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Worksheet 10 Commentary to Model Equity Compensation Plan Exempt from Section 409A

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The views expressed in this Article are solely those of the author, and not those of his law firm or its clients.

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> "In most English words and phrases there lurk uncertainties." *Robinson v. United States*, 324 U.S. 282, 286 (1945).

> "Condemned to the use of words, we can never expect mathematical certainty from our language." *Grayned v. City of Rockford*, 408 U.S. 104, 110 (1972).

The ABC, Inc. Equity Compensation Plan (the "Model Plan") is designed to satisfy the exemptions for equity compensation plans from Section 409A of the Internal Revenue Code of 1986, as amended (the "code")[1] found in the final Section 409A regulations (the "Final Regulations").[2] The Final Regulations provide exemptions for nonqualified stock options,[3] incentive stock options,[4] stock appreciation rights ("SARs"),[5] and restricted stock.[6]

[1] Section 409A was added to the code by the American Jobs Creation Act of 2004, Pub. L. No. 108-375, §885, 118 Stat. 1418, 1634–41.

[2] Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Final Regulations," 72 Fed. Reg. 19,234 (April 17, 2007), and Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Correction," 72 Fed. Reg. 41,620 (July 31, 2007).

[3] Treas. Reg. §1.409A-1(b)(5)(i)(A).

[4] Treas. Reg. §1.409A-1(b)(5)(ii).

[5] Treas. Reg. §1.409A-1(b)(5)(i)(B).

[6] Treas. Reg. §1.409A-1(b)(6).

Public Law 115-97, otherwise known as the Tax Cuts and Jobs Act of 2017, added Section 83(i) to the code to provide an exemption for deferral elections for stock issued under nonqualified stock options and restricted stock units ("RSUs"). The exemption applies to options and RSUs granted by eligible corporations to qualified employees, each as defined in Section 83(i).[7] The exemption applies to stock attributable to options exercised and RSUs settled after December 31, 2017.[8]

[7] I.R.C. §§83(i) and 409A(d)(7).

[8] Section 13603(c)(2) of Public Law 115-97.

The Model Plan contains the provisions that satisfy the requirements of the exemptions for nonqualified stock options, incentive stock options, SARs, and restricted stock. It also contains provisions that satisfy the requirements of the Final Regulations for nonqualified deferred compensation plans subject to Section 409A, but are not necessary to satisfy the requirements of these exemptions. Service recipients (e.g., employers) often use provisions that satisfy the requirements for nonqualified deferred compensation plans in their exempt equity compensation plans so that the equity compensation plans are consistent with the nonqualified deferred compensation plans that cover the same group of service providers (e.g., employees).[9] In this manner, service recipients can achieve the elusive goal of having a compensation program that makes sense.

[9] The Final Regulations define service recipient as the person for whom services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under I.R.C. §414(b)–(c). Treas. Reg. §1.409A-1(g). The Final Regulations modify this definition for determining the service recipient employer on an employee's separation from service. Treas. Reg. §1.409A-1(h)(3). See discussion of this modification *infra* notes 476 to 481 and accompanying text. For convenience, this Article refers to a service recipient as the employer.

The Final Regulations define service provider as an individual, corporation, subchapter S corporation, partnership, personal service corporation under I.R.C. §269A(b)(1), noncorporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation under I.R.C. §448(d)(2), and noncorporate entity that would be a qualified personal service corporation if it were a corporation, for any taxable year in which such individual, corporation, subchapter S corporation, partnership, or other entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting. Treas. Reg. §1.409A-1(f)(1). For convenience, this Article refers to a service provider as the employee.

The Final Regulations contain detailed rules for determining whether an independent contractor is a service provider subject to I.R.C. §409A. Treas. Reg. §1.409A-1(f)(2).

On June 21, 2016, the Treasury Department and Internal Revenue Service issued proposed regulations that address provisions of the Final Regulations dealing with the exemptions for equity compensation plans, and the requirements for nonqualified deferred compensation plans subject to Section 409A (the "Proposed Regulations").[10] The Proposed Regulations are largely pro-taxpayer.

[10] Department of the Treasury, Internal Revenue Service, Notice of Proposed Rulemaking, "Application of Section 409A to Nonqualified Deferred Compensation Plans," 81 Fed. Reg. 40,569 (June 22, 2016).

The Proposed Regulations are proposed to apply on or after the date on which they are published as final regulations in the Federal Register. For the period before this date, the Final Regulations and other applicable guidance will continue to apply, and taxpayers may rely on the Proposed Regulations before they are published as final regulations. Until the final regulations are published, the IRS will not assert positions that are contrary to the positions taken in the Proposed Regulations.[11]

[11] *Id.* at Proposed Effective Dates, 81 Fed. Reg. at 40,577.

THE PROMISED LAND OF EXEMPTION FROM SECTION 409A

In the absence of an exemption from Section 409A, nonqualified deferred compensation plans can permit employees to exercise options and SARs only on one or more of the following six payment events and times:[12] (1) separation from service;[13] (2) disability;[14] (3) death;[15] (4) at a specified time or pursuant to a fixed schedule;[16] (5) a change-in-control;[17] and (6) the occurrence of an unforeseeable emergency.[18]

[12] Treas. Reg. §1.409A-3(b) (a plan of nonqualified deferred compensation may provide for payment upon the earliest or latest of more than one event or time, provided that each event or time is listed in Treas. Reg. §1.409A-3(a)(1)–(6)).

[13] I.R.C. §409A(a)(2)(A)(i) (separation from service as determined by the Secretary is a permissible payment event); I.R.C. §409A(a)(2)(B)(i) (mandatory six month delay in payment to a specified employee on separation from service); Treas. Reg. §1.409A-1(h) (definition of separation from service); Treas. Reg. §1.409A-3(a)(1) (separation from service is a permissible payment event); Treas. Reg. §1.409A-3(i)(2) (mandatory six month delay in payment to a specified employee on separation from service).

For the use of "termination of employment" as a permissible proxy for separation from service, see *infra* notes 562 to 565 and accompanying text.

[14] I.R.C. §409A(a)(2)(A)(ii) and (C) (disability as defined in the statute is a permissible payment event); Treas. Reg. §1.409A-3(a)(2) and (i)(4) (disability as defined in the Final Regulations is a permissible payment event).

[15] I.R.C. §409A(a)(2)(A)(iii) (death is a permissible payment event); Treas. Reg. §1.409A-3(a)(3) (same).

[16] I.R.C. §409A(a)(2)(iv) (a specified time (or pursuant to a fixed schedule) specified under the plan at the date of deferral of the compensation is a permissible payment date); Treas. Reg. §1.409A-3(a)(4) and (i)(1) (a specified time or fixed schedule, as defined in the Final Regulations, is a permissible payment date).

[17] I.R.C. §409A(a)(2)(A)(v) (to the extent provided by the Secretary, a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, is a permissible payment event); Treas. Reg. §1.409A-3(a)(5) and (i)(5) (a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, as these terms are defined in the Final Regulations, is a permissible payment event).

[18] I.R.C. §409A(a)(2)(A)(vi) (occurrence of an unforeseeable emergency is a permissible payment event); Treas. Reg. §1.409A-3(a)(6) and (i)(3) (occurrence of an unforeseeable emergency, as defined in the Final Regulations, is a permissible payment event).

The provision for payments to be made at a specified time or pursuant to a fixed schedule deprives the employee of the flexibility to choose when to exercise options and SARs subject to Section 409A. Amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred.[19] If an amount is payable in an employee's taxable year (or pursuant to a fixed schedule of the employee's taxable years) that is designated at the time that the amount is deferred and that is objectively determinable, the amount is treated as payable at a specified time (or pursuant to a fixed schedule). A specified time or fixed schedule also includes the designation at the time that the amount is deferred of a defined period or periods within the employee's taxable year or taxable years that are objectively determinable. In addition, the employee must not have a right to designate the taxable year of payment.[20]

[19] Treas. Reg. §1.409A-3(b) and (i)(1).

[20] *Id.*

Under these rules, an option or SAR subject to Section 409A can provide the employee with the right to exercise the stock right only in one specified taxable year, or on a Section 409A-compliant payment event, such as separation from service or change-in-control.[21] If the employee has the discretion to determine when to exercise the stock right, the arrangement runs afoul of the requirement that amounts be payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred. Because most employees want the flexibility to exercise an option or SAR at any time after vesting, complying with Section 409A's payment rules deprives the employee of the flexibility to choose when to exercise an option or SAR.

[21] *See* Chief Counsel Advisory 201521013.

Another way to comply with Section 409A's payment rules is for the option or SAR to provide for exercise at any time after vesting, but payment only at a specified time, such as the last taxable year of the term of the option or SAR, or on a permissible event, such as separation from service or change-in-control.[22] This approach also deprives the employee of the flexibility to choose when to exercise an option or SAR.

[22] *See* Benjamin D. Panter, "'Options' for Early Stage Companies: Designing the Right Stock Option Program," *BNA Pension & Benefits Reporter*, May 15, 2015, at 924, 926 ("[A] 409A option may be structured that it vests in equal installments over a four-year period, but can only be exercised upon or within the 30-day period following a Section 409A qualified change in control. Under this construct, even if the option were granted with an exercise price below fair market value at the time of grant, and thus, subject to 409A, the option would be deemed a nonqualified deferred compensation arrangement structured in compliance with Section 409A.").

Similarly, a promise to transfer stock or other property in a future taxable year in which the stock or property will be substantially vested is subject to Section 409A's payment rules, unless the promise satisfies the short-term deferral exemption.[23] This means that the employer can transfer the stock or property to the employee only on a Section 409A permissible payment event or at a specified time or pursuant to a fixed schedule.

[23] Treas. Reg. §1.409A-1(b)(6)(ii).

Equity compensation that is exempt from Section 409A gives the employee the flexibility to exercise an option or SAR at any time after vesting. In addition, the prohibition on the acceleration of the time or schedule of any payment does not apply.[24] The employer can freely accelerate the vesting of the employee's right to exercise an option or SAR, or the vesting of restricted stock.

[24] Treas. Reg. §1.409A-3(j)(1).

The ability to accelerate is important because equity compensation plans often provide for the acceleration of vesting, or grant the employer the discretion to accelerate vesting, on a change-in-control, an involuntary separation from service within two years after a change-in-control, or a separation from service for good reason within two years after a change-in-control. In addition, when the plan is exempt from Section 409A, the plan's definition of change-in-control does not have to comply with the definition of the Final Regulations.[25]

[25] Treas. Reg. §1.409A-3(i)(5).

Finally, in their employment agreements, executives with the leverage often bargain for the acceleration of vesting of all or a portion of equity compensation on a separation from service without cause or for good reason.

Thus, exemption from Section 409A for equity compensation plans is truly the Promised Land wistfully reminiscent of an earlier time when parties could negotiate the terms of their arrangements free from the shackles of Section 409A.[26]

[26] *Cf.* Carole King, *Been to Canaan, on* Rhymes & Reasons (Ode Records 1972) ("Green fields and rolling hills, room enough to do what we will. Sweet dreams of yestertime are running through my mind of a place I left behind. Been so long, I can't remember when. I've been to Canaan and I want to go back again. Been so long, I'm living till then, 'cause I've been to Canaan and I won't rest until I go back again.").

See generally Alex B. Long, "[Insert Song Lyrics Here]: The Uses and Misuses of Popular Music Lyrics in Legal Writing," 64 *Washington & Lee Law Review* 531 (Spring 2007).

EXEMPTION FOR NONQUALIFIED STOCK OPTIONS

The Final Regulations provide that a nonqualified stock option is not a deferral of compensation subject to Section 409A when the following requirements are met:

(1) The issuer of the stock is an eligible issuer of service recipient stock;[27]

[27] Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1).

(2) The option is an option to purchase service recipient stock;[28]

[28] Treas. Reg. §1.409A-1(b)(5)(iii)(A).

(3) The exercise price may never be less than the fair market value of the underlying stock, disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i), on the grant date, and the number of shares subject to the option is fixed on this date.[29] Since an indexed stock option has an exercise price tied to a benchmark index, such as the DJIA, S&P 500, or a peer group, the option will not satisfy the exercise price requirement;

[29] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

(4) The transfer or exercise of the option is subject to taxation under code Section 83 and Treasury Regulation Section 1.83-7;[30]

[30] Treas. Reg. §1.409A-1(b)(5)(i)(A)(2).

(5) The option does not have any feature for the deferral of compensation other than the deferral of recognition of income until the later of: (a) the exercise or disposition of the option under Treasury Regulation Section 1.83-1; and (b) the time that the stock acquired on the option's exercise first becomes substantially vested under Treasury Regulation Section 1.83-3(b);[31] and

[31] Treas. Reg. §1.409A-1(b)(5)(i)(A)(3).

(6) The holder does not have any right, contingent on the exercise of the option, to receive an amount equal to all or part of

the dividends declared and paid between the grant date and the exercise date on the number of shares underlying the option. This amount is an impermissible offset or reduction to the exercise price.[32]

[32] Treas. Reg. §1.409A-1(b)(5)(i)(E).

The Final Regulations provide that the following rights are not a feature for the deferral of compensation: (1) the right to receive substantially nonvested stock (as defined in Treasury Regulation Section 1.83-3(b)) on exercise of the option; and (2) the right to pay the exercise price with previously acquired shares.[33] A classic feature for the deferral of compensation is the conversion of an option's intrinsic value into an unfunded, unsecured promise to pay at one or more future dates.

[33] Treas. Reg. §1.409A-1(b)(5)(i)(D).

The advantages of nonqualified stock options are:

(1) Since options are not treated as outstanding shares until exercised, they are not included in the denominator in calculating earnings per share.

(2) Grantees realize an economic benefit only if the value of the stock exceeds the exercise price, and do not realize a loss if the value of the stock falls below the exercise price. Accordingly, options encourage grantees to act in ways that increase the stock price, which aligns the interests of the grantees and shareholders.

(3) The grantee can choose the time of exercise and as a result the time that the grantee incurs tax.

The disadvantages of nonqualified stock options are:

(1) The employer must take an accounting charge at the time of grant, but the grantee may never realize any economic value, or the value ultimately realized by the grantee may exceed the charge taken by the employer.

(2) For private companies, if the grantee exercises the option before a liquidity event, the grantee must have the cash to pay the exercise price and the tax on the gain.

(3) The plans of most public companies provide for cashless exercise through a broker-assisted procedure or net settlement in shares. With a cashless exercise, the employer loses the cash from payment of the exercise price that the grantee would pay to the employer. Depending on the size of the grants and the exercise price, the lost cash flow can be substantial. Furthermore, if an executive undertakes a broker-assisted cashless exercise, or borrows against the shares to be received on exercise, the parties must structure these transactions to avoid the prohibition on loans to executives under Section 402 of the Sarbanes-Oxley Act.

(4) Since grantees benefit if the stock price increases, but do not have downside protection if the stock price decreases, grantees are more likely to take imprudent risks.

(5) Since grantees often have a long period to exercise an option, a grantee can strategically time his or her exercise to when the stock price has increased and realize substantial gain. However, over the long-term the shareholders may not realize substantial gain from interim increases in the stock price.

(6) The grant of options and stock-settled SARs increases share overhang, which represents the potential dilution of a company's shareholders from equity awards. Overhang is calculated by dividing the sum of shares underlying outstanding options and other equity awards and shares reserved for issuance of future options and equity awards by the sum of outstanding shares held by shareholders, shares underlying outstanding options and other equity awards and shares reserved for issuance of future options and other equity awards. Existing shareholders are often wary of plans that create

large overhang because the exercise of the options dilutes the value of their shares. Institutional shareholders often measure dilution based on outstanding options and stock-settled SARS and reserved options and stock-settled SARs.

(7) In a declining market, underwater options often lose their incentive and retentive value. They are also an inefficient use of the company's equity reserves, especially when shares count against the plan's share reserve and reduce the number of shares available for future awards. In addition, since underwater options may not provide any value to grantees, they can produce an unnecessary accounting expense.

(8) Options that use service-based vesting reward employer-wide growth, rather than individual or business unit performance. Institutional Shareholder Services does not treat options with service-based vesting or performance-accelerated awards as performance-based compensation in its pay-for-performance analysis. In addition, Institutional Shareholder Services generally does not consider equity awards to be performance-based if performance assessments are determined by committee discretion or only on broad assessments of company or executive performance.[34]

[34] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 36, at 15 (Dec. 16, 2022).

EXEMPTION FOR SARS

The Final Regulations provide that an SAR is not a deferral of compensation subject to Section 409A when the following requirements are met:

(1) The issuer of the stock is an eligible issuer of service recipient stock;[35]

[35] Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1).

(2) The stock is service recipient stock;[36]

[36] Treas. Reg. §1.409A-1(b)(5)(iii)(A).

(3) The compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock, disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i), on the exercise date, over an amount specified on the grant date (the SAR exercise price) for a number of shares fixed on or before the grant date;[37]

[37] Treas. Reg. §1.409A-1(b)(5)(i)(B)(1).

(4) The SAR's exercise price may never be less than the fair market value of the stock, disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i), on the SAR's grant date.[38] Since an indexed SAR has an exercise price tied to a benchmark index, such as the DJIA, S&P 500, or a peer group, it will not satisfy the exercise price requirement;

[38] Treas. Reg. §1.409A-1(b)(5)(i)(B)(2).

(5) The SAR does not have any feature for the deferral of compensation other than the deferral of recognition of income until the SAR's exercise.[39] The right to receive substantially nonvested stock (as defined in Treasury Regulation Section 1.83-3(b)) on the SAR's exercise is not a feature for the deferral of compensation;[40] and

[39] Treas. Reg. §1.409A-1(b)(5)(i)(B)(3).

[40] Treas. Reg. §1.409A-1(b)(5)(i)(D).

(6) The holder does not have any right, contingent on the exercise of the SAR, to receive an amount equal to all or part of the

dividends declared and paid between the grant date and the exercise date on the number of shares underlying the SAR. This amount is an impermissible increase in the amount payable under the SAR.[41]

[41] Treas. Reg. §1.409A-1(b)(5)(i)(E).

The advantages of SARs are:

(1) SARs settled in cash are not treated as equity compensation under NYSE and NASDAQ listing rules. Under these rules shareholder approval is not necessary for plans that provide for only cash-settled SARs.

(2) Grantees realize an economic benefit only if the value of the stock exceeds the exercise price, and do not realize a loss if the value of the stock falls below the exercise price. Accordingly, SARs encourage grantees to act in ways that increase the value of the stock, which aligns the interest of grantees and shareholders.

(3) Grantees participate in the company's growth without receiving shares.

(4) The grantee chooses the time of exercise and as a result the time that the grantee incurs tax. For SARs settled in cash, the grantee receives cash at the time the grantee incurs the tax. For SARs settled in the stock of a private company, if the grantee exercises the SAR before a liquidity event, the grantee must have the cash to pay the tax on the gain.

(5) When a grantee exercises an SAR, the grantee does not need cash to pay the exercise price. In addition, the grantee does not have to undertake a broker-assisted cashless exercise, or borrow against the proceeds or for stock-settled SARs the shares to be received on exercise.

(6) SARs settled in cash do not dilute other shareholders.

The disadvantages of SARs are:

(1) SARs settled in cash do not increase the grantee's equity investment in the employer. Once the grantee receives the cash, the grantee’ interests are no longer aligned with the shareholders.

(2) SARs settled in cash are treated as liability awards for accounting purposes, which requires quarterly adjustments to the compensation charge based on the stock price.

