Bank Director

Breakout II: Key Considerations for Compensation and Equity Programs

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#BDComp22

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November 8, 2022

Presenters

Lynda Crouse

Lynda assists clients with the design, implementation and administration of all types of employee and director compensation and benefit arrangements, including employment agreements, incentive plans, equity plans, 401(k) plans, ESOPs, SERPs and other deferred compensation plans. She also helps clients comply with securities laws applicable to these types of compensation and benefit arrangements. Lynda also routinely works with clients on complex corporate transactions and restructurings to address employee and benefit transition issues.

Shannon Patterson

Shannon represents companies of all sizes in various industries, with a focus on public companies in the community banking and wider financial services sector. She advises clients on securities law, corporate governance and executive compensation matters. Shannon assists public companies in satisfying the disclosure and corporate governance requirements of the U.S. Securities and Exchange Commission, the New York Stock Exchange and the Nasdaq Stock Market. She helps clients merge their compliance efforts with established business goals to improve corporate performance.

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401(k) Plan Litigation Risks and Mitigation

Background: Trend of Litigation

- **Litigation against plans is costly and common regardless of the size of the plan**

- **Significant increase in the number of class lawsuits alleging mismanagement of 401(k) and 403(b) plans, with over 170 nationwide class actions filed since 2020**

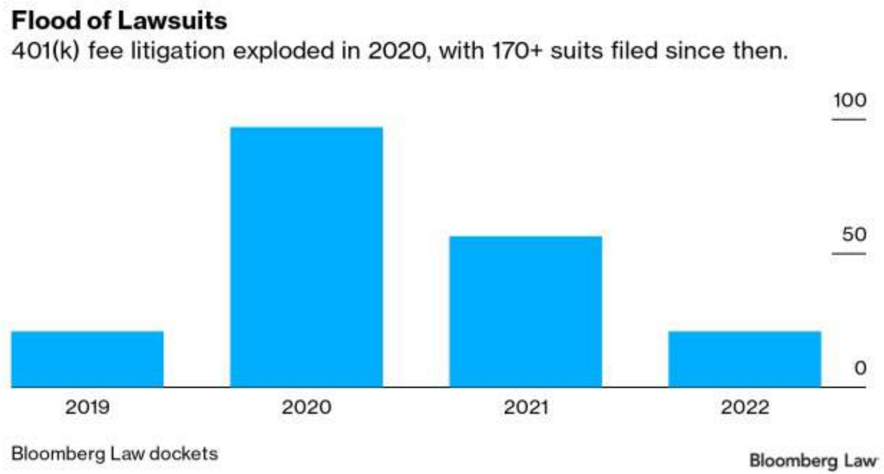

Figure 1. Wille, J.; https://news.bloomberglaw.com/employee-benefits/flood-of-401k-fee-lawsuits-spur-wave-of-early-plaintiff-wins

Hughes vs. Northwestern University

- **We expect this trend to continue after the Supreme Court's decision in *Hughes vs. Northwestern University***
  - The Supreme Court considered the standard for determining the motion to dismiss in the context of claims that the duty of prudence under ERISA had been breached
- **Key Takeaway for Fiduciaries**
  - Maintaining a large number of investment options will not discharge a fiduciary of its failure to continually monitor and remove or replace poor-performing, high-cost or otherwise imprudent investments from the menu
- **Post-*Hughes* Decisions**
  - Courts have recognized that fiduciary conduct must be judged in a context-specific fashion at the time the challenged conduct occurred and with recognition of what are often competing considerations faced by fiduciaries

Common Allegations

Excess recordkeeping fees	Choosing a higher-cost share class	Failing to remove poorly performing funds	Excessive expense ratios
Using active investment strategies instead of passive	Failing to understand the totality of the fees (*e.g.*, revenue sharing)	Failing to remove company stock	Money market vs. stable value funds
Standard vs. customized Target Date Funds	Conflict of interest/self-dealing	Excessive investment options (*i.e.*, university cases)	Failure to follow investment policy statement

