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# **Selected Trends and Developments in Private Equity Compensation**

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# Today's Topics

- > Accounting-related developments
- > Corporate and securities law developments
- > Tax-related developments
- > Impact of these developments on compensation structures



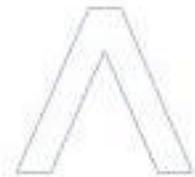
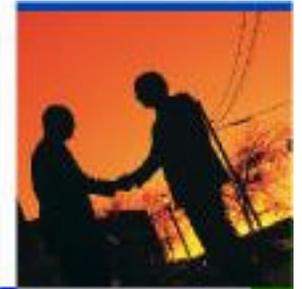
# Accounting-Related Developments

- > Since July 2002, there has been a significant movement toward “expensing” stock options, particularly among public companies.
- > Companies are finally beginning to adopt stock incentive plans that reflect the repeal of “pooling accounting.”
- > FASB’s Emerging Issues Task Force, or “EITF,” has adopted an accounting interpretation that, in many cases, may preclude the use of restricted stock to replace underwater stock options.



# Accounting-Related Developments: Option Expensing

- > Under current rules, companies are not required to charge the fair value of stock option grants as an expense against operating income (but they must do so in a footnote to their financials).
  - In July 2002, only 2 of the S&P 500 companies expensed stock options.
  - By September 2002, more than 90 of the S&P 500 companies expensed stock options.
  - Private companies that will never be public sometimes are less concerned with the accounting treatment of options.



# Accounting-Related Developments: Option Expensing

- > It seems likely that, within the next 2-4 years, FASB will require that the fair value of options be expensed. In October 2002, FASB may have taken the next step, by releasing an exposure draft calling for more prominent footnote disclosure.
- > The proliferation of option expensing could lead to new trends:
  - Option grants with performance-only vesting
  - Grants of stock-settled SARs
  - Grants of NSOs in lieu of ISOs (because the deduction associated with NSOs will reduce the applicable compensation charge)



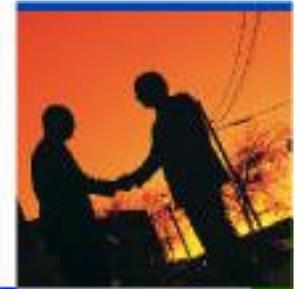
# Accounting-Related Developments: Repeal of Pooling

- > Most stock option plans require that, in the case of a change of control, the acquirer will assume or substitute for all options, and that if the acquirer refuses to do so, the options will be accelerated. Some plans also provide for automatic acceleration.
- > This “hard-wired” approach is generally used to avoid pooling issues.
- > With the repeal of pooling, companies have begun to reconsider this approach.
  - The “hard-wired” approach could provide unintended benefits from acceleration.
  - The elimination of pooling offers more flexibility.



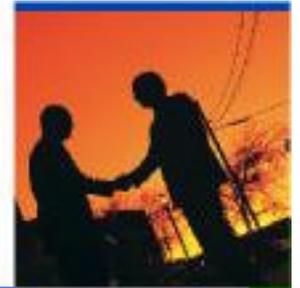
# Accounting-Related Developments: Repeal of Pooling

- > It is now possible to give the board a choice of alternatives, such as:
  - Providing for assumption/substitution
  - Allowing acceleration
  - Allowing for the cash-out or stock-out of options
- > Employees nevertheless may insist on automatic acceleration.
- > Retroactive changes can have adverse tax and accounting consequences and may not be permitted under the plan.



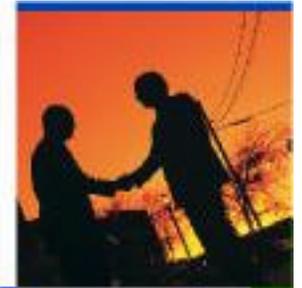
# Accounting-Related Developments: Option Repricings

- > FASB has ruled that option repricings result in variable treatment of options.
- > In order to avoid variable accounting, companies recently have deployed several strategies to deal with underwater options, including:
  - Leaving the underwater options in place and granting additional options
  - Canceling the underwater options in exchange for the grant of new options more than 6 months later
  - Canceling the underwater options in exchange for the immediate grant of restricted stock or cash



# Accounting-Related Developments: Option Repricings

- > The EITF has announced that where a company offers to cancel underwater options in exchange for restricted stock, if an option holder rejects the offer, the option will be variable.
- > This announcement has had a chilling effect on the use of restricted stock to deal with underwater options.



# Corporate and Securities Law Developments: Sarbanes-Oxley

- > In July 2002, Congress passed the Sarbanes-Oxley Act, which provides that a public company shall not directly or indirectly extend or maintain credit, arrange for the extension of credit, or renew an extension of credit, in the form of a personal loan, to or for any director or executive officer.
- > This Act, which carries heavy penalties for violations, could prohibit common compensation arrangements, such as:
  - Option exercise loans and cashless exercise programs
  - Relocation loans
  - Tax and withholding loans



# Corporate and Securities Law Developments: Sarbanes-Oxley

- > Many professionals have taken the position that cashless exercise programs are not covered by the Act.
- > The Act is also relevant for private companies that may become public.



# Tax-Related Developments: Vanishing Loans

- > In a technical advice memorandum, the IRS has stated that “loans” that are intended to be forgiven over time as services are performed may not be respected as loans and may instead be treated as advance payments of compensation resulting in:
  - Current income to the recipient
  - A withholding obligation if the recipient is an employee
- > This type of arrangement is somewhat common, and care must be taken to avoid the above treatment.



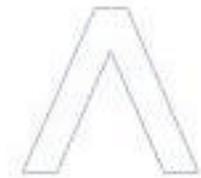
# Tax-Related Developments: Reverse Vesting

- > Many companies allow unvested options to be exercised for restricted stock. This arrangement is often referred to as “reverse vesting.”
- > At a conference late last year, the IRS announced its informal position as to how reverse vesting works with ISOs:
  - The making of a timely Section 83(b) election in connection with the exercise will be effective for AMT and ISO holding period purposes but not for capital gain holding period purposes.
- > Uncertainty regarding reverse vesting of ISOs suggests that it generally should be used only for NSOs.



# Tax-Related Developments: Non-compete and Similar Forfeiture Provisions

- > Companies increasingly are utilizing non-compete and similar types of forfeiture provisions.
- > Common triggers:
  - Competition
  - Inappropriate use of trade secrets
  - Solicitation of employees
  - Disparagement



# Tax-Related Developments: Non-compete and Similar Forfeiture Provisions

- > Common consequences:
  - Forfeiture of vested options
  - Recapture of spread on previously exercised options
  - Recapture of gain on sale of shares acquired under previously exercised options
- > Recent survey indicates that 24% of public companies utilized such provisions
- > Potential tax issues
- > Potential injunction issues



## Summary of Key Points

- > Option expensing is becoming more common and eventually may change the way that equity grants are made.
- > Companies are beginning to adopt more flexible plans in light of the repeal of pooling.
- > While repricings are still common, issuing restricted stock in exchange for underwater options is becoming less common.



## Summary of Key Points

- > The Sarbanes-Oxley Act may have a significant impact on several loan-related compensation arrangements.
- > The IRS is also scrutinizing employee loan arrangements.
- > Reverse vesting for ISOs should be reconsidered.
- > Non-compete and similar forfeiture provisions may have unexpected tax and other consequences.



# Questions and Answers

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