(3) SARs settled in cash means that the employer must have the cash flow necessary to satisfy its payment obligation to the grantee.

(4) Since grantees benefit if the stock price increases, but do not have downside protection if the stock price decreases, grantees are more likely to take imprudent risks.

(5) Since grantees often have a long period to exercise an SAR, a grantee can strategically time his or her exercise to when the stock price has increased and realize substantial gain. However, over the long-term the shareholders may not realize substantial gain from interim increases in the stock price.

(6) The grant of stock-settled SARs increases share overhang, which is the number of remaining shares authorized under the plan and shares subject to previously granted awards as a percentage of the company's total outstanding stock. Existing shareholders are often wary of plans that create large overhang because the exercise of stock-settled SARs dilutes the value of their shares. Institutional shareholders often measure dilution based on outstanding options and stock-settled SARs or reserved options and stock-settled SARs.

(7) In a declining market, underwater SARs usually lose their incentive and retentive value. Underwater stock-settled SARs

are also an inefficient use of the company's equity reserves, especially when shares count against the plan's share reserve and reduce the number of shares available for new awards. In addition, since underwater stock-settled SARs may not provide any value to grantees, they can produce an unnecessary accounting expense.

(8) SARS that use service-based vesting reward employer-wide growth, rather than individual or business unit performance. Institutional Shareholder Services does not treat SARs with service-based vesting or performance-accelerated awards as performance-based compensation in its pay-for-performance analysis. In addition, Institutional Shareholder Services generally does not consider equity awards to be performance-based if performance assessments are determined by committee discretion or only on broad assessments of company or executive performance.[42]

[42] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 36, at 15 (Dec. 16, 2022).

Share Overhang and Shareholder Dilution

Institutional Shareholder Services may recommend an “Against” vote for an equity compensation plan that it estimates to be excessively dilutive to existing shareholders. Institutional Shareholder Services may take this position when a company's equity compensation program is estimated to dilute shareholders’ holdings by more than 20% for the S&P 500 model, and 25% for the Russell 3000 model. This position does not apply to the Non-Russell 3000 or Special Cases models. Institutional Shareholder Services determines dilution by share capital dilution (as opposed to voting power dilution) calculated as (A+B+C) ÷ CSO, where A = number of new shares requested; B = number of shares that remain available for issuance; C = number of unexercised and unvested outstanding awards; and CSO = common shares outstanding.[43]

[43] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 42, at 20 (Dec. 16, 2022).

Payment of Dividends on Option and SAR Shares

A plan that provides a right to dividends or other distributions (other than stock dividends under Treasury Regulation Section 1.409A-1(b)(5)(v)(H)) declared and paid on the number of shares underlying an option or SAR, the payment of which is not contingent on, or otherwise payable on, exercise of the option or SAR, may provide for a deferral of compensation. However, a right to receive such an amount will not, by itself, be treated as a reduction to the exercise price of the option. Thus, a right to such dividends or distributions that is not contingent, directly or indirectly, upon exercise of the option or SAR will not cause the option or SAR to lose its exemption.[44]

[44] Treas. Reg. §1.409A-1(b)(5)(i)(E).

Under this rule, employers can provide for dividend equivalents that accrue over time to be paid on vesting of the option or SAR. Once vesting of the option or SAR and payment of the dividend equivalents occur, the holder will no longer be entitled to dividend equivalents. The holder will also not be entitled to dividends on the underlying stock until after the holder exercises the option or SAR. This arrangement encourages the holder to exercise the option or SAR early to regain the economic benefit of the dividends.

Under the *Equity Plan Scorecard* of Institutional Shareholder Services, for the factor of dividends paid on unvested awards, a plan receives full points when the plan expressly prohibits the payment of dividends on unvested awards. Accrual of dividends payable on the vesting of the underlying award is permissible. A plan does not receive any points when it is silent on the payment of dividends on unvested awards, or when it provides for the payment of dividends on unvested awards.[45] Thus, if the plan is silent on the payment of dividends, a company's general practice of not paying dividends until vesting does not receive any points.

[45] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 37 and 38, at 17–18 (Dec. 16, 2022).

Section 7(a)(i)–(ii) of the Model Plan provides that before a Grantee vests in and exercises an Option or SAR, the Grantee will not have any right to ordinary and extraordinary dividends and other distributions. For dividends on Restricted Stock, Section 7(a)(iii) provides for three alternatives. Alternative 1 provides that before a Grantee vests in Restricted Stock, the Grantee will not have any right to ordinary and extraordinary dividends and other distributions. Alternative 2 provides that before a Grantee vests in Restricted Stock, the Grantee will have the right to ordinary and extraordinary dividends and other distributions. Alternative 3 grants the Administrator or Board the discretion to pay dividends currently, withhold and credit dividends to a separate account to be paid on specified dates, to credit withheld cash dividends with interest, to reinvest cash dividends in additional Shares, and to establish vesting requirements for the dividends.

Modifications and Extensions of Options and SARs

Under the Final Regulations, nonqualified stock options and SARs are called "stock rights."[46] The employer and grantee must be wary of whether any change in the terms of a stock right is a modification or extension. A modification means any change in the terms of a stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the stock right) that may provide the holder with a direct or indirect reduction in the exercise price regardless of whether the holder in fact benefits from the change.[47] A modification results in the grant of a new stock right that must satisfy the requirements for exemption anew on the date of modification.[48]

[46] Treas. Reg. §1.409A-1(b)(5)(i)(A)–(B).

[47] Treas. Reg. §1.409A-1(b)(5)(v)(B).

[48] Treas. Reg. §1.409A-1(b)(5)(v)(A).

An extension means giving the holder additional time to exercise the stock right beyond the time originally prescribed under its terms, the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation not permitted by Treasury Regulation Section 1.409A-1(b)(5)(i)(A)(3) for nonqualified stock options, or by Treasury Regulation Section 1.409A-1(b)(5)(i)(B)(3) for SARs.[49]

[49] Treas. Reg. §1.409A-1(b)(5)(v)(C)(1).

When an extension occurs, the stock right is treated as having had an additional deferral feature from the original grant date.[50] The stock right is retroactively treated as subject to Section 409A as of the grant date. Thus, an extension results in a retroactive violation of Section 409A as of the grant date. Under proposed regulations, the tax for the Section 409A violation is imposed when the stock right vests.[51]

[50] Treas. Reg. §1.409A-1(b)(5)(v)(A).

[51] Prop. Treas. Reg. §1.409A-4(a)(1)(i) (as proposed at 73 Fed. Reg. 74,380, 74,393 (Dec. 8, 2008)).

An extension does not occur if the change occurs when the exercise price of the stock right equals or exceeds the fair market value of the stock. If the exercise period is extended in this situation, the original stock right is treated as modified rather than extended, and a new stock right as having been granted. Again, the modified stock right must satisfy the requirements for exemption anew on the date of modification.[52]

[52] Treas. Reg. §1.409A-1(b)(5)(v)(C).

An extension also does not occur if the exercise period is extended to a date no later than the earlier of the latest date on which the stock right would have expired by its original terms under any circumstances, and the tenth anniversary of the original grant date.[53]

[53] *Id.*

Finally, an extension does not occur if the expiration of the stock right is tolled while the holder cannot exercise it because exercise would violate an applicable federal, state, or foreign law, or would jeopardize the employer's ability to continue as a going concern. The period during which the stock right may be exercised cannot be extended by more than thirty days after its exercise would first no longer violate an applicable federal, state, or foreign law, or would first no longer jeopardize the employer's ability to continue as a going concern.[54] A provision of foreign law is considered to apply only to foreign earned income (as defined under Section 911(b)(1) without regard to Section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period set forth in Section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.[55]

[54] *Id.*

[55] *Id.*

Sections 7(d)(vii) and 9(c) of the Model Plan reflect these rules.

In two situations, it is unclear whether the provision for the tolling of the expiration date applies. First, the employer does not have a valid Form S-8 registration statement in effect, but exercise in the absence of a Form S-8 would not violate the securities laws, and another registration statement is filed or another exemption from registration applies.[56] Second, the employee cannot exercise the stock right because the employee is subject to a blackout period on the sale of stock.[57]

[56] Erica F. Schohn, "Equity Arrangements," in *Section 409A Handbook* 14-1, 19 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

[57] *Id.*

The Final Regulations provide for the following right to rescind changes to avoid a modification or extension. A change to the terms of a stock right (or change in the terms of the plan under which the stock right was granted or in the terms of any other agreement governing the stock right) is not a modification or extension to the extent that the change is rescinded by the earlier of the date that the stock right is exercised, and the last day of the grantee's taxable year in which the change occurred.[58]

[58] Treas. Reg. §1.409A-1(b)(5)(v)(I).

The exemption from Section 409A for incentive stock options does not have any requirements other than those for incentive stock options under Section 422.[59] However, the exemption does not apply to a modification, extension, or renewal of an incentive stock option that is treated as the grant of a new option that is not an incentive stock option under Treasury Regulation Section 1.424-1(e). In this situation, the option is treated as if it had been a nonqualified stock option from its original grant date. Accordingly, if the modification, extension, or renewal of the option would have been treated as the grant of a new option, or as causing the option to have had a deferral feature from the grant date under Treasury Regulation Section 1.409A-1(b)(5)(v), then for purposes of whether the incentive stock option qualifies for exemption from Section 409A, the modification, extension, or renewal is treated as the grant of a new option, or as causing the option to have had a deferral feature from the grant date.[60]

[59] Treas. Reg. §1.409A-1(b)(5)(ii).

[60] Treas. Reg. §1.409A-1(b)(5)(ii).

EXEMPTION FOR RESTRICTED STOCK

The Final Regulations provide that the grant of restricted stock does not result in the deferral of compensation subject to Section 409A when the following requirements are met:

(1) the employee receives property from the employer, or pursuant to a plan maintained by the employer, that is substantially nonvested (as defined in Treasury Regulation Section 1.83-3(b)), or is includible in income solely due to a valid election under code Section 83(b);[61] and

[61] Treas. Reg. §1.409A-1(b)(6)(i); *see also* Rev. Proc. 2012-29, I.R.B. 2012-28, at 49 (July 9, 2012) (sample language for making a Section 83(b) election, and examples of the income tax consequences of election).

(2) the arrangement is not a plan under which an employee obtains a legally binding right to receive property in a future year in which the property will be substantially vested (as defined in Treasury Regulation Section 1.83-3(b)) at the time of transfer of the property.[62] However, a legally binding right to receive property in a future taxable year in which the property will be substantially nonvested (as defined in Treas. Reg. §1.83-3(b)) at the time of the transfer of the property does not provide for the deferral of compensation. The legally binding right will be a deferral of compensation if it is offered in conjunction with another legally binding right that is a deferral of compensation.[63]

[62] Treas. Reg. §1.409A-1(b)(6)(ii); Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §III.E (first paragraph), 72 Fed. Reg. 19,234, 19,243 (April 17, 2007).

[63] *Id.*

Under these rules, the following transfers of restricted stock are exempt from Section 409A: (1) the transfer of vested stock in the year in which the employee obtains a legally binding right to the stock; (2) the transfer of unvested stock in the year in which the employee has a legally binding right to the stock without regard to whether the employee has made a Section 83(b) election; and (3) the employee has a legally binding right to the transfer of unvested stock in a later year, unless the right is offered in conjunction with another legally binding right that is a deferral of compensation.[64]

[64] Regina Olshan, "Coverage," in *Section 409A Handbook* 2-1, 11–12 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

When the employee has a legally binding right to the transfer of vested stock in a later year, the arrangement is not exempt from Section 409A as a transfer under Section 83.[65] However, the arrangement can be structured to be exempt from Section 409A as a short-term deferral.[66] Thus, whether a transfer occurs on the date of the grant of restricted stock, or on a later date, is of critical importance in determining whether the restricted stock is exempt from or subject to Section 409A.[67]

[65] *Id.*

[66] *See* Erica F. Schohn, "Equity Arrangements," in *Section 409A Handbook* 14-1, 25 ex. 3 and 4 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023) (in hiring an employee, the employer awards the employee a legally binding right to receive fully vested common stock on the third anniversary of his date of hire so long as he remains employed through the grant date. The arrangement to transfer vested common stock in the future is a deferral of compensation that is not exempt from I.R.C. 409A by reason of being a transfer of property that is not vested under I.R.C. §83, but the arrangement is likely exempt from I.R.C. §409A as a short-term deferral).

[67] See discussion of the criteria under the Section 83 regulations for determining whether a transfer occurs *infra* notes 352 to 403 and accompanying text.

The advantages of restricted stock are:

(1) Since grantees share in the upside of an increase in share price and in the downside of a decline in share price, the grantees' interests are aligned with shareholder interests. Since grantees realize value even when the share price declines, in a down market restricted stock may have greater retentive value than options.

(2) Grantees can vote and receive dividends. Employers often grant restricted stock instead of restricted stock units when the employer wants the grantee to currently have voting and dividend rights.

(3) Grantees who make a Section 83(b) election can convert post-grant appreciation during the vesting period from ordinary income to capital gain.

(4) Since restricted stock does not require the grantee to exercise the award, the grantee does not have to have the cash to pay the exercise price.

(5) For a publicly-traded company, restricted stock does not require a valuation or appraisal of the stock.

The disadvantages of restricted stock are:

(1) Grantees still realize value if the share price declines.

(2) Restricted stock that uses service-based vesting rewards employer-wide growth, and not individual or business unit performance. Institutional Shareholder Services does not treat restricted stock with service-based vesting as performance-based compensation in its pay-for-performance review.

(3) For private companies, the grantee recognizes income on vesting or a Section 83(b) election, but is usually unable to sell the shares to pay the tax. In this situation, the grantee must have the cash to pay the tax.

(4) Institutional shareholders have requested companies to limit the amount of full value awards, such as restricted stock.

(5) Since restricted stock is a full value award, large grants can have a dilutive effect on the per share value of other shareholders. Shares are outstanding and included in the denominator for calculating earnings per share on a diluted basis.

(6) Institutional Shareholder Services does not award points under its *Equity Plan Scorecard* for a plan that pays dividends or dividend equivalents on unvested awards.[68] To address this issue, the plan can have dividends accrue and paid when the shares vest.

[68] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 38, at 18 (Dec. 16, 2022).

EXEMPTION FOR QUALIFIED STOCK RECEIVED UNDER NONQUALIFIED STOCK OPTIONS AND RESTRICTED STOCK UNITS

An employee who receives vested stock on the exercise of a nonqualified stock option, or on settlement of an RSU, recognizes compensation income. For a nonqualified option, the employee recognizes income equal to the excess of the fair market value of the stock over the exercise price.[69] For an RSU, the employee recognizes income equal to the fair market value of the stock.[70]

[69] Treas. Reg. §1.83-7(a).

[70] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 494. An RSU is "an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a

certain period or the attainment of certain performance goals." *Id.* at 498.

When the stock is not publicly traded, the employee holds illiquid stock and has to come out-of-pocket with the cash to pay the tax, which the employee often does not have.[71] This scenario has become more common as tech companies defer their initial public offerings. Public Law 115-97 added a new Section 83(i) aimed at start-up and early-stage companies to ameliorate this hardship through an election to defer the recognition of income. Public Law 115-97 also provides an exemption to Section 409A for the deferral election.[72] Section 83(i) is effective for stock attributable to options exercised, or RSUs settled, after December 31, 2017.[73]

[71] For the financing opportunities available to option holders to exercise options, see David F. Larcker, Brian Tayan & Edward M. Watts, "Stock Option Financing in Pre-IPO Companies," *Harvard Law School Forum on Corporate Governance and Financial Regulation*, Aug. 26, 2021 (available at https://corpgov.law.harvard.edu/2021/08/26/stock-option-financing-in-pre-ipo-companies/).

[72] I.R.C. §409A(d)(7).

[73] Section 13603(c)(2) of Public Law 115-97.

Economic Benefit of Early Exercise

The lack of liquidity that hinders an employee from obtaining the cash to pay the tax is in tension with the tax treatment that encourages an employee to exercise incentive and nonqualified options as soon as they become vested. Incentive stock options are not taxable on exercise unless their value triggers the alternative minimum tax on the difference between the exercise price and fair market value of the shares. This difference encourages early exercise to lessen the amount of gain and any amount of alternative minimum tax. On disposition of the shares, the appreciation in their value equal to the difference between the exercise price and disposition proceeds is treated as capital gain subject to favorable tax rates. This difference also encourages early exercise to increase the amount of capital gain subject to favorable tax rates.

Nonqualified stock options are subject to income and employment taxes on exercise on the difference between the exercise price and fair market value of the shares. Again, this difference encourages early exercise to lessen the amount of gain and the income and employment taxes. The fair market value of the shares received becomes their new cost basis. On disposition of the shares, their appreciation equal to the difference between their cost basis and disposition proceeds is treated as capital gain subject to favorable tax rates. Again, this difference encourages early exercise to increase the amount of capital gain subject to favorable tax rates.

Under this tax treatment, both incentive stock options and nonqualified stock options are most valuable when granted in the early stages of a company's lifecycle when valuations of the company's shares are at their lowest. In addition, early exercise makes sense before a funding round or an initial public offering when valuations often increase. In this situation, the employee will be subject to tax using the lower valuation, and will get the economic benefit of the higher valuation shortly thereafter.

Finally, since most options usually have a ten year term, early stage employees of a company that remains private longer and whose options are approaching their expiration date and who have not exercised them due to a lack of liquidity often face the difficult choice of exercising or forfeiting their options.

Benefits of Exemption from Section 409A

The exemption from Section 409A for nonqualified stock options avoids the requirement of Treasury Regulation Section 1.409A-1(b)(5)(i)(A)(3) that the option not have any feature for the deferral of compensation other than the deferral of recognition of income until the later of: (1) the exercise or disposition of the option under Treasury Regulation Section 1.83-1; and (2) the time that the stock acquired pursuant to the option's exercise first becomes substantially vested under Treasury

Regulation Section 1.83-3(b).

The exemption from Section 409A for RSUs avoids the requirements of the subsequent deferral election rules of Treasury Regulation Section 1.409A-2(b).

Section 83(i) allows a qualified employee of an eligible corporation to elect to defer the recognition of income on the transfer of qualified stock to the employee. The employee must make the election no later than thirty days after the first date that the employee's rights in the stock are transferable or no longer subject to a substantial risk of forfeiture.[74] The rules under Section 83(c)(2)–(3) apply to these determinations. For example, income inclusion cannot be delayed due to a lock-up period in an initial public offering.[75] A right to stock is transferable if the employee can transfer the stock to any person other than the employer, and the transferee's right to the stock is not subject to a substantial risk of forfeiture.[76]

[74] I.R.C. §83(i)(4)(A).

[75] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 503.

[76] I.R.C. §83(c)(2); Treas. Reg. §1.83-3(d).

The employee makes the election in a manner similar to a Section 83(b) election.[77] In addition, the employee must agree to satisfy the requirements that the Treasury and IRS determine are necessary to ensure that the employer satisfies its withholding obligations.[78]

[77] I.R.C. §83(i)(4)(A); Treas. Reg. §1.83-2.

[78] I.R.C. §83(i)(3)(A)(ii).

An employee can make a deferral election for stock received under an incentive stock option, but the option loses its status as an incentive stock option.[79] Similarly, an employee can make a deferral election for stock received under an option granted under an employee stock purchase plan under Section 423, but the option also loses its status as granted under an employee stock purchase plan.[80]

[79] I.R.C. §422(b) (flush language); Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 499, 502.