Fiduciary Duties

- **Understand what your duties are and comply with them**
- **ERISA fiduciary duties include:**
  - Duty of Loyalty/Exclusive Benefit Rule
  - Duty of Care
  - Duty of Prudence
  - Duty to Diversify
  - Duty to Monitor
  - Duty to Follow Plan Documents
  - Duties Related to Co-Fiduciaries
- **ERISA fiduciaries should also review their current fiduciary practices to ensure they align with best practices**

Mitigating Litigation Risks – Fiduciary Best Practices

- **Identify fiduciaries**
  - Consider establishing an investment committee
  - Consider a third-party investment advisor
- **Annual fiduciary training**
- **Regularly review all plan fees – meet at least quarterly**
  - Understand the totality of the fees, including any revenue sharing arrangements
  - Continually monitor to see if a less expensive share class is available
  - Have a scoring methodology to highlight poorly performing funds and remove those funds as necessary
- ***Document*** **fiduciary decisions and reason for decisions**
- **Adopt policies and procedures to establish a prudent investment process**

Mitigating Litigation Risks – Fiduciary Best Practices

- **Annual review**
  - Are disclosures appropriate/being followed?
  - Are fees in order?
  - Is diversity of investments appropriate in light of current events?
- **Always follow Investment Policy Statements**
- **Have a rigorous conflict of interest policy and follow it**
- **Have strong cybersecurity practices**
- **Protect the attorney/client privilege in communications with outside counsel**

Mitigating Litigation Risks – Fiduciary Best Practices

- **Have a regular benchmarking process for plan service providers (every 3-5 years)**
  - Recordkeepers
  - 401(k) plan investment advisors
- **Have a diverse and broad investment menu**
- **Beware of what is included in publicly available information**
  - Reflect good fiduciary practices on publicly available information, such as Form 5500s (e.g., include in audit report if a benchmarking assessment was conducted)
- **Avoid the appearance of impropriety**

EQUITY PLAN CONSIDERATIONS

Equity Plan Considerations

- **What awards can be granted under the plan?**
- Award types authorized by plan:
  - Restricted Stock
  - Profits Interests
  - Restricted Stock Units (Phantom Equity)
  - Stock Options (NQSOs and ISOs)
  - Stock Appreciation Rights
- Some states limit the types of equity awards banks can grant
- Regulators limit the types of equity awards de novo banks can grant

- **Always be aware of plan limits**
  - Maximum shares authorized under plan
  - Plan recycling provisions
  - Annual limits
  - Non-employee director compensation limits

Equity Plan Considerations

Who has authority to grant awards?

- Board
- Compensation Committee (if delegated in plan or by the board)
  - Compensation Committee must recommend or approve awards for executive officers (*NYSE/NASDAQ*)
- CEO/CFO/CHRO (if delegated in plan or by Compensation Committee)
  - Limited to specific number of shares and dollar amounts
  - Should be limited to non-Section 16 insiders to facilitate compliance with short-swing profit rules (*public companies*)
  - Should be limited to non-executive employees (*NYSE/NASDAQ*)

Who can receive award?

- ISOs may only be granted to employees
- Does the plan permit awards to directors of subsidiaries or advisory directors?
- Does the plan permit awards to consultants or advisors?
- Former employees and directors typically cannot receive awards (unless serving in consultant or advisor role)
- Is the proposed award consistent with stated purpose of the plan?

Equity Plan Considerations

Know what you have and estimate what you will need

- **Share counting**
  - State corporate law purposes
  - Plan compliance purposes
  - Dilution
- **Recycling provisions in the plan**
  - Gross versus net share counting
  - Forfeited or expired awards
- **Performance-based grants**
- **Estimates of future needs**

Equity Plan Considerations

- **Shareholder approval to adopt or amend an equity plan is required:**
  - If company listed on NYSE/NASDAQ (with limited exceptions)
  - If state law requires shareholder approval for equity plans of banks
  - To grant stock options that qualify as ISOs
- **Before adopting or amending an equity plan, a public company should review proxy voting guidelines of:**
  - Shareholder advisory groups (e.g., Institutional Shareholder Services and Glass Lewis & Co.); and
  - The company's top institutional investors
- **Form S-8 registration prior to issuance of shares of a public company**

