



# Revisiting Executive Compensation and Employee Incentive Plans

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Kathryn advises companies of all sizes on general business concerns, mergers and acquisitions, venture capital investments, and commercial contracting matters. She regularly counsels companies on a wide range of legal issues, including entity formation and structure, corporate governance, executive compensation issues, commercial leasing, licensing agreements, and regulatory compliance. Kathryn also represents companies in the negotiation and implementation of institutional financing and commercial loan transactions with large institutional lenders. She serves as the Practice Group Chair for PilieroMazza's Business & Corporate Group and is a member of the firm's Healthcare and Cybersecurity & Data Privacy teams.

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Nichole counsels employers and their compliance professionals in a broad range of labor and employment matters, including employment discrimination, wage and hour, family and medical leave, labor union negotiations and grievances, executive compensation, and reductions in force. Nichole’s primary goal in representing employers is to help guide them through difficult situations, proactively address compliance, and avoid costly disputes. She serves as the Practice Group Chair for PilieroMazza’s Labor & Employment Group and Team Leader for the Firm’s Construction Industry Team.

# About PilieroMazza

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PilieroMazza—a business law firm—serves as a strategic partner to government contractors and commercial businesses from across the United States in numerous industries.

We deliver results for our clients by implementing legal and business solutions that take the client's best interests into consideration. Moreover, PilieroMazza's efficient operational structure and lean approach to staffing matters translate into competitive pricing for our clients, while providing the highest standard of client service and legal acumen.

PilieroMazza is privileged to represent clients in the following areas:

- Audits & Investigations
- Business & Corporate
- Business Succession Planning
- Corporate and Organizational Governance
- Cybersecurity & Data Privacy
- Debt Financing
- Employee Incentive and Bonus Plans
- False Claims Act
- Government Contracts
- Government Contract Claims & Appeals
- Intellectual Property & Technology Rights
- Labor & Employment
- Labor & Employment for Government Contractors
- Litigation & Dispute Resolution
- Mergers & Acquisitions
- Native American Law & Tribal Advocacy
- Private Equity & Venture Capital

# Overview and Agenda

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- Potential Purposes of Incentive Programs
- Strategic Considerations
- Components of Compensation Plan
- Incentive Plans Available
  - Synthetic Equity Options
  - True Equity Options
- Restrictive Covenants
- Implementation and Integration
- Considerations for Government Contractors and Set Aside Businesses

# Purposes of Incentive Plans and Executive Compensation

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1. **Recruit:** All forms of incentive plans are helpful in recruiting employees
2. **Retain:** Incentive plans can reward employees who remain at the company
3. **Motivate:** Incentive plans can reward employees for a company's appreciating value and can align their interests with the shareholders

# Current Trends

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- Linking a higher percentage of compensation to performance, based on measures such as income, profit, contracts obtained, and cash flow
- Focusing on long-term results. Short-term incentives coupled with attractive long-term incentives to keep the executive engaged
- Move away from compensation like extensive severance packages, tax gross ups, etc.
- Benchmark compensation to company goals and other executive packages

# Strategic Considerations: Determining the Appropriate Starting Point

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- Not one size fits all
- Relevant and useful no matter the stage of a company's life cycle
- Evaluate company culture, talent pool, and current employee retention and motivation programs
- Alignment of the following:
  - Company and shareholder goals
  - Employee capabilities and commitment
  - Tasks and objectives, and confidence it can be done

# Fundamental Questions: Sharing in the Upside

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- Does the company want to share real equity? If so, how much? Set a “pool”
- Which employees will be eligible to participate (executive officers versus “rank and file”)? Will consultants be included as well?
- What are you rewarding for? Value since inception, future growth, company-wide, division, etc.?
- How and when will payment occur? Will the company have liquidity to make payment?
- How is the award earned and will it be subject to forfeiture? Under what circumstances?
- What if a vested participant terminates employment?

# Fundamental Questions: Sharing in the Downside

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- How will termination affect compensation agreement?
- What restrictions are reasonable to place on the executive during and post-employment?
- Are there restrictions on compensation amounts?
- What are the Employee Retirement Income Security Act (ERISA) and / or tax consequences of the arrangement?
- Consequences of failures to achieve expectations?

# Terms to Consider: Employment Agreement

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- Structuring the **term of employment** (job description and incentives)
- Determination of **competitive compensation arrangements**
- Consequences of **change of control**
- Structuring **exit arrangements** (basis of termination, economic consequences, dispute resolution)

# Components of an Employment Agreement

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- Scope of Employment
- Salary
- Bonus Structure
- Benefits
- Term and Termination
- Liability Protection
- Other Incentive Plans
- Confidentiality
- Invention Assignment
- Restrictive Covenants
- Breach
- Dispute Resolution
- Change of Control

# Components of a Compensation Agreement

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- Employer interests in:
  - Retention
  - Termination with minimal adverse impact financially and legally
  - Post-employment protection
  
- Employee interests in:
  - Compensation
  - Employment security
  - Rights and flexibility post-employment termination