[80] I.R.C. §423(d).

Furthermore, an employee cannot make a deferral election for nonvested stock for which the employee previously made a Section 83(b) election to recognize compensation income on receipt of the stock.[81] In addition, the employee cannot make a deferral election if the stock becomes readily tradeable on an established securities market at any time before the employee makes the election.[82]

[81] I.R.C. §83(i)(4)(B)(i).

[82] I.R.C. §83(i)(4)(B)(ii).

Length of Deferral Period

If the employee makes the deferral election, the deferral period ends and the employee recognizes the compensation income on the earliest of the following dates:

(1) the first date that the stock becomes transferable (including, solely for purposes of this date, becoming transferable to the employer);

(2) the first date that the employee becomes an excluded employee;

(3) the first date on which any stock of the employer becomes readily tradable on an established securities market as determined by the Secretary of the Treasury. An established securities market does not include any market unless it is recognized as an established securities market by the Secretary for purposes other than Section 83(i);

(4) the date five years after the first date that the employee's right to the stock becomes transferable or no longer subject to a substantial risk of forfeiture; and

(5) the date on which the employee revokes his or her deferral election.[83]

[83] I.R.C. §83(i)(1).

An employee would likely revoke his or her deferral election under clause (5) in a loss year or a low tax bracket year.

Both clauses (1) and (4) provide for income inclusion upon the stock becoming transferable, but are inconsistent. Clause (1) provides for income inclusion at the time the stock becomes transferable, and clause (4) provides for income inclusion five years after the stock becomes transferable.

One commentator resolves this inconsistency by construing the statute to provide that if the stock becomes transferable to the employer, regardless of whether it is transferable to third-parties, the deferral period ends. If the stock becomes transferable only to third-parties, but not to the employer, the deferral period ends five years after the stock becomes transferable. In addition, if the employee sells or otherwise transfers the stock to a third-party within the five year deferral period, the deferral period ends on the sale or transfer. The sale or transfer would be treated as a revocation of the election under clause (5).[84]

[84] Alan Tawshunsky, “A Closer Look at Tax Deferred Equity Compensation Under New §83(i),” 46 *Compensation Planning Journal* 66 (Bloomberg Law April 6, 2018).

It is unresolved under either clause (1) and (4) whether the right to transfer stock for estate planning purposes or to family members makes the stock transferable.

In PLR 202042010, the employer had the unilateral right to repurchase stock subject to the election for its fair market value at any date before the transferability restrictions lapsed. The transferability restrictions provided that the employee did not have any right to sell, give, assign, pledge, hypothecate, or otherwise transfer or dispose of the stock until the earliest of: (1) five years from the option's exercise date; (2) the first date that any of the employer's stock becomes readily traded on an established securities market; (3) the date the employee becomes an excluded employee; or (4) the employer's exercise of its repurchase right.

The IRS ruled that the arrangement would not run afoul of the rule that qualified stock does not include any stock if the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the employer at the time that the employee's rights in the stock first become transferable or not subject to a substantial risk of forfeiture.[85] The IRS also ruled that the stock would not become transferable, including becoming transferable to the employer, until the earliest of the dates provided by the transferability restrictions.[86]

[85] I.R.C. §83(i)(2)(B).

[86] I.R.C. §83(i)(1)(B)(i).

The rationale of the IRS was that notwithstanding the prohibition on the employee's right to sell or transfer stock to the employer, Code Section 83(i) contemplates that the employer may be able to repurchase stock from the employee without running afoul of its provisions. Specifically, the statute provides that no election may be made with respect to qualified stock if the employer purchased any of outstanding stock in the calendar year preceding the calendar year that includes the first date the rights of the employee are transferable or are not subject to a substantial risk of forfeiture unless: (1) not less than 25% of the total dollar amount of the stock so purchased is deferral stock; and (2) the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.[87]

[87] I.R.C. §83(i)(4)(B)(iii).

Accordingly, a unilateral repurchase right in the employer did not make qualified stock transferable by the employee. [88] In addition, the transferability restrictions and repurchase right did not provide the employee with the unilateral right to sell the stock to, or otherwise receive cash in lieu of stock from, the employer at the time that the employee's rights to the stock first become transferable or not subject to a substantial risk of forfeiture. As a result of the transferability restrictions, the stock did not become transferable until the earliest date provided by the restrictions.

[88] I.R.C. §83(i)(1)(A).

Under PLR 202042010, counsel can take the position that an arrangement that gives the employer a call right on the occurrence of a specified event does not negatively affect qualified stock status, and does not make the stock transferable to the employer by the employee.

Amount of Income Inclusion

The amount of income included at the end of the deferral period is the earlier value of the stock when the employee's rights to the stock became transferable or substantially vested. This is the date that the employee exercised the option or settled the RSU for vested stock.[89] This rule applies regardless of whether the stock's value during the deferral period: (1) declines, whether to a value above or below the amount of the employee's tax liability; or (2) increases. Any appreciation above the amount of the income included at the end of the deferral period is taxed on disposition of the stock.

[89] I.R.C. §83(a) and (i)(1)(A).

For example, an employee settles an RSU, receives stock with a value of $1,000, and makes a deferral election that lasts five years. At the end of the five year deferral period, the stock has a value of $1,200. Seven years after the settlement date the employee sells the stock for $1,300. The employee recognizes $1,000 of ordinary compensation income at the end of the five year deferral period, and a $300 long-term capital gain on the subsequent sale. If the employee sold the stock for $800 seven years after the settlement date, the employee recognizes $1,000 of ordinary compensation income at the end of the five year deferral period, and a $200 long-term capital loss on the subsequent sale.

Finally, when an employee makes a deferral election, the employer's compensation deduction is deferred until the employer's taxable year in which or with which ends the employee's taxable year when the employee recognizes the compensation income.[90]

[90] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 500; Treas. Reg. §1.83-6(a)(1).

EMPLOYER'S WITHHOLDING OBLIGATIONS

The employer must withhold income tax on the last day of the deferral period when the employee includes the earlier value of the stock in income.[91] The rate of withholding cannot be less than the maximum rate of tax under Section 1 without regard to any adjustments, which is currently 37%.[92] The employer must withhold without regard to: (1) the payment of regular wages; (2) the number of allowances or other amounts claimed by the employee on Form W-4; (3) any additional requests by the employee for withholding; and (4) the withholding method used by the employer.[93]

[91] I.R.C. §3401(i).

[92] I.R.C. §3402(t)(1); IRS Notice 2018-97.

[93] IRS Notice 2018-97.

Furthermore, deferral stock is treated as a noncash fringe benefit.[94] At the end of the deferral period, the employer must make a reasonable estimate of the value of the deferral stock and make deposits of the withholding amount based on this estimate. By January 31 of the following calendar year, the employer must determine the actual value of the deferral stock at the end of the deferral period, and report this amount and the withholding on Form W-2 and Form 941.[95]

[94] I.R.C. §3402(t).

[95] IRS Notice 2018-97.

If the employer pays the income tax withholding with its own funds, the employer can recover that amount from the employee until April 1 of the following calendar year. Unless Section 3402(d) applies, an employer that does not deduct and withhold federal income tax is liable for payment of the tax regardless of whether it collects the tax from the employee. Under Section 3402(d), if the employer does not deduct and withhold the correct amount of income tax, and thereafter the employee pays the income tax against which the withholding tax under Section 3402 is credited, the IRS will not collect the employer's withholding tax. However, Section 3402(d) does not relieve the employer from liability for any penalties for failure to deduct and withhold.[96]

[96] *Id.*

An employee who makes a deferral election must agree with the employer to have the deferral stock held in escrow.[97] The stock must be deposited into the escrow before the end of the calendar year in which the deferral election is made, and must remain in escrow until: (1) the employer has recovered the withholding amount from the employee; or (2) the employer removes the stock from escrow and retains the number of shares with a fair market value equal to the amount of its withholding obligation not recovered from the employee. The employer can remove the stock from escrow at any time between the date of income inclusion and March 31 of the following calendar year. Fair market value is determined under Treasury Regulation Section 1.409A-1(b)(5)(iv) at the time that the employer retains the shares.

[97] *Id.*

Any remaining shares held in escrow after the employer's withholding obligation has been satisfied, whether by retention of the shares or otherwise, must be delivered to the employee as soon as reasonably practicable.[98]

[98] *Id.*

Under these rules, unless the employee provides the employer with cash, the employer must use its own cash to satisfy its withholding obligation. If the fair market value of the deferral stock declines, the employer may still have to come out of pocket with cash to satisfy its withholding obligation even when the employer retains all the employee's deferral stock.

If the employer and employee do not agree to deposit the deferral stock into escrow, the employee will not be a qualified employee. The employer can preclude its employees from making the deferral election by deciding not to establish the escrow, and use its decision to avoid any obligation to comply with Section 83(i)'s requirements.[99]

[99] *Id.*

A deferral election does not affect the timing of the employer's obligation to withhold Social Security, Medicare, and FUTA taxes.[100] Withholding for these taxes is usually triggered by the receipt of vested stock on the exercise of a nonqualified option,[101] and by the vesting of an RSU.[102] An incentive stock option or an option under an employee stock purchase plan is exempt from withholding for these taxes.[103] If these options become a nonqualified option due to an employee's deferral election, the exemption no longer applies.[104]

[100] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 501.

[101] Rev. Rul. 79-305, 1979-2 C.B. 350.

[102] I.R.C. §3102(a) (employer must collect FICA taxes by deducting the amount of the tax from wages as and when paid); Treas. Reg. *§3121(v)(2)-1(e)(5)* (employers may use any date on or after the vesting of an RSU and before the end of the tax year to take the value of the stock into account for FICA withholding purposes).

[103] I.R.C. §§3121(a)(22) (income from the transfer of stock on the exercise of an incentive stock option or an option under an employee stock purchase plan, or from any disposition of the stock, is excluded from wages for FICA purposes) and 3306(b)(19) (income from the transfer of stock on the exercise of an incentive stock option or an option under an employee stock purchase plan, or from any disposition of the stock, is excluded from wages for FUTA purposes).

[104] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 502.

Effect of Prior Employer Purchases of Stock

An employee cannot make a deferral election for a year if, in the preceding year, the employer corporation purchased any of its outstanding stock, whether on the open market or from employees. This prohibition does not apply if at least 25% of the total dollar amount of the stock purchased is deferral stock,[105] and the determination of which individuals from whom deferral stock was purchased is made on a reasonable basis.[106] These requirements are also treated as met if the stock purchased is all the employer corporation's outstanding deferral stock.[107] Under these requirements, to preserve the ability to offer Section 83(i) deferral elections, employers may be unable to repurchase stock from terminated employees.

[105] I.R.C. §83(i)(4)(C)(i).

[106] I.R.C. §83(i)(4)(B)(iii).

[107] I.R.C. §83(i)(4)(C)(iii).

Stock that the employer purchases from an individual is not treated as a purchase of deferral stock if immediately after the purchase the selling individual holds any deferral stock for which a deferral election was in effect longer than the election for the purchased stock.[108] Accordingly, in applying the purchase requirement, an employee's deferral stock for which a deferral election has been in effect for the longest period must be purchased first.[109]

[108] I.R.C. §83(i)(4)(C)(ii).

[109] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 499.

Although the Conference Report does not address the reason for the restriction on share repurchases, Congress apparently thought that companies that have enough cash for share repurchases should use the cash to net settle options and RSUs. As a result, companies that use their cash for share repurchases should not have the benefit of Section 83(i), especially when a key reason for Section 83(i) was to enable cash-strapped start-up and early-stage companies to attract the employees with the talent needed to grow the company.

Definition of Qualified Employee

A qualified employee means an individual who is not an excluded employee, and who agrees as part of the deferral election to ensure that the employer's income tax withholding obligations are satisfied.[110] An independent contractor cannot be a qualified employee.

[110] I.R.C. §83(i)(3)(A).

An excluded employee means any individual who:

(1) was at least a one-percent owner as determined under the Section 416(i)(1)(B)(ii) top-heavy rules for qualified retirement plans at any time during the ten preceding calendar years, or who first becomes a one-percent owner in a taxable year. A one-percent owner is a person who owns, or is treated as owning under the Section 318 attribution rules, more than one-percent of a corporation's outstanding stock, or stock with more than one-percent of the total combined voting power of all stock. A one-percent owner includes that person's immediate family members, who generally are a spouse, children, grandchildren, and parents. A one-percent owner also includes an employee who holds an option or RSU for stock equal to more than one-percent of a company;

(2) is, or has been at any prior time, the CEO or CFO;

(3) bears a relationship under Section 318(a)(1) to any individual in clause (2), i.e., immediate family members, who generally are a spouse, children, grandchildren, and parents; or

(4) has been one of the four highest compensated officers for any of the preceding ten taxable years, or who first becomes one of the four highest compensated officers in a taxable year, as determined under the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934, as amended (as if these rules applied to the corporation).[111] An officer's compensation is: (a) the sum of all elements of compensation that would be reportable in the Total column of the Summary Compensation Table under Item 402(c) of Regulation S-K for the last completed fiscal year; minus (b) any amount that would be reportable in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table.

[111] I.R.C. §83(i)(3)(B).

Definition of Qualified Stock

Qualified stock means any stock if: (1) an employee receives the stock on exercise of an option or in settlement of an RSU; and (2) the employer or its parent grants the option or RSU in connection with the employee's performance of services, and in a year in which the corporation is an eligible corporation.[112] Stock received under other forms of equity compensation, such as stock appreciation rights and restricted stock, is not qualified stock.[113]

[112] I.R.C. §83(i)(2)(A).

[113] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 500.

In addition, qualified stock does not include any stock if the employee may sell the stock to, or otherwise receive cash in lieu of stock from the employer, at the time the rights of the employee in the stock first become transferable or not subject to a substantial risk of forfeiture.[114] This requirement likely precludes the net share settlement on vesting of RSUs for employment taxes. In addition, if the employee has the right to receive cash in lieu of stock on settlement of an RSU, the RSU is ineligible for a deferral election even if the employee receives stock.

[114] I.R.C. §83(i)(2)(B).

The later addition of an employer's call right for an employee's stock on separation from service should not disqualify the stock; the employer exercises the call right in its discretion and the stock is not transferable by the employee.[115] The later addition of an employee's put right may render the stock transferable by the employee and disqualify it. However, put rights are usually granted only to founders and senior management, who are unlikely to be qualified employees.

[115] *See* PLR 202042010 and discussion *supra* notes 85 to 88 and accompanying text.

Definition of Eligible Corporation

An employer corporation is an eligible corporation for a calendar year if:

(1) no stock of the employer corporation (or any predecessor) was readily tradable on an established securities market during any preceding calendar year.[116] Accordingly, the corporation cannot be a successor to a former public company; and

[116] I.R.C. §83(i)(2)(C)(i)(I).

(2) the corporation has a written plan under which, in the calendar year in which the Section 83(i) deferral election is to apply, not less than 80% of all employees who provide services to the corporation in the United States or its possessions are granted options, or RSUs, with the same rights and privileges to receive qualified stock (the "80% requirement").[117] The employer corporation is determined on a controlled group basis under Section 414(b).[118] The same rights and privileges test does not apply to options and RSUs granted in any calendar year beginning before January 1, 2018; rather, it applies to grants made on or after January 1, 2018.[119]

[117] I.R.C. §83(i)(2)(C)(i)(II).

[118] I.R.C. §83(i)(5).

[119] I.R.C. §83(i)(2)(C)(iv).

When stock becomes readily tradeable on an established securities market in an initial public offering, the employer likely loses its status as an eligible corporation on the date of the first public sale, rather than the date a lock-up or similar restriction on the transfer of stock ends. Accordingly, the right to make a deferral election ends, and a deferral election previously made ends, on the date of the first public sale. Furthermore, since employees recognize income on the date of the first public sale and they will often be subject to a lock-up agreement, they will often be unable to sell their shares on this date or shortly thereafter to obtain the cash to pay their tax.

In applying the 80% requirement, the employer must take into account the total number of employees employed at any time during the calendar year regardless of whether they were employed at the beginning or end of the year, or terminated during the year.[120] Excluded employees and part-time employees are not counted.[121] A part-time employee means an employee who is customarily employed for less than thirty hours per week.[122] The employer appears to have full discretion to determine which 20% of the employees to exclude from the plan, or decline to grant options or RSUs.

[120] IRS Notice 2018-97.

[121] I.R.C. §83(i)(2)(C)(iii).

[122] I.R.C. §§83(i)(2)(C)(iii) and 4980E(d)(4).

Only options or RSUs granted in a single calendar year are counted under the 80-percent requirement.[123] Furthermore, the 80% requirement cannot be satisfied in a year by granting a combination of options and RSUs. Rather, the qualified employees must be granted options or RSUs for that year.[124] For example, if in a year the employer grants 65% of its U.S. qualified employees nonqualified stock options with the same rights and privileges, and 85% of its U.S. qualified employees RSUs with the same rights and privileges, the 80% requirement would be met for the RSUs, but not for the options.

[123] IRS Notice 2018-97.

[124] I.R.C. §83(i)(2)(C)(i)(II).

The single calendar year rule will likely mean that employers will change their grant practices for options. Employers often grant a large number of initial new hire awards, and grant refresh awards once the initial new hire awards vest. To satisfy the 80% requirement, employers will no longer grant a large number of initial new hire awards, but will grant a smaller number of awards annually, or grant refresh awards annually. This change means that if the value of the shares increases over time, the exercise prices for the subsequent awards will also increase.

The same rights and privileges determination is applied separately for stock options and RSUs.[125] The same rights and privileges determination is generally similar to the determination under Section 423(b)(5) for employee stock purchase plans.[126] One difference is that under Section 423(b)(5), the amount of stock that any employee can purchase must bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of employees. In addition, the plan can limit the maximum amount of stock that an employee can purchase.

[125] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 502.

[126] Conference Report on H.R. 1, Tax Cuts and Jobs Act, H. Rept. 115-466, at 501.

Unlike the Section 423(b)(5) rules, Section 83(i) does not require the number of shares available to each employee to satisfy the uniform relationship test; rather the number of shares available to each employee must be more than a de minimis amount.[127] Accordingly, the employer can favor management or highly compensated employees with more grants of options or RSUs.

[127] I.R.C. §83(i)(2)(C)(ii).

The same rights and privileges test is unlikely to be met if the options or RSUs are subject to different: (1) vesting requirements; (2) methods for payment of the stock; (3) methods for determination of the per share purchase price; or (4) events that trigger accelerated vesting, such as an involuntary separation from service or change-in-control.

The 80% requirement means that a privately-held corporation that wishes to grant options or RSUs only to management or highly compensated employees will not be an eligible corporation. Section 3(b)(i) of the Model Plan grants the Administrator and Board the exclusive authority and discretion to select the Employees, Directors, and Contractors eligible for Awards, and Section 3(b)(ii) the exclusive authority and discretion to determine whether, when, and to whom to grant Awards. Accordingly, unless the grants of Awards satisfy the 80% requirement, the Awards will not qualify for the deferral election.

Employer's Notice Obligation

An employer corporation that transfers qualified stock to a qualified employee must provide a notice to the employee at the time, or a reasonable period before, the employee's right to the qualified stock is substantially vested, and an amount attributable to the stock would, absent the deferral election, first be includible in the employee's gross income. The notice must:

(1) certify that the stock is qualified stock;

(2) notify the employee of the availability of the deferral election;

(3) notify the employee that if the employee makes the election, the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee in the stock first became transferable or not subject to a substantial risk of forfeiture, regardless of whether the value of the stock declines during the deferral period;

(4) notify the employee that the amount of income recognized at the end of the deferral period will be subject to income tax withholding under Section 3401(i) at the rate determined under Section 3402(t); and

(5) notify the employee of his or her responsibilities regarding withholding.[128]

[128] I.R.C. §83(i)(6).