Equity Plan Considerations – Federal Securities Laws

- **Securities generally cannot be offered or sold unless either:**
  - The offering is registered with the SEC on a Securites Act registration statement, or
  - There is an exemption from the Securities Act registration requirements for the offering, including:
    - Rule 701
    - Section 4(a)(2) and Regulation D, or
    - Rule 144 (for resales of shares underlying awards granted under Rule 701 or Section 4(a)(2) and Regulation D)

Equity Plan Considerations – State Securities Laws

- **Private companies must also comply with any applicable state securities laws ("blue sky laws") when granting equity compensation awards**
  - For issuers registering shares with the SEC, state blue sky laws are preempted
  - Private companies should consider whether any additional filings, requirements, or limitations apply in any state in which participants reside
  - Many state blue sky laws exempt shares issued for compensatory purposes if the offering complies with Rule 701 under federal securities laws

Incorporating ESG Metrics into Equity-Based Compensation

Incorporating ESG Metrics into Equity-Based Compensation

- **Environmental, Social and Governance considerations (ESG) are expected to play an increasing role in equity-based compensation decisions**
- **Key Considerations**
  - Understand the ESG risks for your company and industry
  - Look at industry peers for insight
  - Consult with your investors and other stakeholders
  - Establish whether metrics should be based on individual, group or company goals
  - Test your model rigorously
  - Determine how ESG should be measured (stand-alone metric or modifier)
  - Determine the weighting of metrics
  - Do not overpromise ESG behavior changes linked to any new pay design
  - Consider the disclosure in the proxy and to other stakeholders (such as employees) if ESG goals are not achieved

What You Need to Know About ASU 2021-07

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- **ASU No. 2021-07**
  - Simplifies the determination of the fair value of a private company stock option or other stock-settled award on the grant date or date the award is modified
  - Allows private companies to elect a practical expedient to determine the current price of a share underlying a stock option or other stock-settled award using the reasonable application of a reasonable valuation method

- **Effective for all qualifying awards granted or modified during fiscal years beginning after December 15, 2021**

What You Need to Know About ASU 2021-07

- **Consider the following factors in connection with a reasonable valuation:**
  - The value of the tangible and intangible assets of the company
  - The present value of the anticipated future cash flows of the company
  - The market value of stock or equity interests in similar entities engaged in trades or businesses substantially similar to those engaged in by the company
  - Recent arm's-length transactions involving the sale or transfer of the stock or equity interests of the company
  - Other relevant factors, such as control premiums or discounts for lack of marketability and whether the valuation is used for other purposes that have a material economic effect on the company, its shareholders, or its creditors
  - The company's consistent use of a valuation method to determine the value of its stock or assets for other purposes

SEC Regulatory Updates

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Pay Versus Performance – Public Companies

- **Pay Versus Performance (PVP) Disclosure**
  - New Item 402(v) requires companies to disclose in tabular format certain executive compensation and financial performance measures for its five most recently completed fiscal years
- **Companies Covered**
  - All public reporting companies will be required to include the new PVP disclosure, but the rule excludes emerging growth companies, registered investment companies, and foreign private issuers not subject to proxy rules
  - Smaller reporting companies have reduced reporting requirements
- **Effective Date**
  - New Item 402(v) will be required in proxy statements filed with respect to fiscal years ending on or after December 16, 2022 (i.e., in the 2023 proxy statement)

Clawback Policies – Public Companies

- **Clawback Policies**
  - On June 8, 2022, the SEC reopened the comment period again for its 2015 proposal that would direct the national securities exchanges to establish listing standards requiring companies to adopt policies for the recovery of erroneously awarded incentive-based compensation from their executive officers
  - The proposed rule would implement Section 954 of the Dodd-Frank Act, which was added to the Exchange Act as Section 10D

Why Private Companies Should Watch SEC Developments

- **Increased investor and regulatory focus on executive compensation**
- **Additional internal considerations for cash and equity incentive design**
  - Selecting appropriate metrics
- **Issues involving clawback design and implementation**
  - Cash and equity
  - Triggering events
  - Enforcement and discretion

