Plan documents
  - Failure to have plan timely reapproved by shareholders
    - If have discretion to choose performance goals – material terms of plan must generally be reapproved by the company’s shareholders every five years
- Structure of award
  - Exceeding the annual per person limit for stock option award to a new officer
    - Shareholder litigation regarding exceeded limits
  - Not using shareholder approved performance goals set forth in plan
- Compensation committee
  - Disqualification of compensation committee member as an “outside director” based on interim CEO service, or professional service relationship between Board member’s firm (e.g., accounting, law) and the company

Common QPBC compliance issues

- Grant process
  - Failure to timely establish performance goals within 90 days of beginning of period (or before 25% of period has elapsed), or making changes to goals after that period
  - Delegation to CEO of authority to determine bonuses or equity awards for other executive officers
- Payment approval process
  - Adjustment of pre-established performance goals (except as permitted in plan)
  - Positive discretion - paying compensation when performance goals have not been attained
  - Increasing the amount of compensation otherwise due on achievement of pre-established performance goal
  - Full board approving CEO compensation
- Severance – guaranteed payment of award as severance upon termination of employment without cause or for good reason
- Inducement grants – do not qualify as performance-based compensation

What should we be doing?

Cooley

QBPC best practices

- Adopt omnibus plan – include the ability to grant cash awards that can qualify as performance-based compensation in the company's omnibus equity incentive plan
  - Company will only have to submit one plan for shareholder approval
- Plan should provide that compensation committee may select performance goals from pre-approved performance criteria annually, and include the ability to adjust the methods that can be used to calculate performance targets in the plan
  - Will require re-approval of the plan by shareholders every five years
- Compensation committee charter should provide maximum flexibility – allowing creation of subcommittees – not provide that compensation paid to CEO is recommended to and approved by the full board

Negative discretion plan

Question: Is there any way to grant QPBC awards that are earned based on performance goals that are not pre-approved by the company's shareholders?

- YES!! → a negative discretion plan
- Rule 1 – Performance-based compensation may only be paid based upon the attainment of one or more objective performance goals that have been pre-approved by the company's shareholders
- Rule 2 – Use of discretion to increase an award to the extent the performance goals are exceeded does not meet the Section 162(m) QPBC requirements, BUT use of discretion to *reduce* an award is permitted under Section 162(m)
- Negative discretion plan
  - Bonus pool funded at a multiple of target bonuses for all participants in the plan, based upon achievement of one or more performance goals set forth in the shareholder-approved plan
  - Individual awards then adjusted ***downward*** based on one or more performance goals to measure performance that are not set forth in the plan and were not approved by the shareholders, to reach the desired bonus amount

Negative discretion plan example

- Assume CEO and three executive officers have annual target performance bonuses of 100%, 60%, 50% and 50% of their base salaries respectively, with the sum of their target bonuses equaling $900,000
- The company wants to calculate bonuses based on both company-wide performance metrics as well as individual performance goals tailored to each executive, with each performance target weighted 20%
- Negative discretion plan funds bonuses into a bonus pool at an amount equal to 200% of participant target bonuses, or $1,800,000, if one or more shareholder-approved performance goals are attained (such as attainment of a specified amount of net earnings or an EBITDA target)
- Awards at the 200% level for each participant could then be adjusted ***downward*** based upon achievement of individual or corporate level non-shareholder approved performance targets (e.g. sum of results of achieving each of 5 targets weighted 20% per target to reach target bonus)
  - As long as the bonus paid to each individual is less than 200% of the individual's target bonus (the funded amount), the bonuses may qualify as QPBC for purposes of Section 162(m)