An employer's failure to provide the notice is subject to a penalty of $100 for each failure, unless the failure is due to reasonable cause and not willful neglect. The maximum penalty for all failures during a calendar year is $50,000.[129]

[129] I.R.C. §6652(p).

Comparison of Tax Treatment of Incentive Stock Options and Deferral Stock

There are four key differences between the tax treatment of incentive stock options and stock for which a qualified employee makes a deferral election. First, when an employee makes a deferral election for stock received under an incentive stock option, the option becomes a nonqualified stock option. The election triggers the employer's withholding obligation for Social Security, Medicare, and FUTA taxes that the employer would not have on an employee's exercise of an incentive stock option.[130]

[130] I.R.C. §§421(b), 3121(a)(22)(A), and 3306(b)(19).

Second, with an incentive stock option, the appreciation that occurs between the grant date and exercise date is converted from ordinary income to capital gain once the employee satisfies the holding period requirements. The employee cannot dispose of shares received on exercise of an incentive stock option within two years from the option's grant date, and one year after receipt of the shares on exercise.[131] With deferral stock, the appreciation that occurs between the grant date and date of receipt of the stock is always ordinary income.

[131] I.R.C. §422(a)(1).

Third, with an incentive stock option, recognition of gain can be deferred indefinitely until disposition of the stock. With deferral stock, recognition of income always occurs at the end of the deferral period.

Fourth, with an incentive stock option, upon a disqualifying disposition before the employee satisfies the holding period requirements, the ordinary income cannot exceed the gain on disposition. With deferral stock, the ordinary compensation income is recognized in full regardless of whether it exceeds the gain on the disposition.

Furthermore, since the gain on exercise of an incentive stock option is subject to the alternative minimum tax (“AMT”),[132] many employers have historically granted nonqualified stock options instead of incentive stock options. These employers may now wish to reconsider this practice. Under Public Law 115-97, the AMT exemption and phase-out amounts have increased significantly.[133] As a result, the effect of the AMT on incentive stock options is likely to be less significant than in the past.

[132] I.R.C. §56(b)(3) (gain on exercise of incentive stock option is a preference adjustment and part of alternative minimum taxable income).

[133] I.R.C. §55(d).

The following examples illustrate the different tax consequences of an incentive stock option and deferral stock. On July 1, 2018, the employer grants an employee an incentive stock option with an exercise price of $1,000. The employee exercises the option on July 1, 2020, and receives stock with a fair market value of $1,200. The employee sells the stock on May 1, 2021 for $1,100. Since the sale is a disqualifying disposition, the ordinary income recognized is limited to $100, the difference between the $1,100 sales price and the $1,000 exercise price. No withholding of income, Social Security, Medicare, and

FUTA taxes occurs on exercise or disposition.[134]

[134] I.R.C. §§421(b) (no federal income tax withholding on a disqualifying disposition); 3121(a)(22)(B) (income from the disposition of stock received on the exercise of an incentive stock option or an option under an employee stock purchase plan is excluded from wages for FICA purposes); 3306(b)(19)(B) (income from the disposition of stock received on the exercise of an incentive stock option or an option under an employee stock purchase plan is excluded from wages for FUTA purposes).

Had the employee made a deferral election on exercise, the incentive stock option would have become a nonqualified stock option. When the employee sold the stock, he or she would have to recognize the $200 bargain element as compensation income. The excess of the $200 of income over the $100 gain on sale is a $100 capital loss. In addition, the deferral election would have triggered the withholding of Social Security, Medicare, and FUTA taxes, and the sale would have triggered the withholding of income taxes on the compensation income.

Alternatively, the employee retires on July 1, 2020, and exercises the option on December 1, 2020 for stock with a fair market value of $1,200. On July 1, 2022, the employee sells the stock for $1,300. The exercise more than three months after termination of employment means that the option no longer qualifies as an incentive stock option.[135] As a result, on receipt of the stock on December 1, 2020, the employee recognizes $200 of compensation income, and on sale of the stock on July 1, 2022, the employee recognizes $100 of capital gain. In addition, no withholding of income, Social Security, Medicare, and FUTA taxes is required on the exercise or disposition.

[135] I.R.C. §422(a)(2).

Had the employee made a deferral election on exercise of the option, the incentive stock option would have become a nonqualified stock option. The employee would not recognize any compensation income on exercise on December 1, 2020. When the employee sells the stock on July 1, 2022, the deferral ends and the employee recognizes $200 in compensation income and $100 in capital gain. Thus, the employee deferred tax on the $200 in compensation income from December 1, 2020 until July 1, 2022. However, the deferral election would have triggered withholding of Social Security, Medicare, and FUTA taxes, and the sale would have triggered the withholding of income taxes on the compensation income.

Considerations for Whether an Employer Should Adopt a Plan With a Section 83(i) Election

In the absence of a liquidity event before the end of the deferral period, such as an initial public offering or sale of the corporation, the advantages of a Section 83(i) election are the time value of money that inures to the employee by deferring the payment of tax for up to five years, and the time during the deferral period for the employee to obtain the cash to pay the tax.

It appears that the application of Section 83(i) is mandatory for any plan of an eligible corporation that satisfies the eligibility and qualified stock requirements. For example, if an employer has a broad-based plan and a small number of qualified employees, the plan will satisfy the 80% requirement by granting nonqualified stock options or RSUs to 80% of these employees.

An employer that has sufficient cash to satisfy its income tax withholding obligations regardless of the availability of a deferral election may not find Section 83(i) attractive. Furthermore, if an employer wants to avoid Section 83(i)'s requirements, or avoid the deferral of its tax deduction, it can decline to satisfy the 80% requirement. It can do so by granting options or RSUs with different rights and privileges to different groups of employees, such as options or RSUs with different vesting requirements. The employer can also avoid Section 83(i)'s requirements by deciding not to establish the escrow for its withholding obligation.

If an employer wishes to avoid Section 83(i)'s requirements, and still provide employees with advantageous tax treatment, it should consider the following approaches. Rather than granting RSUs, which qualify for capital gain treatment beginning on the settlement date, or nonqualified stock options, which qualify for capital gain treatment beginning on the exercise date, the employer can grant restricted stock. With a Section 83(b) election made on the grant date, the restricted stock qualifies for capital gain treatment beginning on the grant date. For successful start-up and early-stage companies, the value of restricted stock on the grant date is usually less than its value on a later vesting date.

Finally, incentive stock options may provide employees with more advantageous tax treatment than a deferral election. When a plan provides employees with incentive stock options and a Section 83(i) election, the employer should advise the employees to consult their personal tax advisors to evaluate the tax treatment of making a Section 83(i) election for shares issued under incentive stock options, and refraining from making a Section 83(i) election and maintaining incentive stock option status.

EVALUATION OF EQUITY COMPENSATION PLANS BY INSTITUTIONAL SHAREHOLDER SERVICES AND GLASS, LEWIS & CO.

Under the listing rules of the NYSE and NASDAQ, publicly-traded companies must obtain shareholder approval to adopt a new equity compensation plan, and to materially revise (the NYSE term) or amend (the NASDAQ term) an existing plan.[136] To reduce the need for shareholder approval of material revisions or amendments, companies should draft new plans to provide the greatest flexibility in the types of awards provided by the plan and their features.

[136] NYSE Listed Company Manual §303A.08; NASDAQ Rule 5635(c). For a critical analysis of the NYSE and NASDAQ shareholder approval requirements, see Andrew C.W. Lund, “What Was the Question? The NYSE and NASDAQ's Curious Listing Standards Requiring Shareholder Approval of Equity-Compensation Plans,” 39 *Connecticut Law Review* 119 (Nov. 2006).

A material revision under the NYSE rule includes without limitation:

(1) a material increase in the number of shares available under the plan, other than an increase solely to reflect a merger, reorganization, spin-off, stock split, or similar transaction. If a plan contains a formula for automatic increases in the shares available, otherwise known as an evergreen formula, or for automatic grants pursuant to a formula, each increase or grant is a revision that requires shareholder approval unless the plan has a term of not more than ten years;

(2) an expansion of the types of awards available under the plan;

(3) a material expansion of the class of employees, directors, or other service providers eligible to participate in the plan;

(4) a material extension in the plan's term;

(5) a material change to the method of determining the exercise price of options. A change in the method of determining the exercise price from the fair market value of the closing price on the date of grant to the average of the high and low price on that date is not material; and

(6) the deletion or limitation of any provision prohibiting repricing of options. A plan that does not specifically permit repricing of options is treated as prohibiting repricing. In this situation, any repricing of options is treated as a material revision even if the plan document is not actually revised.[137]

[137] NYSE Listed Company Manual §303A.08.

A material amendment under the NASDAQ rule includes but is not limited to:

(1) any material increase in the number of shares to be issued under the plan, other than to reflect a merger, reorganization,

spin-off, stock split, or similar transaction;

(2) any material increase in benefits to participants, including any material change to: (a) permit a repricing or decrease in the exercise price of outstanding options; (b) reduce the price at which shares or options to purchase shares may be offered; or (c) extend the plan's duration;

(3) any material expansion of the class of participants eligible to participate in the plan; and

(4) any expansion in the types of options or awards provided under the plan.[138]

[138] NASDAQ Rule 5635(c), NASDAQ IM-5635-1(1)–(4) (March 12, 2009).

To protect against shareholder challenges to the adequacy of disclosure in proposals seeking shareholder approval, companies should consider the following disclosures:

(1) a summary of the information provided to the compensation committee by its independent compensation consultant;

(2) the board's methodology or rationale for determining the number of additional shares to add to the plan's share reserve;

(3) the anticipated size and timing of grants of new awards and their value and cost;

(4) the dilutive effect that new awards may have on current shareholders and the amount of anticipated stock repurchases;

(5) the company's gross burn rate, net burn rate, and overhang compared to its peers or the survey data used to determine the plan's size; and

(6) a breakdown of the groups of individuals eligible for awards, e.g., directors, employees, and consultants, the size of each group, and the anticipated size of grants of awards to employees of foreign subsidiaries.

When seeking shareholder approval for adoption of an equity compensation plan or a material revision or amendment to an equity compensation plan, companies need to consider the views of proxy advisors Institutional Shareholder Services and Glass, Lewis & Co.[139] Companies also need to consider whether an equity compensation plan can negatively affect the proxy advisors' recommendations on say-on-pay votes,[140] and votes on director nominees for the compensation committee[141] or the full board.[142]

[139] *See* NASDAQ & United States Chamber of Commerce Center for Capital Markets, *Proxy Season 2018: Examining Developments & Looking Forward*, at 2 ("Two proxy firms — Institutional Shareholder Services (ISS) and Glass Lewis — control roughly 97% of the proxy advisory industry, constituting a duopoly that have become the de facto standard setters for corporate governance in the U.S.").

For the role and influence of proxy advisors, see *Examining the Market Power and Impact of Proxy Advisory Firms*, Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, 113th Cong., 1st Sess., June 5, 2013, Serial No. 113-27 (available at https://www.gpo.gov/fdsys/pkg/CHRG-113hhrg81762/pdf/CHRG-113hhrg81762.pdf); *Recommendation of the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to SEC Guidance and Rule Proposals on Proxy Advisors and Shareholder Proposals* (Jan. 16, 2020) (available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-proxy-advisors-shareholder-proposals.pdf).

The Review Committee of the Best Practices Principles Group, *Best Practice Principles for Providers of Shareholder Voting Research & Analysis* (July 2019).

Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control," 14 *Stanford Journal of Law, Business & Finance* 384 (2009); Michael Cappucci, "The Proxy War Against Proxy Advisors," 16 *New York University Journal of Law & Business* 579 (2020); George W. Dent, Jr., "A Defense of Proxy Advisers," 2014 *Michigan State Law Review* 1287; Asaf Eckstein & Sharon Hannes, "A Long/Short Incentive Scheme for Proxy Advisory Firms," 53 *Wake Forest Law Review* 787 (Winter 2018); Asaf Eckstein, "Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation," 40 *Delaware Journal of Corporate Law* 77 (2015); Sagiv Edelman, "Proxy Advisory Firms: A Guide for Regulatory Reform," 62 *Emory Law Journal* 1369 (2013); Matthew Fagan, "Third-Party Institutional Proxy Advisors: Conflicts of Interest and Roads to Reform," 51 *University of Michigan Journal of Law Reform* 621 (Spring 2018); Douglas Sarro, "Proxy Advisors as Issue Spotters," 15 *Brooklyn Journal of Corporate, Financial & Commercial Law* 371 (Spring 2021); Andrew F. Tuch, "Why Do Proxy Advisors Wield So Much Influence? Insights From U.S.–U.K. Comparative Analysis," 99 *Boston University Law Review* 1459 (May 2019).

James R. Copland, David F. Larcker & Brian Tayan, Rock Center for Corporate Governance, "The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry," *Stanford Closer Look Series — CGRP72* (May 30, 2018).

140 Glass, Lewis & Co., *2023 Policy Guidelines United States*, Advisory Vote on Executive Compensation (Say-on-Pay), at 50–52; Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 10, at 7 (Dec. 16, 2022); Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations*, Executive Pay Evaluation, at 45 and 50–51 (Dec. 13, 2022).

141 Glass, Lewis & Co., *2023 Policy Guidelines United States*, Compensation Committee Performance, at 23–25; Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 11 and 12, at 7–8 (Dec. 16, 2022).

142 Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 11 and 12, at 7–8 (Dec. 16, 2022).

In addition to the views of the proxy advisors, companies need to consider the views of its largest institutional shareholders. Among institutional shareholders, Blackrock's voting guidelines are often a bellwether for policy trends.[143]

143 BlackRock Investment Stewardship, *Global Principles Effective as of January 2023*; BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, Adam J. Shapiro, David E. Kahan & Michael J. Schobel, "Compensation Season 2022," *Harvard Law School Forum on Corporate Governance*, Jan. 9, 2022 (available at https://corpgov.law.harvard.edu/2022/01/09/compensation-season-2022/#more-142763).

Institutional Shareholder Services uses its *Equity Plan Scorecard* to evaluate equity compensation plans and recommend whether shareholders should approve a plan. There are no changes to the *Equity Plan Scorecard* due to the COVID-19 pandemic.[144]

144 Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions,* Q&A 75, at 26 (Dec. 16, 2022); Institutional Shareholder Services, *U.S. Compensation Policies and the COVID-19 Pandemic — Updated for 2022 U.S. Proxy Season Frequently Asked Questions,* Q&A 11, at 5 (Dec. 7, 2021).

The *Equity Plan Scorecard* uses three categories known as pillars: plan cost; plan features; and grant practices. These pillars and their weightings are keyed to the following models of company size and status: (1) S&P 500; (2) Russell 3000 index (excluding S&P 500 companies); (3) Non-Russell 3000; and (4) Special Cases (recent IPOs, spinoffs, and bankruptcy emergent companies that do not disclose at least three years of grant data) for Russell 3000/S&P 500 companies and non-

Russell 3000 companies.[145]

[145] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 33, at 15–16 (Dec. 16, 2022).

The *Equity Plan Scorecard* considers a range of positive and negative factors, rather than a series of “pass/fail” tests, to evaluate equity plan proposals. A company's total *Equity Plan Scorecard* score generally determines whether Institutional Shareholder Services makes a “For” or “Against” recommendation. Effective for shareholder meetings as of February 1, 2023, the following scores generally result in a positive recommendation: (1) for the S&P 500 model, a score of 59 or higher; (2) for the Russell 3000 model, a score of 57 or higher; (3) for the Non-Russell 3000 model, a score of 55 or higher; and (4) for all other models, a score of 53 or higher.[146] The score for a positive recommendation assumes that no overriding factors or negative amendments apply.[147]

[146] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions,* Q&A 31 and 34, at 15, 16 (Dec. 16, 2022).

[147] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions,* Q&A 39, at 19 (Dec. 16, 2022).

Under this framework, a high score in one category can overcome a low score in another category so that a positive recommendation results. For example, a plan with a higher cost than the company's peers can receive a positive recommendation if the plan's features and grant practices score well. Conversely, a plan with a lower cost than the company's peers can receive a negative recommendation if the plan's features and grant practices score poorly.

In addition, if Institutional Shareholder Services identifies an unmitigated pay-for-performance misalignment that results in an adverse recommendation on a say-on-pay proposal or the election of compensation committee members, it may also recommend a vote against an equity plan proposal that appears on the same ballot. This determination is made on a case-by-case basis, and Institutional Shareholder Services considers the severity of the pay-for-performance misalignment, whether problematic equity plan grant practices are a significant factor in the misalignment, and whether equity plan awards have been heavily concentrated in the CEO and the other named executive officers or whether they have been broad-based.[148]

[148] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions,* Q&A 14, at 8–9 (Dec. 16, 2022).

For example, Institutional Shareholder Services may recommend a vote against an equity plan proposal if a significant amount of future long-term incentive compensation awarded to senior executives is not performance-based. Standard stock options and performance-accelerated awards are not considered performance-based, and premium-priced options should have a meaningful premium to be considered performance-based. In addition, Institutional Shareholder Services may recommend a vote against an equity plan proposal if the rigor of the company's performance-based equity program is too low based on the company's historical or peer group comparison, if target performance results in an above target payout, or if the company does not disclose the performance metrics.[149]

[149] Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations,* Shareholder Proposals on Compensation, at 57–58 (Dec. 13, 2022); *see also* David I. Walker, “The SEC's Compensation Clawback Loophole,” forthcoming, *Northwestern University Law Review Online* (2023) (“[T]he payout on time-vested options is uniformly based on the absolute increase in a firm's share price. There is no adjustment for rises or dips in the economy, the stock market, or the sector. As a result, in a rising market time-vested options generally pay off for executives even if their share price underperforms the surging market, while in a down market, stock

options provide little incentive even for high performing firm executives. By contrast, many performance share plans introduce relative performance evaluation into the equation. The metrics for determining the number of shares an executive receives are often based on firm performance relative to the broad market or relative to industry peers, eliminating or reducing windfalls as well as unjustified losses.") (footnotes omitted).

Furthermore, Institutional Shareholder Services takes the position that post-Covid-19 pandemic boards are able to return to traditional pre-pandemic incentive program structures. Accordingly, any mid-year changes to annual incentive metrics, performance targets, or measurement periods, or programs that heavily emphasize discretionary or subjective criteria will generally be viewed negatively. Changes to in-progress long-term incentive cycles or shifts to predominantly time-vesting incentives or short-terms measurement periods will generally be viewed negatively. The expectations regarding one-time awards and the compensation committee's responsiveness to a low say-on-pay vote result are consistent with pre-pandemic years. Any Covid-19-related pay changes or decisions should be accompanied by clear disclosure to assist investors' evaluation of the decisions.[150]

[150] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions,* Q&A 75, at 26 (Dec. 16, 2022).