# Restrictive Covenants

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- Ways to restrict employees post-employment:
  - Confidentiality
  - Non-Disparagement
  - Non-Competition and Non-Solicitation
  - Invention Protection and Assignment
- Language matters
- Jurisdiction is key

# Types of Incentive Compensation Plans

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- **Cash Bonus Plans**
  - Spot, sign on, commission, holiday, and other bonuses
  - Discretionary; can be tied to key metrics (e.g., revenue, profitability)
- **Broad-Based Qualified Plans**
  - Builds ownership culture throughout the company
  - Employee Stock Ownership Plans (ESOP); Employee Stock Purchase Plan; Retirement Plans (401k); Qualified Incentive Stock Option Plan
- **Equity Plans**
  - Sharing equity with key employees
- **Synthetic Equity (Equity Linked)**
  - Provides compensation that is linked to appreciation in the company's equity without providing actual equity

# Cash Bonus or Bonus Plan

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- Short-term incentive
- Discretionary vs. non-discretionary
- Tie to key metrics (e.g., revenue, profitability)
- Government contractor considerations (allowability):
  - The bonuses must be based on a written agreement, plan, or policy implying an agreement
  - The criteria should avoid subjective evaluations
  - The basis for the award is supported. This means the criteria for award must be supported and documented

# Equity Plans vs. Synthetic Equity Plans

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## – Equity Plans

- Holder receives equity in the company (triggers fiduciary duties to minority owners and voting, dividend, etc. rights)
- Typically, some capital investment is required
- Benefit typically not tied to specific date / event in the future
- Monetizing event often taxed at capital gains tax rates
- Securities laws compliance (federal and state)

## – Synthetic Equity Plans

- Holder does not receive equity in the company; instead, plan compensation is tied to company performance
- Typically, no capital investment requirement
- Benefit typically tied to specific date / event in the future
- Monetizing event taxed at ordinary income tax rates
- Typically, no trigger for compliance with securities laws (if awards are in cash only)

# Stock Options

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- **Stock Options** are the right to purchase the company's stock at a fixed price for a period of time
- **Characteristics:**
  - Holder receives equity interest only after exercising the option
  - Holder must purchase the shares at their strike price
  - Holder can sell the purchased shares at any time but may realize tax advantages for ISOs if the shares are held for at least 1 year

# Stock Options

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## – Considerations:

- Company retains equity until options are exercised, and holder decides whether and when to exercise
- Holder purchases the shares from the company, rather than the company granting the holder the shares
- Holder realizes an immediate gain when exercising options on shares that have appreciated in value and is taxed on the delta of the fair market value of the stock over the strike price paid upon exercise

# Stock Appreciation Rights (Synthetic or Settled in Stock)

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- **Stock Appreciation Rights (SARs)** are the right to receive in stock of the company or cash the appreciation in value of the underlying “SARs” shares
- Once the SARs vest, the holder chooses when to exercise them
- **Characteristics:**
  - For SARs settled in stock, holder does not receive equity until exercising the SARs
  - When the holder exercises the SARs, the company pays the holder stock or cash in an amount equal to the change in value of the company’s stock from the grant date to the exercise date
  - Holder is not required to pay an exercise price

# Stock Appreciation Rights (Synthetic or Settled in Stock)

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## – Considerations:

- The value of SARs is tied to company performance
- Holder can only exercise after vesting, and, once vested, holder decides whether and when to exercise, although the company can set limits around exercise rights
- If not exercised sooner, vested SARs participate in liquidation proceeds over their value at time of grant

# Phantom Equity Plans

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- **Phantom Equity Plans** are unfunded, unsecured promises to pay the value of shares of stock, in cash, in the future
- **Characteristics:**
  - Holder receives cash, and the amount is tied to the change in value of stock from the grant date through the vesting date
  - Employee does not make monetary contribution
  - Payment occurs on events designated in the plan (e.g., change in control, death, disability)
  - Company must have liquidity to pay benefits in cash
- **Considerations:**
  - The value of the benefit is tied to company performance
  - The company can designate which events trigger payment events and can provide for forfeiture if the holder leaves the company
  - Cash benefit taxed at ordinary income rates

# Government Contractor: Limits on Compensation

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- FAR 31.305-6 (general compensation provisions)
- Section 702 of the Bipartisan Budget Act of 2013 (BBA) established a compensation cap on all government contractor personnel
- 2019: \$540,000
- Inclusive of salary, bonus, deferred compensation, employer contributions to defined benefit plans
- Office of Federal Procurement Policy (OFPP) with annually adjusting the cap per a formula
- All Executive Agencies post 2014

# Final Considerations

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Recruit, Retain,  
Motivate—how does  
your plan accomplish  
these objectives?

Do I want to have  
additional share / unit  
holders?

What are your thoughts  
on repurchase rights?

Do I have the liquidity to  
fund the cash needs of  
my plan?

Are you keeping it  
simple so that the  
company and the  
recipients easily  
understand the plan?

# Questions

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