Practical considerations

- Plan is “all or nothing” – no awards may be paid under plan if umbrella 162(m) shareholder approved goal is not achieved
  - Awards paid regardless of achievement of this performance metric will not qualify as performance-based compensation
- Funded bonus “pool” cannot be adjusted to change participant awards
  - Amount by which one participant’s award is reduced if the participant does not achieve all individual performance goals cannot be used to increase another participant’s award
- Bonus can be paid based on stretch performance if individual goals are exceeded, as long as bonus paid does not exceed funded amount
- Plan can be complex and requires educating management team

Considerations for shareholder approval

Cooley

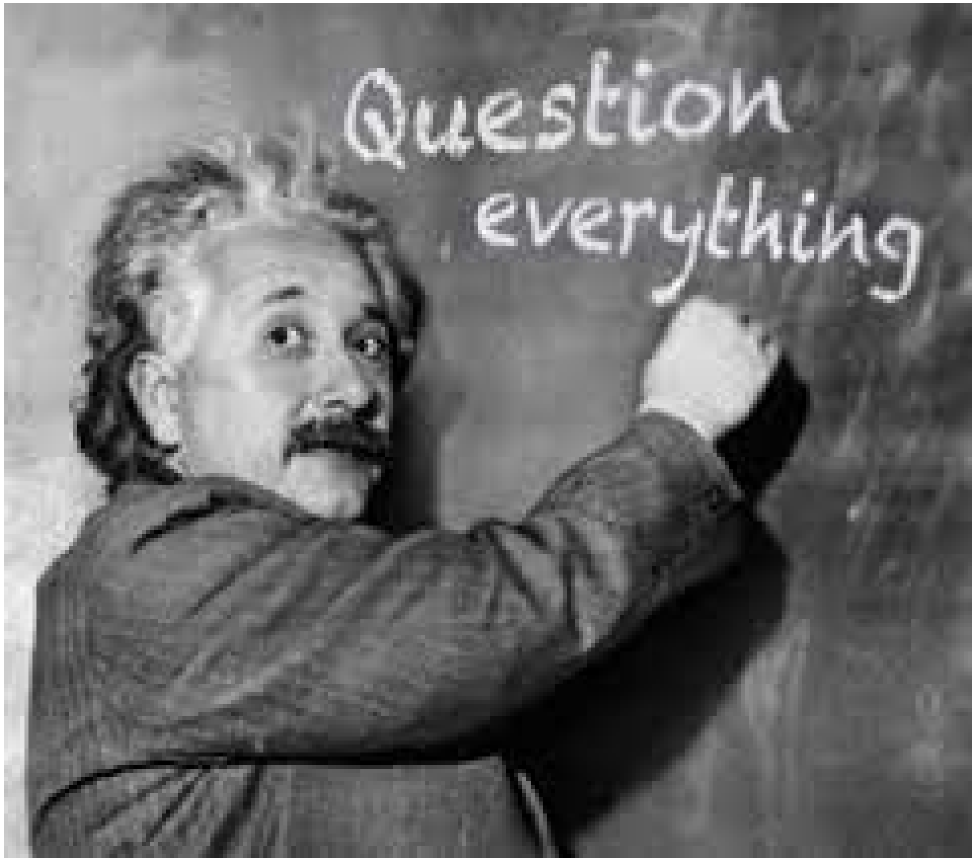
Section 162(m) shareholder proposals

- QPBC – performance criteria set forth in plan must be reapproved by shareholders every five years if plan permits choice among alternatives
- Proxy advisory firms will analyze full plan and may pressure companies to eliminate "problematic" provisions (e.g., repricing, evergreens)

Section 162(m) proposals – advice for 2018

- Evaluate the importance of 162(m) deduction
  - Weigh against potential loss of important provisions/proposal failure
- Consider whether it is necessary to keep “problematic” provisions” (e.g., might be ok to eliminate repricing provision)
- Pay close attention to any changes being made to the plan that might trigger heightened scrutiny and if this is the first time the plan is submitted to public company shareholders

Questions????



Keith Ranta

kranta@cooley.com

Amy Wood

awood@cooley.com

Thank you for joining us!

Cooley