Beginning in 2023, Glass, Lewis & Co. will raise concerns with executive pay programs that provide less than half of an executive's long-term incentive awards to be subject to performance-based vesting conditions. It may refrain from a negative recommendation in the absence of other significant issues with the program's design or operation, but a negative trajectory in the allocation amount may lead to an unfavorable recommendation.[151] In addition, Glass, Lewis & Co. generally will negatively view cases in which performance-based awards are significantly rolled back or eliminated from a company's long-term incentive plan. Such decisions will generally be viewed negatively outside of exceptional circumstances, and may lead to a recommendation against the long-term incentive plan.[152]

[151] Glass, Lewis & Co., *2023 Policy Guidelines United States,* Long-Term Incentives, at 10.

[152] Glass, Lewis & Co., *2023 Policy Guidelines United States,* Long-Term Incentives, at 56.

Glass, Lewis & Co. applies a quantitative analysis to assess the plan's cost and the company's pace of granting awards using a number of different analyses, comparing the equity compensation program with absolute limits that Glass, Lewis & Co. believes are key to equity value creation and with a carefully chosen peer group. In general, its model seeks to determine whether the proposed plan is either absolutely excessive, or is more than one standard deviation away from the average plan for the peer group on a range of criteria. These criteria include dilution to shareholders and the projected annual cost relative to the company's financial performance. Each of the analyses and their constituent parts is weighted and the plan is scored in accordance with that weight.[153]

[153] Glass, Lewis & Co., *2023 Policy Guidelines United States,* Equity-Based Compensation Plan Proposals, at 63–64; *see also* BlackRock Investment Stewardship, *Global Principles Effective as of January 2023,* at 11 ("We acknowledge that the use of peer group evaluation by compensation committees can help ensure competitive pay; however, we are concerned when the rationale for increases in total compensation at a company is solely based on peer benchmarking, rather than a rigorous measure of outperformance. We encourage companies to clearly explain how compensation outcomes have rewarded outperformance against peer firms."); BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023,* at 15 and 16 ("Where executive compensation appears excessive relative to the performance of the company and/or compensation paid by peers, or where an equity compensation plan is not aligned with shareholders' interests, we may vote against members of the compensation committee.") ("Our evaluation of equity compensation plans is based on a company's executive pay and performance relative to peers and whether the plan

plays a significant role in a pay-for-performance disconnect.”).

In addition, Glass, Lewis & Co. evaluates equity plans based on the following overarching principles:

(1) A company should seek additional shares for the plan's share reserve only when needed;

(2) Requested share amounts should be small enough that the company seeks shareholder approval every three to four years (or more frequently);

(3) If a plan is relatively expensive, the company should not grant options only to senior executives and board members;

(4) Dilution of the annual net share count or voting power, along with the overhang of incentive plans, should be limited;

(5) The annual cost of the plan (especially if not shown on the company's income statement) should be reasonable as a percentage of financial results and in line with the company's peer group;

(6) The anticipated annual cost of the plan should be proportional to the company's value;

(7) The intrinsic value of options granted in the past should be reasonable compared with the company's financial results;

(8) The plan should not permit repricing of stock options;[154]

[154] *See also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 16 (“We also generally oppose plans that allow for repricing without shareholder approval.”).

(9) The plan should not contain excessively liberal administrative or payment terms;

(10) The plan should not count shares in a manner that understates the potential dilution or cost to common shareholders. This refers to inverse full-value award multipliers;

(11) The performance metrics should be sufficiently challenging, and subject to relative performance measurements; and

(12) Equity grants should be subject to minimum vesting and holding period requirements that promote sustainable performance and retention.[155]

[155] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Equity-Based Compensation Plan Proposals, at 64–65; *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023,* at 14 (“We encourage companies to ensure that their compensation plans incorporate appropriate and rigorous performance metrics, consistent with corporate strategy and market practice. Performance-based compensation should include metrics that are relevant to the business and stated strategy and/or risk mitigation efforts. Goals, and the processes used to set these goals, should be clearly articulated and appropriately rigorous. We use third-party research, in addition to our own analysis, to evaluate existing and proposed compensation structures. We hold members of the compensation committee, or equivalent board members, accountable for poor compensation practices and/or structures.”).

Pillars and Weightings of *Equity Plan Scorecard*

The chart below sets forth the pillars and scores for each model under the *Equity Plan Scorecard* of Institutional Shareholder Services:[156]

[156] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 33, at 15–16 (Dec. 16, 2022).

Pillar	Model	Maximum Pillar Score	Comments
Plan Cost	S&P 500, Russell 3000, Non-Russell 3000	45	All models include the same Plan Cost factors
	Special Cases –Russell 3000 / S&P 500	50	
	Special Cases –Non-Russell 3000	60	
Plan Features	S&P 500, Russell 3000	17	All models include the same Plan Features factors
	Non-Russell 3000	27	
	Special Cases –Russell 3000 / S&P 500	33	
	Special Cases –Non-Russell 3000	40	
Grant Practices	S&P 500, Russell 3000	38	The Non-Russell 3000 model includes only Burn Rate and Duration factors. The Special Cases model for Russell 3000 / S&P 500 companies includes all Grant Practices factors except Burn Rate and Duration. The Special Cases model for Non-Russell 3000 companies does not include any Grant Practices factors.
	Non-Russell 3000	28	
	Special Cases –Russell 3000 / S&P 500	17	
	Special Cases –Non-Russell 3000	0	

Plan Cost

The first pillar of plan cost considers the potential cost of the transfer of equity from shareholders to employees. This pillar measures this cost by Shareholder Value Transfer ("SVT"), which represents the estimated cost of shares issued under a company's equity incentive plans, and differentiates between full value shares and options. A company's SVT measures the total potential cost of the company's equity plans relative to its peers based on industry, market capitalization, and performance metrics.[157]

[157] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 3, at 5 (Dec. 16, 2022).

There are two SVT measures:

(1) New shares requested ("A shares"), plus all shares that remain available for future grants ("B shares"), plus unexercised/unvested outstanding awards ("C shares").

(2) Only A shares and B shares, and excluding C shares. This measure reduces the impact of grant overhang on the overall cost evaluation, and recognizes that high grant overhang is a sunk, expensed cost. It also may reflect long-term positive stock performance, long vesting periods for grants, and employee confidence in future stock performance.[158]

[158] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 44, at 21 (Dec. 16, 2022).

Institutional Shareholder Services allocates points for each SVT factor based on the relationship of the company's SVT measures (ABC and AB) to their respective benchmarks. The benchmark SVT is based on regression analysis for the company's GICS industry group, market cap size, and operational and financial metrics identified as correlated with total shareholder return performance in the industry. Maximum potential points are accrued for proposals with total costs at or less than approximately 65% of the benchmark SVT. SVT in excess of the benchmark may result in negative points.[159]

[159] *Id.*

Plan Features

The second pillar of the *Equity Plan Scorecard* of Institutional Shareholder Services is plan features. The plan features that can have a negative impact on *Equity Plan Scorecard* results are: (1) the plan does not disclose the change-in-control vesting treatment for both service-based and performance-based awards, or if the plan provides for discretionary vesting of either award type; (2) broad discretionary vesting authority that may result in “pay for failure” or other scenarios contrary to a pay-for-performance philosophy; (3) liberal share recycling, which obscures transparency of share usage and total plan cost; (4) absence of a minimum required vesting period of at least one year for all equity award types, which may result in awards with no retention or performance incentives; and (5) ability to pay dividends before vesting of the underlying award.[160]

[160] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 37, at 16–17 (Dec. 16, 2022).

Vesting on Change-in-Control

A plan does not receive any points if it provides only for discretionary vesting for either service-based or performance-based awards, or is silent on the vesting treatment for either type of award.[161] Since Alternatives 1 to 4 of section 8(a)–(b) of the Model Plan provide for discretionary vesting on a Change-in-Control, it will not receive any points for this feature.

[161] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 38, at 18 (Dec. 16, 2022).

A plan receives full points if it discloses the specific vesting treatment on a change-in-control for both service-based and performance-based awards.[162] Thus, a plan with single-trigger vesting on a change-in-control receives full points as long as the company discloses this feature. Alternatives 5 and 6 of section 8(a)–(b) provide for single-trigger vesting on a Change-in-Control and will receive full points as long as the company discloses this feature.

[162] *Id.*

However, a liberal change-in-control definition that could result in vesting of awards by any trigger other than a full double-trigger is an egregious feature that may result in an “Against” recommendation regardless of other *Equity Plan Scorecard* factors.[163] Furthermore, Institutional Shareholder Services will likely make adverse vote recommendations for management say-on-pay and equity plan proposals that provide for change-in-control severance payments without an involuntary job loss or substantial diminution of duties, such as single or modified single-triggers, walk-away rights, and problematic good reason definitions.[164]

[163] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 39, at 19 (Dec. 16, 2022).

[164] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 47 and 485, at 18–19 (Dec. 16, 2022); *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 16 ("We may oppose plans that provide for the acceleration of vesting of equity awards even in situations where an actual change of control may not occur. We encourage companies to structure their change of control provisions to require the termination of the covered employee before acceleration or special payments are triggered (commonly referred to as 'double trigger' change of control provisions).").

A good reason termination should be limited to circumstances that are reasonably viewed as an adverse constructive termination, such as a material negative change to an executive's title/role, function, or compensation. Good reason definitions should be tailored to preclude potential windfall risk. Accordingly, the occurrence of a change-in-control alone as a good reason trigger is problematic, as are definitions that are triggered by circumstances reflecting potential performance failures, such as a company bankruptcy or delisting.[165] The definition of Good Reason in Section 25(v) of the Model Plan meets these requirements.

[165] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions,* Q&A 49, at 19–20 (Dec. 16, 2022).

Glass, Lewis & Co. considers double-trigger change-in-control arrangements, which require both a change-in-control and a termination or constructive termination, a best practice. Any arrangement that is not explicitly double-trigger may be considered a single-trigger or modified single-trigger arrangement. Glass, Lewis & Co. also believes that excessively broad definitions of change-in-control are potentially problematic as they may lead to situations in which executives receive additional compensation when a meaningful change in status or duties has not occurred.[166]

[166] Glass, Lewis & Co., *2023 Policy Guidelines United States,* Change in Control, at 60.

In addition, for golden parachutes in an acquisition, merger, consolidation, or proposed sale, the following features may result in Institutional Shareholder Services recommending a vote against the golden parachute, depending on their number, magnitude, and timing: (1) single-trigger acceleration of unvested equity awards; (2) full acceleration of equity awards granted shortly before the change-in-control; (3) acceleration of performance awards above the target level of performance without a compelling rationale; or (4) recent amendments that incorporate any problematic features or recent actions, such as extraordinary equity grants, that may make compensation packages so attractive as to influence merger agreements that may not be in the shareholders' best interests.[167]

[167] Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations*, Voting on Golden Parachutes in an Acquisition, Merger, Consolidation, or Proposed Sale, at 48 (Dec. 13, 2022).

Institutional Shareholder Services does not consider automatic full vesting of equity awards on a change-in-control (i.e., single-trigger) a best practice. Vesting acceleration should require a change-in-control and a qualifying involuntary termination event (i.e., double-trigger). Institutional Shareholder Services considers windfall potentials in evaluating equity award treatment on a change-in-control and considers the following nonexclusive factors:

(1) maintaining of vesting criteria. Maintaining vesting criteria on converted awards is a good practice since it retains their retentive and incentive qualities;

(2) pro-rata vesting. A best practice is pro-rata vesting based on actual goal achievement (in the case of performance awards), the partial completion of the vesting period, or a combination thereof. Deeming performance awards earned above target level without a clear rationale is problematic;

(3) the elapsed vesting period. The acceleration of awards granted shortly before a change-in-control, at which point only a fraction of the original vesting period has elapsed, is viewed as a greater windfall; and

(4) the magnitude of accelerated awards. Automatic acceleration concerns are greater when the awards make up the majority of a named executive officer's golden parachutes. In addition, if accelerated awards granted in the cycle before the change-in-control are larger in magnitude as compared to prior award cycles, the company should explain the reason for the increase in the merger proxy.[168]

[168] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions,* Q&A 64, at 23 (Dec. 16, 2022).

Liberal Share Recycling

Under the *Equity Plan Scorecard*, liberal share recycling does not receive any points, and the absence of liberal share recycling receives full points.[169] Liberal share recycling obscures transparency of share usage and total plan cost. Liberal share recycling includes:

[169] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 38, at 18 (Dec. 16, 2022).

(1) the regranting of shares not issued on restricted stock vesting;

(2) the regranting of shares not issued on option or SAR exercises;

(3) the regranting of shares tendered as payment for restricted stock or the option exercise price;

(4) the regranting of shares tendered or withheld on option or SAR exercise for tax withholding;

(5) the regranting of shares tendered or withheld on restricted stock vesting or a Section 83(b) election;

(6) shares added back to the plan's share reserve that the company has repurchased with option exercise proceeds; and

(7) for stock-settled awards, only the shares actually delivered are counted against the plan's share reserve, rather than the shares subject to the original award.[170]

[170] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 21 and 38, at 11 and 18 (Dec. 16, 2022).

If a plan allows SARs to be settled in either cash or stock, Institutional Shareholder Services assumes that all SARs are stock-settled. If the plan also provides that only the net shares delivered for an SAR will be counted against the plan's share reserve, Institutional Shareholder Services deems the plan to allow liberal share recycling.[171]

[171] *Id.*

When a plan has a liberal share recycling feature, a plan amendment to increase the tax withholding rate would be viewed negatively. The amendment would increase concerns over diminished transparency of share usage inherent in liberal share recycling. However, this concern would be lessened if the plan provides that only the number of shares withheld at the minimum statutory rate may be recycled, even if the permissible tax withholding is at a higher rate.[172]

[172] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 25, at 13 (Dec. 16, 2022). See discussion of the permissible rate of tax withholding *infra* notes 345 to 348 and accompanying text.

Alternative 2 of section 2(i) of the Model Plan complies with the guidelines of the *Equity Plan Scorecard* for share recycling, and should avoid not receiving any points under the liberal share recycling factor.

Minimum Vesting Requirements

Broad discretionary vesting authority may result in “pay-for-failure” or other scenarios contrary to a pay-for-performance philosophy. A plan receives full points when it prohibits the plan administrator from accelerating vesting unrelated to death or disability. A plan does not receive any points when it grants the plan administrator the discretion to accelerate vesting. Section 5(e)(i) of the Model Plan grants the Administrator broad discretion to accelerate exercise and vesting dates.

To receive full points for minimum vesting, the plan must use a vesting period of at least one year for all award types. This requirement must apply to no less than 95% of the shares authorized for grant. Exceptions beyond this five percent will prevent the plan from receiving any points for this factor. A plan does not receive any points if the plan does not apply the minimum vesting requirement to all equity award types, or if the plan allows for individual award agreements or other ways to reduce or eliminate this requirement.[173] Ratable vesting that allows for partial vesting before one year, or a general statement of ratable vesting over a period of time, e.g., awards will vest over two years, does not receive any points because ratable vesting could be daily or monthly. The plan should preclude the possibility of awards vesting before one year from the grant date.[174]

[173] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 46, at 21 (Dec. 16, 2022).
[174] *Id.*

Section 5(d) of the Model Plan provides that Awards must use service-based vesting, performance-based vesting, or a combination thereof. For Awards that use service-based vesting, the Grantee must vest in the Award no earlier than in one-third of the Award after one year of service, an additional one-third after two years of service, and the final one-third after three years of service. For Awards that use performance-based vesting, the minimum performance period is one year. For Awards that use a combination of service-based vesting and performance-based vesting, the Award must satisfy either the minimum service-based vesting requirement, or the minimum performance-period.

Alternative 1 provides that an Award will be deemed to satisfy section 5(d) if it vests before satisfaction of the minimum vesting requirement on a Grantee's death or Separation From Service due to Disability.

Alternative 2 provides that an Award will be deemed to satisfy section 5(d) if it vests before satisfaction of the minimum vesting requirement on a Grantee's death; Separation From Service due to Disability; Involuntary Separation From Service Without Cause or Separation From Service for Good Reason; retirement; a Change-in-Control under section 8; or for a Substitute Award made in replacement of an award scheduled to vest earlier than required by the minimum vesting requirement.

Once the minimum vesting requirement is satisfied, any other vesting may be accelerated in accordance with the Model Plan.

Under the proxy guidelines of Glass, Lewis & Co., most well-structured long-term equity incentive plans will have the following provisions:

(1) no retesting or lowering of performance conditions;

(2) performance metrics that management cannot easily manipulate. Glass, Lewis & Co. generally believes that half of an award should consist of performance-based awards, putting a material portion of executive compensation at-risk and demonstrably linked to the company's performance. In cases in which performance-based awards are significantly rolled back or eliminated from a company's long-term incentive plan, such decisions will generally be viewed negatively outside of exceptional circumstances, and may lead to a recommendation against the plan;

(3) two or more performance metrics. Glass, Lewis & Co. generally believes that measuring a company's performance with multiple metrics serves to provide a more complete picture of the company's performance than a single metric. Furthermore, reliance on just one metric may focus too much management attention on a single target and is more susceptible to manipulation;

(4) at least one relative performance metric that compares the company's performance to a relevant peer group or index. When utilized for relative measurements, external benchmarks such as a peer group or sector index should also be disclosed and transparent. The rationale behind the selection of a peer group or specific index should also be disclosed. Internal benchmarks should also be disclosed and transparent, unless the company makes and fully explains a cogent case for confidentiality. Similarly, actual performance and vesting levels for previous grants earned during the fiscal year should be disclosed;

(5) performance periods of at least three years;

(6) stretching metrics that incentivize executives to strive for outstanding performance while not encouraging excessive risk-taking;

(7) individual award limits expressed as a percentage of base salary; and

(8) clearly disclosed equity granting practices.[175]

[175] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Long-Term Incentives, at 55–56.

Peer Group Choice

The peer group chosen by Institutional Shareholder Services and Glass, Lewis & Co. for measuring performance may differ from the peer group chosen by the company.[176] Differences often occur when proxy advisors:

[176] *See generally* Council of Institutional Investors, *CII Policies on Executive Compensation*, §5.4 Peers (Sept. 17, 2019) ("Overreliance on benchmarking to peer practices can escalate executive compensation and lead compensation committees to adopt pay practices that may not be optimal for their companies. It makes sense for a compensation committee to understand what peers are doing, but not necessarily to imitate peers. In making reference to peers, it is imperative that compensation committees have a clear-eyed understanding of how peers performed relative to the company. Compensation committee members have an important responsibility to guard against opportunistic peer group selection."); Robert C. Pozen & S.P. Kothari, "Decoding CEO Pay," *Harvard Business Review* (July–August 2017) ("CEOs get large rewards for outperforming a peer group's average but modest penalties for underperformance. Much of the problem stems from the choice of peers. The typical compensation committee compares the TSR of its own company with the TSRs of its peers over the previous three years as well as the current pay packages for its top executives with those of its peers. To provide a fair comparison, the peer group should consist of companies with similar revenues and market capitalizations and from similar industries. A biased peer group totally undermines its utility in setting compensation. Unfortunately, the peer groups of many firms are packed

with much larger enterprises, in order to provide a high benchmark for compensation comparisons.") (available at https://hbr.org/2017/07/decoding-ceo-pay).

(1) choose peer groups based only on revenue, which can result in a peer group that does not have any member in the same market capitalization range as the company;

(2) exclude peers in the company's geographical area, which is the area in which the company competes for talent, or which has a high cost of living; and

(3) include peers that are not in the company's industry.