Compensation and Benefits Issues in M&A Transactions

Buyer-Side Diligence Considerations

- **Identify and quantify any significant compensation and benefits related costs and liabilities, including:**
  - unfunded pension liabilities
  - potential withdrawal liabilities associated with multiemployer plans
  - retiree or post-termination medical obligations
  - any significant benefits-related litigation exposure or ongoing governmental actions
  - any potential compliance issues with the Affordable Care Act
  - payment obligations that are triggered by, or vest as a result of, the transaction
  - any Code Section 409A ("409A") violations concerning deferred compensation arrangements; and
  - any expected excess parachute payments under Code Section 280G ("280G")

Treatment of Equity Awards in Operative Agreements

- **Treatment of outstanding equity compensation awards (e.g., stock options, restricted stock and stock units) can be a key element of a transaction**
- For example, the treatment of outstanding equity awards can affect many aspects of the transaction, including
  - how the transaction is structured
  - the purchase price, and
  - the type of consideration (for example, cash or stock) paid by the buyer

Treatment of Equity Awards in Operative Agreements

- **Equity Award Treatment Analysis**
  - Step 1: Carefully review the specific terms of all existing employee plans and agreements, including equity plan documents, outstanding award agreements, employment agreements, severance agreements and change in control agreements
  - Step 2: Determine whether the transaction will constitute a change in control
  - Step 3: Determine what treatment is permitted by the applicable plan documents and award agreements
  - Step 4: The parties should determine the treatment of the awards and include such treatment in the purchase agreement

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Treatment of Equity Awards in Operative Agreements

Treatment Alternatives for Equity Awards

- Cancellation/Cashout Equity Awards
  - Holders generally receive the excess (if any) of the per share acquisition price over the per share purchase price (if any) in exchange for the cancellation of the awards
  - The parties must consider whether underwater stock options can be cancelled
  - The parties must determine how to allocate the cost of the cashout
  - Potential Section 409A issues if equity awards constitute nonqualified deferred compensation

Treatment of Equity Awards in Operative Agreements

Treatment Alternatives for Equity Awards

- Assumption/Conversion/Substitution of Equity Awards
  - Buyer could assume the awards and the seller's equity plan or assume the awards into one of buyer's equity plans
  - Awards could be assumed and converted into/substituted with awards of the buyer
  - Holders cannot receive more value after the assumption/substitution/conversion than they had immediately before the transaction
  - Payment timing generally needs to remain the same under the assumed/converted/substituted award as it was under the original award

Section 409A Considerations in M&A Transactions

- **409A Considerations**
  - Conducting due diligence to uncover 409A violations (and correction opportunities)
    - Review SERPs, supplemental deferral or "excess“ plans, equity plans and awards (including phantom stock and restricted stock units), employment agreements, severance/separation plans and agreements and change in control agreements
  - Including 409A representations and warranties in the purchase agreement
  - Analyzing the deal structure to determine whether the transaction constitutes a change in control event for 409A purposes
  - Structuring the treatment of equity awards in a manner that complies with 409A
  - Identifying opportunities for accelerating or delaying deferred compensation payments

Section 280G Considerations in M&A Transactions

- **Under 280G, if payments by a corporation that are contingent on a change in control exceed the 280G threshold, a portion of those payments are subject to a 20% excise tax and the corporation loses it deduction for such payments**
  - These payments are commonly referred to as “parachute payments” and any payments that exceed the threshold are called “excess parachute payments”
- **To the extent there are potential excess parachute payments under Code Section 280G, determine whether:**
  - any payments can be restructured to reduce the parachute payments; or
  - if a private company, consider a shareholder approval vote to cleanse any excess parachute payments

Section 280G Considerations in M&A Transactions

- **Shareholder Approval Vote for Private Companies**
  - If the executive agrees to waive the payments, subject to reinstatement upon shareholder approval; and
  - More than 75% of the shareholders of the company entitled to vote in such an election – after every such shareholder receives a liberal disclosure of the payments the executive would receive – vote to reinstate the payments
  - Then the corporation may deduct the expense and there is no 20% excise tax on the payment
  - The interim acts section of the purchase agreement generally includes a covenant requiring the seller to undergo a shareholder approval vote to cleanse any excess parachute payments
- **Public Companies are not permitted to use the shareholder approval exemption**
  - The most effective tool for public companies to reduce or eliminate any 280G issues is a valuation of post-employment restrictive covenants

Questions and Contact Information

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Thank you!