The criteria used by Institutional Shareholder Services to choose a company's peer group are found in its *U.S. Peer Group Selection Methodology and Issuer Submission Process Frequently Asked Questions*. Institutional Shareholder Services uses the company peer group used for benchmarking CEO pay decisions. If a company uses multiple peer groups in the executive compensation process, it should provide Institutional Shareholder Services with the peer group that most closely matches that description. The peer group provided to Institutional Shareholder Services should be the group used in making the majority of decisions regarding CEO pay for the fiscal year ending prior to a company's next annual meeting.[177]

[177] Institutional Shareholder Services, *U.S. Peer Group Selection Methodology and Issuer Submission Process Frequently Asked Questions,* Q&A 23, at 9 (Dec. 16, 2022).

The peer group chosen by Institutional Shareholder Services generally contains a minimum of twelve and maximum of twenty-four companies based on: (1) the Global Industry Classification Standard ("GICS") industry classification of the company; (2) the GICS industry classifications of the company's disclosed benchmarking peers; and (3) size constraints for both revenue (or assets for certain financial companies) and market value.[178]

[178] *Id.* at Q&A 2, at 4.

GICS codes are maintained by Standard & Poor's and Morgan Stanley International. They are based on a classification of economic sectors, and are further subdivided into a hierarchy of industry groups, industries, and subindustries.[179] A company should review its current GICS industry group classification to ensure that it is accurate. If a company thinks that its classification is inaccurate, it can appeal the classification by contacting Standard & Poor's.

[179] *Id.* at Q&A 17, at 8.

The Institutional Shareholder Services derived pay-for-performance peer group is different from the comparator group used in calculations for the *Equity Plan Scorecard.* [180]

[180] *Id.* at Q&A 18, at 8.

In determining peer groups, Glass, Lewis & Co. uses a proprietary methodology that considers both market and industry peers, along with each company's network of self-disclosed peers. Each component is considered on a weighted basis and is subject to size-based ranking and screening. The peer groups are provided to Glass, Lewis & Co. by Diligent Intel based on Glass, Lewis & Co.'s methodology and using Diligent Intel's data.[181]

[181] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Pay for Performance, at 54.

A company should also review its peer group to see whether there are companies disproportionately affected, whether positively or negatively, by the war in Ukraine, the COVID-19 pandemic, a lengthy downturn, a sector realignment, or other macroeconomic condition, and evaluate whether these companies should be removed from its peer group.

The SEC has issued guidance on the requirements under Exchange Act Rule 14a-9 for proxy voting advice. One of the types of information that a proxy voting advisor may need to disclose deals with the selection of peer groups:

> To the extent that the proxy voting advice is materially based on a methodology using a group of peer companies selected by the proxy advisory firm, the disclosure may need to include the identities of the peer group members used as part of its recommendation and the reasons for selecting these peer group members as well as, if material, why its peer group members differ from those selected by the registrant. For example, such disclosure may be needed for a voting recommendation on a registrant's advisory vote on an executive compensation proposal that is based on a comparison of the registrant's executive compensation policies to those of other companies selected by the proxy advisory firm.[182]

[182] Securities & Exchange Commission, Release No. 34-86721, *Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, at 12 n. 34 (Aug. 21, 2019).

On the same day that the SEC issued the foregoing guidance on proxy voting advice, it also issued guidance on the due diligence an investment advisor that uses a proxy advisor should perform to show that the investment advisor makes voting determinations in a client's best interest and in accordance with the investment advisor's proxy voting policies and procedures. The guidance recommends the following due diligence for the selection of a company's peer group:

> [A]n investment adviser should also consider whether the proxy advisory firm has an effective process for seeking timely input from issuers and proxy advisory firm clients with respect to, for example, its proxy voting policies, methodologies, and peer group constructions, including for "say-on-pay" votes. For example, if peer group comparisons are a component of the substantive evaluation, the investment adviser should consider how the proxy advisory firm incorporates appropriate input in formulating its methodologies and construction of issuer peer groups. Where relevant, an investment adviser should also consider how the proxy advisory firm, in constructing peer groups, takes into account the unique characteristics regarding the issuer, to the extent available, such as the issuer's size; its governance structure; its industry and any particular practices unique to that industry; its history; and its financial performance.[183]

[183] Securities & Exchange Commission, Release Nos. *IA-5325* & *IC-33605*, *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, at 17–18 (Aug. 21, 2019).

The SEC's most recent guidance on the use of peer groups is found in its adoption of Item 402(v) of Regulation S-K dealing with the disclosure of pay versus performance.[184] The SEC adopted Item 402(v) on August 25, 2022, and it applies to fiscal years ending on or after December 16, 2022. For calendar year companies, the requirements begin to apply in 2023.

[184] 15 U.S.C. §78n(i); Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance*, 87 Fed. Reg. 55,134 (Sept. 8, 2022); 17 C.F.R. §229.402.

The disclosure requirements apply to all reporting companies other than emerging growth companies, registered investment companies, and foreign private issuers.[185] Small reporting companies are subject to lesser requirements.[186]

[185] Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance,* 87 Fed. Reg. 55,134, 55,137 (Sept. 8, 2022).

[186] Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance,* 87 Fed. Reg. 55,134, 55,136–37 (Sept. 8, 2022).

The disclosure requirements apply to proxy and information statements for which executive compensation disclosure is required under Item 402 of Regulation S-K in connection with a shareholder vote. Thus, the requirements apply to proxy statements for annual and special shareholder meetings filed on Schedule 14A, and information statements filed on Schedule 14C. They do not apply to Form S-1 registration statements or Form 10-K annual reports regardless of whether they include Regulation S-K Item 402 compensation disclosure because these statements and reports are not prepared in connection with a shareholder vote.[187]

[187] Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance,* 87 Fed. Reg. 55,134, 55,137–38 (Sept. 8, 2022).

One of the disclosure requirements is tabular disclosure of cumulative total shareholder return ("TSR") for the company and its peer group for the five most recently completed fiscal years.[188] For the first year of the new disclosure, only the three most recently completed fiscal years are required, with an additional year added for the next two years.

[188] Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance,* 87 Fed. Reg. 55,134, 55,153 (Sept. 8, 2022) ("We also believe that absolute company performance alone, as reflected in TSR, may not be a sufficient basis for comparison between companies, and that peer group TSR will provide investors with more comprehensive information for assessing whether the registrant's performance was driven by factors common to its peers or instead by the registrant's own strategy and other choices.").

Michael Dark & Nicole Lavallee, "What to Expect This Proxy Season With New Exec Pay Rules," *Employment Law360* (Portfolio Media Feb. 8, 2023) ("Total shareholder return can be a blunt instrument to assess executive performance because it can be heavily influenced by environmental factors such as monetary policy and global macroeconomics that executives cannot control. However, shareholders can at least partially address this concern by comparing corporate total shareholder return with the newly provided total shareholder return data of competitors to help assess whether apparent performance improvements were in fact industrywide — and thus less likely the result of prudent management.") (available at https://www.law360.com/articles/1573719/what-to-expect-this-proxy-season-with-new-exec-pay-rules).

Smaller reporting companies do not have to disclose peer group TSR, or describe any relationship between the company's TSR and its peer group TSR. Smaller reporting companies must report only for the three most recently completed fiscal years. For the first year of the new disclosure, only the two most recently completed fiscal years are required, with an additional year added for the next year.[189]

[189] Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance,* 87 Fed. Reg. 55,134, 55,162 (Sept. 8, 2022).

TSR is calculated on the same cumulative basis as in Item 201(e) of Regulation S-K. Item 201(e) provides the guidelines for the shareholder return performance line graph included in an issuer's Form 10-K under Rules 14a-3 and 14c-3 of the Exchange Act. The line graph compares the yearly percentage change in a company's cumulative TSR with one of: (1) a published industry or line-of-business index; (2) peer companies chosen in good faith by the company; or (3) companies with similar market capitalizations, but only if the company does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group.[190]

[190] Item 201(e)(1)(ii) of Regulation S-K.

Cumulative TSR is calculated by dividing the sum of the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and the difference between the company's share price at the end and the beginning of the measurement period, by the share price at the beginning of the measurement period. The cumulative TSR for each fiscal year is measured from the last trading day before the covered fiscal year began through and including the end of the covered fiscal year. The closing price at the measurement point is converted into a fixed investment of $100 in company stock, or the stocks of the peer group, so that the results are consistently compared. The TSR for each member of the peer group must be weighted according to its market capitalization at the beginning of each measurement period.[191]

[191] Item 402(v)(2)(iv) of Regulation S-K.

Companies may use one of the following peer groups: (1) the same peer group used under Item 201(e)(1)(ii) of Regulation S-K; or (2) the same peer group used in the Compensation Discussion & Analysis for purposes of disclosing the registrant's compensation benchmarking practices.[192] The company may use a peer group that is disclosed in its Compensation Discussion & Analysis as a peer group that the company actually uses to help determine executive pay, even if the company does not use that peer group for benchmarking under Item 402(v)(2)(xiv) of Regulation S-K.[193] Unless the peer group is a published industry or line-of-business index, the company must disclose the members of the peer group in a footnote.

[192] Item 402(v)(2)(iv) of Regulation S-K.

[193] SEC Compliance & Disclosure Interpretation Regulation S-K, Question 128D.05 (Feb. 10, 2023).

Furthermore, if a company chooses a different peer group from the peer group used in the immediately preceding fiscal year, the company must explain the reason for the change in a footnote, and also compare the company's cumulative TSR with the cumulative TSR of each of the prior peer group. For example, in each of 2020 and 2021 a company provided the same list of companies as a peer group in its Compensation Discussion & Analysis under Item 402(b), and provided a different list of companies for 2022. With respect to the company's initial pay versus performance disclosure in its 2023 proxy statement for three years, the company should present the peer group TSR for each year in the table using the peer group disclosed in its Compensation Discussion & Analysis for that year.[194]

[194] SEC Compliance & Disclosure Interpretation Regulation S-K, Question 128D.07 (Feb. 10, 2023).

Companies that use a line of business or industry index, or a peer group used to satisfy the performance line graph requirements of Item 201(e), should not be affected by the foregoing rule.

The company must also provide a clear description in narrative or graphical format or a combined narrative and graphical format of the relationship between the company's TSR and its peer group TSR. The SEC believes that this description "may provide a useful point of comparison to assess the relationship between the registrant's executive compensation actually paid and its financial performance compared to the performance of its peers during the same time period."[195]

[195] Securities & Exchange Commission, Release No. 34-95607, *Pay Versus Performance,* 87 Fed. Reg. 55,134, 55,140 (Sept. 8, 2022).

Companies that have not historically used TSR metrics in their equity compensation and other incentive plans may now start to use TSR metrics to more closely align their plans with attainment of these metrics. Finally, regardless of the peer group that a company uses for its pay versus performance disclosure, proxy advisors may use different peer groups in evaluating the link between executive pay and a company's performance.

Dividends

For the factor of dividends paid on unvested awards, a plan receives full points when it expressly prohibits the payment of dividends on unvested awards for all award types. A plan does not receive any points when it is silent on the payment of dividends on unvested awards, or provides for the payment of dividends on unvested awards.[196] Thus, a company's general practice of not paying dividends until vesting when the plan is silent on the payment of dividends will not receive any points. Accrual of dividends payable on the vesting of the underlying award is permissible.

[196] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 37 and 38, at 17–18 (Dec. 16, 2022).

Section 7(a)(i)-(ii) of the Model Plan provides that before a Grantee vests in and exercises an Option or SAR, the Grantee will not have any right to ordinary and extraordinary dividends and other distributions. For dividends on Restricted Stock, Section 7(a)(iii) provides for three alternatives. Alternative 1 provides that before a Grantee vests in Restricted Stock, the Grantee will not have any right to ordinary and extraordinary dividends and other distributions. Alternative 1 should receive full points. Alternative 2 provides that before a Grantee vests in Restricted Stock, the Grantee will have the right to ordinary and extraordinary dividends and other distributions. Alternative 3 grants the Administrator or Board the discretion to: pay dividends currently; withhold and credit dividends to a separate account to be paid on specified dates; credit withheld cash dividends with interest; reinvest cash dividends in additional Shares; and establish vesting requirements. Alternatives 2 and 3 should not receive any points.

Section 162(m) Amendments

Amendments to reflect the repeal of the qualified performance-based compensation exception to the deduction disallowance of Code Section 162(m) are problematic if they remove provisions that represent good governance practices. For example, an amendment that removes individual award limits would be viewed as a negative change. Institutional Shareholder Services encourages companies to maintain plan provisions that represent good governance practices even if they are no longer required under Code Section 162(m).[197]

[197] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 27, at 13 (Dec. 16, 2022).

Glass, Lewis & Co. does not generally view amendments to equity plans and changes to compensation programs in response to the elimination of tax deductions under Code Section 162(m) as problematic. To provide for meaningful shareholder review, Glass, Lewis & Co. prefers that disclosure include specific performance metrics, a maximum award pool, and a maximum award amount per employee. Glass, Lewis & Co. also believes that it is important to analyze the estimated awards to see if they are reasonable and in line with the company's peers.[198]

[198] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Executive Compensation Tax Deductibility — Amendment to IRC 162(m), at 67–68.

Glass, Lewis & Co. typically recommends voting against a Section 162(m) proposal if: (1) a company fails to provide at least a list of performance targets; (2) a company fails to provide one of either a total maximum or an individual maximum; or (3) the proposed plan or individual maximum award limit is excessive when compared with the company's peers.[199]

[199] *Id.* at 68.

Grant Practices

The third pillar of the *Equity Plan Scorecard* of Institutional Shareholder Services is grant practices.[200] This pillar considers:

[200] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 37, at 17 (Dec. 16, 2022).

(1) A company's three year average adjusted burn rate as a percentage of weighted average common shares outstanding as

compared to a benchmark. For shareholder meetings on or after February 1, 2023, Institutional Shareholder Services uses a Value Adjusted Burn Rate ("VABR") to determine the burn rate factor. The VABR benchmarks are calculated as the approximately 86th percentile of three-year burn rates within the company's two- or four-digit GICs group, segmented by the S&P 500 index, Russell 3000 index (less the S&P 500), and non-Russell 3000 index. In addition, a de minimis benchmark threshold has been established separately for each of the S&P 500 index, the Russell 3000 index less the S&P 500, and the non-Russell 3000 index;[201]

[201] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions,* Q&A-14 and 15, at 9, and Appendix: 2023 Value-Adjusted Burn Rate Benchmarks, at 23–25 (Dec. 16, 2022).

(2) vesting periods for the CEO's service-based awards and performance-based awards for the prior three years. A vesting period or performance measurement period of three years or more receives full points. A vesting period or performance measurement period of less than three years does not receive any points. When no performance-based awards are granted in the prior three years, no points are awarded. When no service-based options and restricted shares are granted in the prior three years, full points are awarded;

(3) the plan's estimated duration based on the sum of shares remaining available and the new shares requested, divided by the three-year annual average of burn rate shares. Given that a company's circumstances may change over time, shareholders may prefer that companies limit share requests to an amount estimated to be needed over no more than five to six years. A duration of less than or equal to five years receives full points; a duration of more than five and less than or equal to six years receives half of full points; and a duration of more than six years does not receive any points;

(4) the proportion of the CEO's most recent equity awards with a three-year look-back subject to performance conditions. Since stock prices may be significantly influenced by market trends, making a substantial proportion of top executives' awards subject to specific performance conditions is a best practice. If the proportion is 50% or more, full points are awarded; if the proportion is 33% to less than 50%, half of full points is awarded; and if the proportion is less than 33%, no points are awarded; and

(5) the company's clawback policy. To receive points, the policy should authorize recovery upon a financial restatement and cover all or most equity compensation for all named executive officers, including both time- and performance-based vesting equity awards. A policy that adheres to the minimum requirements of the SEC's final clawback rules under Dodd-Frank will not receive any points.[202] These rules generally do not require that a company's clawback policy apply to time-based vesting equity awards.[203]

[202] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions,* Q&A-38 and 45 at 19 and 21 (Dec. 16, 2022).

[203] Securities & Exchange Commission, Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release Nos. 33-11126 and 34-96159, 87 Fed. Reg. 73,076, 73,139 (Nov. 28, 2022); SEC Rule §240.10D-1(d) (definition of incentive-based compensation).

Glass, Lewis & Co. believes that it is prudent for boards to adopt detailed variable compensation recoupment policies that, at a minimum, provide companies with the ability to recover compensation from former and current named executive officers in the event of overpayment due to erroneous data that triggered an accounting restatement. Glass, Lewis & Co. is increasingly focusing attention on the specific terms of recoupment policies beyond whether a company maintains a clawback that satisfies only the minimum requirements. Clawbacks should be triggered, at a minimum, on a restatement of financial results or similar revision of performance indicators upon which incentive awards were based. Such policies allow the board to review all performance-related bonuses and awards made to senior executives during a specified period and, to the extent feasible, allow the company to recoup such incentive pay where appropriate. However, some recoupment policies empower companies to recover compensation without regard to a restatement, such as those triggered by actions causing reputational harm. These policies may inform Glass, Lewis & Co.'s overall view of the compensation program in the future, especially as market pratice continues to evolve around expanded clawback authority.[204]

[204] Glass, Lewis & Co., *2023 Policy Guidelines United States,* Recoupment Provisions (Clawbacks), at 60–61.

Blackrock generally favors recoupment from any senior executive whose compensation was based on faulty financial reporting or deceptive business practices. It also favors prompt recoupment from any senior executive whose behavior caused material financial harm to shareholders, material reputational risk to the company, or resulted in a criminal proceeding, even if such actions did not ultimately result in a material restatement of past results. These consequences include, but are not limited to, settlement agreements arising from such behavior and paid for directly by the company. Blackrock typically supports shareholder proposals on these matters unless the company already has a robust clawback policy that sufficiently addresses its concerns;[205] and

[205] BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023,* at 15–16.

(6) post-exercise and post-vesting shareholding requirements. Equity incentives are intended to help align the interests of management and shareholders and enhance long-term value, which may be undermined if executives can immediately dispose of all or most of the shares received. A holding period of at least twelve months or until the end or employment or retirement receives full points. A holding period of less than twelve months, until share ownership guidelines have been met, the absence of a holding period requirement, or the plan is silent on this issue, does not receive any points.[206]

[206] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 37 and 38, at 17 and 19 (Dec. 16, 2022).

Recent IPOs, spinoffs, and bankruptcy-emergent companies may be evaluated under an *Equity Plan Scorecard* model that uses fewer factors. Neither the burn rate nor duration factors apply for companies that have less than three years of disclosed grant data. Generally, the Special Cases models will be used in the following two cases: (1) the company has less than or equal to 32 months of trading history as of the applicable quarterly data download date; or (2) the company has between 33 and 36 months of trading history as of the applicable quarterly data download date, and less than three years of burn rate data is available.[207]

[207] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 36, at 16 (Dec. 16, 2022).

Egregious Features

The following egregious features are overriding factors that may result in an "Against" recommendation regardless of the plan's score under the *Equity Plan Scorecard*: (1) a liberal definition of change-in-control that could result in vesting of awards by any trigger other than a full double-trigger; (2) repricing or cash buyout of underwater options or SARs without shareholder approval; (3) problematic pay practices or a pay-for-performance misalignment; (4) excessive dilution of shareholders; (5) an evergreen or automatic share replenishment feature; and (6) other features or practices detrimental to shareholder interests.[208]

[208] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 39, at 19 (Dec. 16, 2022).

Liberal Definition of Change-in-Control

A liberal definition of change-in-control that could result in vesting of awards by any trigger other than a full double-trigger is an egregious overriding feature.[209] Examples of a liberal definition are: (1) shareholder approval of commencement of a transaction rather than its consummation; (2) a change in less than one-half of the board; (3) an acquisition of a low percentage of outstanding common stock (15% or less); (4) announcement or commencement of a tender or exchange offer; or (5) any other trigger that could result in windfall compensation without consummation of a change-in-control. If a change-in-control is defined broadly that it can be triggered by ordinary events, such as death, disability, or retirement, the definition may be considered liberal.[210]

[209] *See also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 16 ("We may oppose plans that provide for the acceleration of vesting of equity awards even in situations where an actual change of control may not occur. We encourage companies to structure their change of control provisions to require the termination of the covered employee before acceleration or special payments are triggered (commonly referred to as 'double trigger' change of control provisions).").

[210] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 22, at 12 (Dec. 16, 2022).

A company can qualify a problematic liberal definition to be preconditioned on determinate events that effectively are a change-in-control, such as "consummation of a transaction," or "constructive loss of employment (double-triggered CIC)." For the amendment of an existing plan, the amendment can specify that the nonliberal definition applies to grants made after the amendment date.[211]

[211] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 23, at 12 (Dec. 16, 2022).

Repricing of Underwater Options and SARs

In light of a decline in a company's stock price, whether caused by the war in Ukraine, the Covid-19 pandemic, a lengthy downturn, a sector realignment,[212] or other macroeconomic condition, options and SARs awarded before the decline in stock price may become underwater, which means that the exercise price of the options exceeds the fair market value of the optioned shares. Underwater options lose their incentive and retentive value.[213] In addition, since outstanding options are included in the overhang calculation until they are exercised, cancelled, or expire, underwater options negatively impact the calculation because they are unlikely to be exercised.[214] Finally, since underwater options count against an equity compensation plan's share reserve, they reduce the shares available to grant new awards. For these reasons, companies consider repricings of underwater options and SARs.

[212] *See, e.g.,* Olivia Wakefield, James Dickinson, David Fitt & Joey Franks, Pay Governance, "Biotech Equity is Largely Underwater: Now What?," *Viewpoint on Executive Compensation,* at 1 (March 14, 2023) ("In light of the 2022 biotech sector market downturn, many compensation committees and sector leaders are concerned with the percentage of stock option awards that are underwater and contemplating how to manage equity grants and share reserve pressure in 2023 if biotech stock prices remain depressed.").

[213] *See* David I. Walker, "The SEC's Compensation Clawback Loophole," forthcoming, *Northwestern University Law Review Online* (2023) ("[B]cause time-vested options that become 'underwater' in a bear market no longer create effective incentives, boards have been tempted to reduce or 'reprice' the exercise price of these options or otherwise adjust programs to recreate incentives. Interestingly, no one seems to consider adjustments in a bull market. This asymmetry in treatment ex post is troubling as the mere possibility of repricing undermines ex ante incentives. These sorts of ex post adjustment do not arise with performance share plans which are designed to create and maintain incentives

across a broader zone of performance outcomes.") (footnotes omitted).

[214] *See, e.g.,* Olivia Wakefield, James Dickinson, David Fitt & Joey Franks, Pay Governance, "Biotech Equity is Largely Underwater: Now What?," *Viewpoint on Executive Compensation,* at 2 (March 14, 2023) (overhang levels due to underwater stock options in the biotech sector continue to rise, with many smaller biotechs experiencing overhang of 20% or more due to the fact that stock option recipients are not exercising underwater options).

Under the guidelines of Institutional Shareholder Services, if a plan permits repricing of underwater options or SARs without shareholder approval, this feature is an egregious overriding feature.[215] For NYSE or NASDAQ listed companies, the plan permits repricing without shareholder approval if the plan expressly permits it, and for nonlisted companies if the plan does not prohibit repricing and the companies have a history of repricing without shareholder approval.[216]

[215] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions,* Q&A 40, at 20 (Dec. 16, 2022); *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023,* at 16 ("We also generally oppose plans that allow for repricing without shareholder approval.").

[216] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions,* Q&A 40, at 20 (Dec. 16, 2022).

Under the guidelines of Institutional Shareholder Services, examples of repricing are: (1) the reduction of the exercise price for outstanding stock options or SARs; (2) the cancellation of outstanding stock options or SARs in exchange for new options or SARs with an exercise price less than the exercise price of the original options or SARs; (3) the cancellation of underwater stock options in exchange for stock awards; and (4) cash buyouts of underwater options or SARs.[217]

[217] *Id.*; Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations*, Equity-Based and Other Incentive Plans, at 51 (Dec. 13, 2022).

See also Howland v. Kumar, 2019 WL 2479738 (Del. Ch. June 13, 2019) (plaintiff adequately plead breach of duty of loyalty when directors and officers did not disclose issuance of a patent to the public so as to allow the compensation committee to reprice stock options before publicly announcing issuance of the patent; court found it reasonably conceivable that members of the compensation committee breached their duty of loyalty by misusing corporate information and processes to benefit themselves rather than the company; since the members of the compensation committee approved their own compensation under the repricing and rendered themselves interested in the transaction, the entire fairness standard of review applied).

Under the NYSE Listed Company Manual and NASDAQ rules, if the plan specifically permits repricing of options without shareholder approval, shareholder approval of a repricing is not necessary. This rule rarely applies because most equity compensation plans do not specifically permit repricing without shareholder approval.

A plan that does not specifically permit repricing is treated as prohibiting repricing. In this situation, any repricing of options will be treated as a material amendment of the plan that requires shareholder approval regardless of whether the plan is actually amended.[218] In addition, under the NYSE Listed Company Manual, any attempt to eliminate or limit a plan's prohibition on the repricing of options requires shareholder approval.[219]

[218] NYSE Listed Company Manual §303A.08; NASDAQ Rule 5635(c), NASDAQ IM-5635-1(2) (March 12, 2009), and NASDAQ Listing Center, *Frequently Asked Questions,* Identification Nos. 221 and 222 (July 31, 2012).

[219] NYSE Listed Company Manual §303A.08.

Under the NYSE Listed Company Manual and NASDAQ rules, a repricing means: (1) lowering the strike price of an option after grant; (2) any other action treated as a repricing under generally accepted accounting principles; and (3) cancelling an option when its strike price exceeds the fair market value of the underlying stock in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occurs as part of a merger, acquisition, spin-off, or other similar transaction.[220]

[220] NYSE Listed Company Manual §303A.08; NASDAQ Listing Center, *Frequently Asked Questions,* Identification No. 220 (July 31, 2012).

Under this definition, cash repurchases of underwater options are not repricings that require shareholder approval.[221] Furthermore, NASDAQ takes the position that the repurchase of options for cash in a tender offer does not require shareholder approval regardless of whether the plan specifically permits a cash repurchase. The rationale for this position is that the consideration for the repurchase is cash, and not equity.[222]

[221] NYSE Listed Company Manual §303A.08; NASDAQ Rule 5635(c), NASDAQ IM-5635-1(2) (March 12, 2009), NASDAQ Listing Center, *Frequently Asked Questions,* Identification No. 224 (July 31, 2012), and NASDAQ Staff Interpretive Letter 2004-21.

[222] NASDAQ Staff Interpretive Letter 2004-21.

Companies should be wary of inadvertent repricings. For example, an executive officer surrenders an underwater option to add to the plan's share reserve and make additional shares available for grant to other plan participants. If the company makes a new grant to the executive officer shortly after the surrender, the securities exchange or proxy advisors can take the position that a deemed repricing and listing violation has occurred regardless of whether the transactions are an overt quid-pro-quo.

Under the guidelines of Institutional Shareholder Services and the rules of the NYSE Listed Company Manual and NASDAQ, changing the performance goals for performance-based options and SARs is not a repricing that requires shareholder approval. However, if performance goals are changed during the performance period, under Financial Accounting Standards Board Accounting Standard Codification Topic 718 the change may trigger an incremental accounting expense. The incremental expense is equal to the amount by which the fair value of the newly repriced option or SAR exceeds the fair value of the option or SAR before the change, and is amortized over the remaining vesting period.

Section 13(c) of the Model Plan requires shareholder approval for all the methods of repricing options and SARs under the guidance of Institutional Shareholder Services and the rules of the NYSE and NASDAQ.

Most repricings take the form of a value-for-value exchange or value neutral exchange of an underwater option or SAR for a new option or SAR, or for another equity award, such as restricted stock or restricted stock units. Proxy advisors and institutional shareholders favor value-for-value and value neutral repricings.[223] In these repricings, the underwater option or SAR is exchanged for a new option or SAR with an exercise price equal to the stock's then lower fair market value and with an exchange ratio for economic values of less than one-for-one. Alternatively, the underwater option or SAR is exchanged for restricted stock or restricted stock units also with an exchange ratio for economic values of less than one-for-one.

[223] For an example of a value-for-value option-for-option exchange, see John Ellerman, Peter Ringlee, Steve Demaria, Clement Ma & Perla Cruz, Pay Governance, “Is It Time to Surrender Underwater Stock Options?,” *Viewpoint on Executive Compensation*, at 2–4 (April 30, 2020) (available at https://www.paygovernance.com/viewpoints/is-it-time-to-surrender-underwater-stock-options).

The exchange ratio is usually 85% or 90%, and economic value is measured with a Black-Scholes or binomial lattice model. To ensure that a repricing is value neutral, the repricing usually has a number of exchange ratios to address a range of option or SAR exercise prices. In addition, the new options, SARs, restricted stock, or RSUs often have a different vesting schedule than the underwater options or SARs.

When an exchange results in the return of shares to the plan's share reserve and the exchange ratio is less than one-for-one, the repricing reduces share overhang and shareholder dilution. In addition, since restricted stock and restricted stock units usually do not have a purchase or exercise price and otherwise provide immediate value to the grantee, an exchange ratio of less than one-for-one usually results in less share overhang and shareholder dilution than an option-for-option or SAR-for-SAR exchange. In addition, even if the share price further declines, restricted stock and restricted stock units will continue to provide a degree of value.

When a company repurchases underwater options for cash, the purchase price is usually based on Black-Scholes or another pricing model. The amount of the company's cash outlay turns on how much the options are underwater, and the extent to which the repurchase is limited to vested options. A cash repurchase reduces share overhang and shareholder dilution, and shareholder approval is usually not required. In addition, the risk of options becoming underwater again goes away, but the holders lose the benefit of future stock appreciation.

Institutional Shareholder Services will recommend a vote against say-on-pay proposals that permit repricing of underwater options and SARs without shareholder approval. It will also recommend a vote against or a withhold vote for members of the compensation committee and potentially the full board that approved a repricing without prior shareholder approval regardless of whether the plan permitted the repricing.[224] Under the COVID-19 guidance of Institutional Shareholder Services, there were no changes in its option repricing policies as a result of the pandemic.[225]

[224] Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations,* Equity-Based and Other Incentive Plans, at 45 and 51 (Dec. 13, 2022).

[225] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions,* Q&A 75, at 26 (Dec. 16, 2022); Institutional Shareholder Services, *U.S. Compensation Policies and the COVID-19 Pandemic — Updated for 2022 U.S. Proxy Season Frequently Asked Questions,* Q&A 11, at 5 (Dec. 7, 2021).

Institutional Shareholder Services applies a case-by-case approach to evaluate management proposals that seek shareholder approval of a repricing, and considers the following factors:

(1) historic trading patterns. The stock price should not be so volatile that the options are likely to be back in-the-money over the near term;

(2) rationale for the repricing; for example, whether the decline in the stock price was beyond management's control;

(3) whether the repricing is a value-for-value exchange;

(4) whether the surrendered options will be added back to the plan's share reserve. If so, Institutional Shareholder Services will review the company's total cost of equity plans and its three-year average burn rate;

(5) whether the repricing occurs at least one year after a precipitous drop in the company's stock price;

(6) whether the new option vests immediately and whether there is a blackout period;

(7) whether the new option's term is the same as the surrendered option;

(8) whether the new option's exercise price is set at fair market value or a premium to market;

(9) the proposal must exclude executive officers and directors;

(10) whether the proposal clearly states why the board wants to have an exchange program. For example, repricing underwater options after a recent precipitous drop in the company's stock price shows poor timing and warrants additional scrutiny;

(11) whether the grant dates of the surrendered options are far enough back (two to three years) so as not to suggest that the repricing is being done to take advantage of short-term downward price movements; and

(12) whether the exercise prices of the surrendered options are above the 52-week high for the stock price.[226]

[226] Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations*, Other Compensation Plans, at 53–54 (Dec. 13, 2022).

Glass, Lewis & Co. is generally opposed to repricing employee and director options regardless of how it is accomplished. Shareholders have substantial risk in owning stock, and employees and directors should be similarly situated in their equity compensation to align their interests with shareholders.[227]

[227] *See also* Olivia Wakefield, James Dickinson, David Fitt & Joey Franks, Pay Governance, "Biotech Equity is Largely Underwater: Now What?," *Viewpoint on Executive Compensation,* at 3 (March 14, 2023) ("While many biotech companies may consider option repricing or exchanges as potential approaches to solving the underwater issue, those solutions are relatively rare. Pay Governance's research found that 29 biotech companies sought shareholder approval for either an option exchange or repricing between 2017 and 2022. Of those 29, all but two received shareholder approval despite the majority of the proposals receiving an 'against' vote recommendation from Institutional Shareholder Services. The limited use of option exchanges and repricing is due largely to the opinion that such exchanges are not shareholder friendly. A common point raised when discussing option repricing or exchanges is that the employee equity experience should have direct alignment with the shareholder equity experience in both good times and bad. Repricing or exchanging stock options decouples that shared sense of economic outcome. Further, stock options typically have a 7- or 10-year term. In other words, as a 'long-term incentive,' stock options are literally designed to reward value creation over the long-term, and their terms should not be altered as a quick fix.") (available at https://www.paygovernance.com/viewpoints/biotech-equity-is-largely-underwater-now-what).

Furthermore, grantees who believe they will be rescued from underwater options will be more inclined to take unjustifiable risks. In addition, a predictable pattern of repricing or exchanges substantially alters a stock option's value because options that will practically never expire deeply out of the money are worth more than options that carry a risk of expiration.[228]

[228] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Option Exchanges and Repricing, at 65; *see also* David I. Walker, "The SEC's Compensation Clawback Loophole," forthcoming, *Northwestern University Law Review Online* (2023) ("[B]cause time-vested options that become 'underwater' in a bear market no longer create effective incentives, boards have been tempted to reduce or 'reprice' the exercise price of these options or otherwise adjust programs to recreate incentives. Interestingly, no one seems to consider adjustments in a bull market. This asymmetry in treatment ex post is troubling as the mere possibility of repricing undermines ex ante incentives. These sorts of ex post adjustment do not arise with performance share plans which are designed to create and maintain incentives across a broader zone of performance outcomes.") (footnotes omitted).

The one situation in which Glass, Lewis & Co. may find a repricing or option exchange program acceptable is if macroeconomic or industry trends, rather than specific company issues, cause a stock's value to decline dramatically and the repricing is necessary to motivate and retain employees. In viewing the company's stock decline as part of a larger trend, Glass, Lewis & Co. would expect the impact to closely reflect the market or industry price decline in terms of timing and magnitude. In this situation, Glass, Lewis & Co. thinks it fair to conclude that option grantees may be bearing a risk that was not foreseeable when the original bargain was struck on the initial grant.[229] As a result, Glass, Lewis & Co. may opt to support a repricing, and generally requires the following guidelines to be met:

[229] *Id.*

(1) officers and directors cannot participate in the program; and

(2) the exchange is value-neutral or value-creative to shareholders using very conservative assumptions.

Glass, Lewis & Co. also favors the inclusion of the following features in a repricing:

(1) the vesting requirements on exchanged or repriced options are extended beyond one year;

(2) shares reserved for options that are reacquired in an option exchange will permanently retire and not be available for future grants, and will thereby prevent additional shareholder dilution in the future; and

(3) management and the board make a cogent case for needing to motivate and retain existing employees, such as being in a competitive employment market.[230]

[230] *Id.*

Glass, Lewis & Co. expanded on this guidance in January 2021 to address the impact of the COVID-19 pandemic. The volatility of the market and the long lives of most options suggest that for companies less directly impacted, repricing would be premature. On the other hand, given the significant macroeconomic impacts, in seeking repricing approval companies in highly affected industries may cite unforeseeable downturns outside of their executives' control. Glass, Lewis & Co. will still expect these companies to show that they have explored an exhaustive list of alternatives, and that any eligible options are late enough in their term that a meaningful stock price recovery would be unlikely.[231]

[231] Glass, Lewis & Co., *Approach to Executive Compensation in the Context of the COVID-19 Pandemic United States and Canada*, at 7 (Jan. 26, 2021).

Blackrock believes there may be legitimate instances in which underwater options create an overhang on a company's capital structure and a repricing or option exchange may be warranted. Blackrock will evaluate these instances on a case-by-case basis, and may support a request to reprice or exchange underwater options in the following circumstances:

(1) the company has experienced significant price declines as a result of macroeconomic trends, rather than individual company performance;

(2) executive officers and directors are excluded; the exchange is value neutral or value creative to shareholders; and tax, accounting, and other technical considerations have been fully considered; and

(3) there is clear evidence that absent repricing, the company will suffer serious employee incentive or retention and recruiting problems.[232]

[232] BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 17.

Blackrock may also support a request to exchange underwater options in other circumstances if it determines that the exchange is in the best interests of shareholders.[233]

[233] *Id.*

To obtain the support of proxy advisors and institutional shareholders for shareholder approval of a repricing, companies often have to structure repricings to have the following features:

(1) the surrendered options were granted three years before the repricing;

(2) the exercise price of the surrendered options is above the 52-week high for the stock;

(3) executive officers and directors are excluded, or included on less favorable terms;

(4) the exchange program is a value-for-value exchange;

(5) the new option has a longer vesting period than the surrendered option;

(6) the exercise price of the new option is set at or above the fair market value of the stock on the date of the exchange; and

(7) the program applies only to significantly underwater options.

In addition, to obtain the support of proxy advisors and institutional shareholders for shareholder approval of a repricing, companies often have to place the following limits on future equity awards: (1) a maximum number of shares that may be awarded annually; (2) a maximum number of shares that may be awarded to an individual; (3) minimum vesting requirements and additional vesting requirements; and (4) a maximum term in which an equity award is outstanding.

In light of the opposition of Institutional Shareholder Services, Glass, Lewis & Co., and Blackrock to the participation of executive officers and directors in a repricing, companies should consider adopting two programs and seek separate shareholder approval for each program: one for the executive officers and directors, and one for all other plan participants. The program for the executive officers and directors should have less favorable terms than the program for all other plan participants.

Moreover, companies almost always want to provide executive officers and directors with equity awards that have incentive and retentive value. These persons often hold a large number of equity awards, and their efforts are critical for the company to effectively deal with any decline in stock price. In setting the vesting conditions for the repriced options and SARs, compensation committees should consider performance goals with workforce sustainability metrics, whether objective or subjective, and performance goals with objective financial metrics that measure enterprise-wide liquidity tied to operations.

Examples of these metrics are: (1) cash balance levels; (2) cash conversion cycle time; (3) changes to operations to reduce health and safety risks to employees, independent contractors, customers, and suppliers; (4) compliance with and maintenance of debt covenants; (5) launch of new revenue streams to offset shuttered operations; (6) long-term liquidity levels; (7) voluntary or involuntary employee turnover rate; (8) voluntary separation programs in lieu of layoffs; (9) workforce targets and maintenance of payroll levels; and (10) working capital ratios. Section 5(b)(ii) of the Model Plan includes these metrics.

A repricing will trigger Section 16 of the Exchange Act, which applies to officers, directors, and more than ten percent shareholders, otherwise known as insiders. The exchange of an outstanding option for a new option with a different exercise price and expiration date is a disposition of the outstanding option and an acquisition of a new option. Both transactions are subject to reporting under Section 16(a).

Under Rule 16b-3(e), the disposition is exempt from short-swing profit liability under Section 16(b) if the exchange is approved in advance by the issuer's board of directors, a committee of two or more nonemployee directors, a committee that following the abstention or recusal of all members who are not nonemployee directors is composed solely of two or more nonemployee directors, or the issuer's shareholders. The acquisition of the new option or other security is also exempt if the acquisition is approved in advance by the issuer's board of directors or a committee of two or more nonemployee directors, or is approved in advance or ratified by the issuer's shareholders no later than by the issuer's next annual meeting. Alternatively, when the transaction is an acquisition from the issuer, the insider can hold the option or other security for at least six months.

The approval resolutions of the issuer's board of directors or committee of two or more nonemployee directors should specify: (1) the name of each officer or director seeking the exemption; (2) the number of securities to be disposed of and acquired for each person; and (3) the material terms of each option.

The tax consequences of repricings are as follows. The exchange of an option or SAR for another option, SAR, restricted stock, restricted stock units, or other equity award, none of which is a currently taxable award, generally does not trigger the grantee's recognition of income.[234]

[234] *See Mitchell v. Commissioner*, 65 T.C. 1099 (1976), *aff'd*, 590 F.2d 312 (9th Cir. 1979); Treas. Reg. §§ 1.83-1(b)(3) and 1.83-7(a); PLR 200615007.

For an option exchange program in which the grantee consents to cancellation of an existing incentive stock option in exchange for a new option with an exercise price equal to the stock's then current fair market value, a modification of the existing incentive stock option occurs. For the new option to be an incentive stock option, the new option must meet all the requirements for incentive stock options on the date of modification.[235] In addition, the mandatory holding periods to maintain incentive stock option status start anew.[236] The mandatory holding period rules require the grantee not to dispose of the stock within two years after the grant date, and within one year after the issuance of the stock on exercise of the option.[237]

[235] I.R.C. §424(h)(1); Treas. Reg. §1.424-1(e)(2) and (4).

[236] *Id.*

[237] I.R.C. §422(a)(1).

Furthermore, any cancelled incentive stock options that would have become exercisable in the calendar year of cancellation will count against the $100,000 limit for that year regardless of whether the cancellation occurs before the option becomes exercisable.[238] To the extent that the new option becomes exercisable in the same calendar year, the number of shares that receive incentive stock option treatment for the new option is further reduced.[239] When the new option does not begin to vest until the next calendar year, the reduction does not occur.

[238] I.R.C. §422(d); Treas. Reg. §1.422-4(b)(5)(ii) and (d), ex. 5(iii).

[239] I.R.C. §422(d)(2); Treas. Reg. §1.422-4(b)(3) and (d), ex. 2.

If the repricing offer under an option exchange program remains open for thirty or more days, the existing incentive stock options will be treated as modified on the date the offer is made regardless of whether the grantee accepts the offer.[240] To avoid this result, the employer should limit any offer to modify an incentive stock option's exercise price to a less than thirty day acceptance period. In this situation, only the incentive stock option holders who accept the offer will be deemed to receive a new grant of incentive stock options.

[240] Treas. Reg. §1.424-1(e)(4)(iii).

For an exchange program in which the grantee consents to cancellation of an existing nonqualified stock option or SAR exempt from Section 409A in exchange for a new option or SAR with an exercise price equal to the stock's then current fair market value, a modification of the existing nonqualified stock option or SAR occurs. For the new nonqualified stock option or

SAR to be exempt from Section 409A, the new option or SAR must meet all the requirements for exemption on the date of modification.[241]

[241] Treas. Reg. §1.409A-1(b)(5)(v)(A)–(B).

Furthermore, employers and grantees should be wary of successive repricings. The IRS can take the position that successive repricings render the exercise price a floating price in violation of the requirement for exemption from Section 409A that the exercise price never be less than the fair market value of the underlying stock on the grant date.[242]

[242] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1) and (B)(1).

Another concern with repricings is whether the repricing will trigger an incremental compensation expense under Financial Accounting Standards Board Accounting Standard Codification Topic 718. The incremental expense is equal to the amount by which the fair value of the newly repriced option or SAR exceeds the fair value of the underwater option or SAR, and is amortized over the award's remaining vesting period.

In a value-for-value repricing, or a value neutral repricing, the fair value of the newly repriced option or SAR or equity award will usually be close to the fair value of the underwater option or SAR. As a result, this repricing will usually avoid an incremental compensation expense.

In a one-for-one repricing, the exercise price of the underwater option or SAR is reduced, and the other provisions of the option or SAR, such as the number of shares subject to the option or SAR and the vesting requirements, continue in effect. As a result, this repricing will usually trigger an incremental compensation expense to be amortized over the remaining vesting period of the option or SAR.

Evergreen Feature

Institutional Shareholder Services may recommend a vote against an equity plan proposal if the plan has an evergreen feature that provides for automatic share replenishment without shareholder approval. Sunset provisions for evergreen features will not be considered a mitigating factor. Evergreen features bypass the shareholders' ability to approve share increases, and may perpetuate plans with shareholder unfriendly features.[243]

[243] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 43, at 20–21 (Dec. 16, 2022); *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 16 ("We generally oppose plans that contain 'evergreen' provisions, which allow for automatic annual increases of shares available for grant without requiring shareholder approval; we note that the aggregate impacts of such increases are difficult to predict and may lead to significant dilution.").

In addition, under the *Equity Plan Scorecard,* when Institutional Shareholder Services estimates the cost of a plan with an evergreen feature, it includes a projection of the future share additions based on the disclosed formula. For example, shares representing one percent of outstanding common stock will be added to the plan's share reserve each year. These additions represent future new share requests that do not require additional shareholder approval. In most cases, these projections result in a very high plan cost estimate. In addition, evergreen features are considered a negative overriding factor that, on a stand-alone basis, may result in a negative recommendation for the equity plan proposal.[244]

[244] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 8, at 7 (Dec. 16, 2022).

Problematic Pay Practices and Other Overriding Factors

The determination of whether the plan is a vehicle for problematic pay practices or a pay-for-performance misalignment is made on a case-by-case basis. Considerations include, but are not limited to: the severity of the pay-for-performance misalignment; whether problematic equity grant practices are driving the misalignment; and whether equity plan awards have been heavily concentrated in the CEO or other named executive officers instead of the plan being broad-based. In determining whether the plan is broad-based, Institutional Shareholder Services looks at the three-year average concentration ratio for awards made to the CEO and other named executive officers. Institutional Shareholder Services may not consider a plan to be broad-based if the three-year average concentration ratio of grants exceeds 35% for the CEO, or 60% for all named executive officers including the CEO.[245]

[245] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 41, at 20 (Dec. 16, 2022); *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 15 and 16 ("Where executive compensation appears excessive relative to the performance of the company and/or compensation paid by peers, or where an equity compensation plan is not aligned with shareholders' interests, we may vote against members of the compensation committee.") ("Our evaluation of equity compensation plans is based on a company's executive pay and performance relative to peers and whether the plan plays a significant role in a pay-for-performance disconnect.").

The overriding factor of the plan being excessively dilutive to shareholders will be triggered when a company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% for the S&P 500 model, and 25% for the Russell 3000 model. This factor does not apply to the Non-Russell 3000 or Special Cases models. This factor examines share capital dilution calculated as (A+B+C) ÷ CSO, where A = number of new shares requested; B = number of shares that remain available for issuance; C = number of unexercised and unvested outstanding awards; and CSO = common shares outstanding.[246]

[246] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 42, at 20 (Dec. 16, 2022).

Examples of other plan features or company practices that are overriding factors detrimental to shareholders may include, but are not limited to, on a case-by-case basis, tax gross-ups related to awards or change-in-control excise taxes, reload options regardless of whether they were included in a prior approved plan, or provision for transferability of stock options to third-party financial institutions without shareholder approval.[247]

[247] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 39, at 19 (Dec. 16, 2022).

Front-Loaded Awards

In evaluating management say-on-pay and equity compensation plan proposals, Institutional Shareholder Services is unlikely to support front-loaded grants that cover more than the grant year and three future years. Very large awards intended to cover future years limit the board's ability to meaningfully adjust future pay arrangements based on unforeseen events, or changes in performance or strategic focus. Commitments not to grant additional awards over the covered period should be firm. Given that these awards typically provide exceptionally large pay opportunities, the usual pay-for-performance considerations are heightened, including completeness of disclosure, emphasis on transparent and rigorous performance criteria, and stringent vesting provisions that limit windfall risk.[248]

[248] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 39, at 16 (Dec. 16, 2022).

Furthermore, management proposals seeking separate shareholder approval of individual equity awards often involve front-loaded awards. Institutional Shareholder Services generally evaluates these proposals on a case-by-case basis subject to heightened pay-for-performance considerations that may include:

(1) the transparency and clarity of disclosure;

(2) the magnitude of pay opportunities;

(3) the prevalence and rigor of performance vesting criteria;

(4) the existence of shareholder-friendly guardrails and termination and change-in-control provisions;

(5) the estimated cost of the award and its dilutive impact; and

(6) any other factors deemed relevant.[249]

[249] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 74, at 26 (Dec. 16, 2022).

Glass, Lewis & Co. reviews large grants that are intended to serve as compensation for multiple years with particular scrutiny. While the use of front-loaded awards is intended to lock-in executive service and incentives, the same rigidity also raises the risk of tying the hands of the compensation committee. As compared with a more responsive annual granting schedule program, front-loaded awards may preclude improvements or changes to reflect evolving business strategies or to respond to other unforeseen factors. In addition, if structured poorly, early vesting of such awards may reduce or eliminate the retentive power at great cost to shareholders.[250]

[250] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Grants of Front-Loaded Awards, at 57; *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 14 ("Where compensation structures provide for a front-loaded award, we look for appropriate structures (including vesting and/or holding periods) that motivate sustained performance for shareholders over a number of years. We generally do not favor programs focused on awards that require performance levels to be met and maintained for a relatively short time period for payouts to be earned, unless there are extended vesting and/or holding requirements.") (footnote omitted).

The considerable emphasis on a single grant can place intense pressure on every facet of its design, amplifying any potential perverse incentives and creating greater room for unintended consequences. In particular, provisions for changes-in-control or separations from service must ensure that executives do not receive excessive payouts that do not reflect shareholder experience or company performance.[251]

[251] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Grants of Front-Loaded Awards, at 57.

Glass, Lewis & Co. considers a company's rationale for granting front-loaded awards and expects such awards to include a firm commitment not to grant additional awards for a specified period. Even when the company makes this commitment, unexpected circumstances may lead the board to make additional payments or awards for retention purposes, or to incentivize management toward more realistic goals on a revised strategy. If a company breaks its commitment, Glass, Lewis & Co. may recommend an "Against" vote on the pay program unless the company provides a convincing rationale.[252]

[252] *Id.*

The multiyear nature of front-loaded awards lends itself to significantly higher compensation in the year of grant than might otherwise be expected. In its qualitative analysis of these awards, Glass, Lewis & Co. considers the quantum of the award on an annualized basis, and may compare this result to the prior practice and peer data among other benchmarks. For equity awards, Glass, Lewis & Co. may consider the total potential dilutive effect of the award on shareholders.[253]

[253] *Id.*

A company may determine that issuing front-loaded equity awards that cover multiple grant cycles instead of annual awards is an effective way to retain key executives over a longer time horizon. Three commentators recommend that if a company grants front-loaded awards, counsel should ensure that they comply with the equity compensation plan's individual and aggregate share limits and its other provisions. Counsel should also ensure that the compensation committee receives the appropriate information to make a fully-informed decision, including a written summary of the material terms of the award, award cost, benchmark data, and drafts of SEC disclosures.[254]

[254] Adam J. Shapiro, David E. Kahan & Michael J. Schobel, "Compensation Season 2022," *Harvard Law School Forum on Corporate Governance,* Jan. 9, 2022 (available at https://corpgov.law.harvard.edu/2022/01/09/compensation-season-2022/#more-142763).

Finally, counsel should advise the compensation committee of the likely response of proxy advisors and institutional investors; in particular that Institutional Shareholder Services is likely to recommend a negative say-on-pay vote, especially if the award results in a significant year-over-year increase in an executive's compensation.[255]

[255] *Id.*

Nonemployee Director Plans

Stand-alone nonemployee director equity plans are not evaluated under the *Equity Plan Scorecard*. Rather, Institutional Shareholder Services generally evaluates the plan's cost against an SVT benchmark. When the number of nonemployee director equity awards exceeds the number granted to employees, Institutional Shareholder Services evaluates plan cost against a burn rate benchmark.

Occasionally, nonemployee director equity plans will exceed the SVT or burn rate benchmark when combined with employee equity compensation plans. In these cases, Institutional Shareholder Services supplements the nonemployee director plan analysis with a qualitative review of board compensation to determine whether the plan, in combination with the other compensation for outside directors, is beneficial to shareholders. This qualitative review is case-by-case and will determine the vote recommendation. In addition, Institutional Shareholder Services will generally recommend an "Against" vote on a stand-alone nonemployee director plan that has egregious features, such as option repricing without shareholder approval.[256]

[256] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 28, at 14 (Dec. 16, 2022).

The qualitative review considers the following factors:

(1) the relative magnitude of director compensation as compared to companies of a similar profile;

(2) the presence of problematic pay practices relating to director compensation;

(3) director stock ownership guidelines and holding requirements;

(4) equity award vesting schedules;

(5) the mix of cash and equity compensation;

(6) meaningful limits on director compensation;

(7) the availability of retirement benefits or perquisites; and

(8) the adequacy of disclosure of director compensation.[257]

[257] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 29, at 14 (Dec. 16, 2022).

With respect to nonemployee director pay generally, Institutional Shareholder Services may issue a negative recommendation for the election of board members responsible for approving or setting nonemployee director pay when there is a recurring pattern of excessive pay without disclosure of a compelling rationale. Adverse recommendations may result when excessive nonemployee director pay, without compelling rationale disclosed, is identified at a company in two or more consecutive years.[258]

[258] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 69, at 24 (Dec. 16, 2022).

Director pay is excessive if it exceeds the pay of the top 2% of all comparable directors within the same index and sector. Directors will be compared to other directors in the same two-digit GICS group and within the same index grouping. Index groupings are: S&P 500; combined S&P 400 and S&P 600; remainder of the Russell 3000 index; and the Russell 3000-Extended.[259] In addition, it is a problematic practice for nonemployee directors to receive performance-based incentive awards, retirement benefits, or other perquisites.[260]

[259] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 70, at 25 (Dec. 16, 2022).

[260] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 68 and 69, at 24–25 (Dec. 16, 2022).

In evaluating a company's disclosed rationale, the following circumstances, if within reason and adequately explained, would typically mitigate concern around high nonemployee director pay:

(1) onboarding grants for new directors that are clearly identified to be one-time in nature;

(2) payments related to corporate transactions or special circumstances (such as special committee service, requirements related to extraordinary need, or transition payments made to a former executive for a limited period); or

(3) payments made in consideration of specialized scientific expertise (as may be necessary in certain industries such as biotech/pharma).[261]

[261] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 69, at 24 (Dec. 16, 2022).

The following circumstances generally will not reduce concern around high nonemployee director pay:

(1) payments made to reward general performance/service;

(2) payments made under separate consulting/service agreements that have an indefinite or prolonged term, or that provide payments for services that appear to be within the scope of routine director responsibilities; or

(3) payments that are recognized as problematic for nonemployee directors, such as performance-based incentive pay, perquisites, or retirement benefits.[262]

[262] Institutional Shareholder Services, *U.S. Compensation Policies Frequently Asked Questions*, Q&A 69, at 24–25 (Dec. 16, 2022).

Glass, Lewis & Co. will consider supporting compensation plans that include option grants or other equity awards that help align the interests of outside directors with shareholders. However, equity grants to directors should not be performance-based so that directors are not incentivized in the same manner as executives. Rather, the grants to directors should serve as a check on imprudent risk-taking by in executive compensation plan design. When an equity plan exclusively or primarily covers nonemployee directors, the plan should not provide for performance-based awards.[263]

[263] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Director Compensation Plans, at 67; *see also* BlackRock Investment Stewardship, *Global Principles Effective as of January 2023*, at 11 ("Non-executive directors should be compensated in a manner that is commensurate with the time and effort expended in fulfilling their professional responsibilities. Additionally, these compensation arrangements should not risk compromising directors' independence or aligning their interests too closely with those of the management, whom they are charged with overseeing.").

When nonemployee director equity grants are covered by the same plan that applies to a company's broader employee base, Glass, Lewis & Co. will use its proprietary model and analyst review of this model to guide its voting recommendations. If such a plan broadly allows for performance-based awards to directors or explicitly provides for such grants, Glass, Lewis & Co. may recommend an "Against" vote on the overall plan, particularly if the company has granted performance-based awards in the past.[264]

[264] Glass, Lewis & Co., *2023 Policy Guidelines United States*, Director Compensation Plans, at 67.

Alternative 3 of Section 2(d)(i) of the Model Plan provides for a maximum aggregate Grant Date fair values of Awards under Financial Accounting Standards Board Accounting Standards Codification Topic 718 (the "ASC Value") that the Company may grant to Nonemployee Directors during the term of the Plan. It also provides that the sum of the maximum ASC Values of Awards that the Company may grant in a year to a Nonemployee Director and all other compensation for that year cannot exceed a specified dollar amount. Alternative 3 provides a separate specified dollar amount for the Board Chair, and a separate specified dollar amount for any other Nonemployee Director.

Section 2(d)(iv) of the Model Plan prohibits Awards to Nonemployee Directors that use performance-based vesting, or that provide for accelerated vesting on consummation of a Change-in-Control or on a Separation From Service for Good Reason or an Involuntary Separation From Service Without Cause within a specified period after consummation of the Change-in-Control. In addition, the Administrator or Board in its exclusive discretion may decline to impose minimum vesting requirements.

SHARES AVAILABLE FOR AWARDS

Incentive Stock Options

Under the incentive stock option regulations, the plan must designate the maximum aggregate number of shares issuable under incentive stock options.[265] Section 2(b) of the Model Plan satisfies this requirement.

[265] Treas. Reg. §1.422-2(b)(3)(i).

The incentive stock option regulations also provide that when a plan provides for incentive stock options, nonqualified stock options, or other stock-based awards, the plan may designate the terms for each type of option or other stock-based awards, and separately designate the maximum number of shares that may be issued under each type of option or other stock-based awards.[266]

[266] *Id.*

The requirement that the plan designate the maximum number of shares issuable under incentive stock options is not satisfied if the plan provides that the number of shares cannot exceed a stated percentage of the shares outstanding at the time of each offering or grant. However, this requirement is satisfied if the plan states the maximum number of shares issuable under incentive stock options as a percentage of the authorized, issued, or outstanding shares when the plan is adopted. In addition, the plan may specify that the maximum aggregate number of shares available for grants may increase annually by a specified percentage of the authorized, issued, or outstanding shares when the plan is adopted. Finally, if the plan provides that the maximum aggregate number of shares issuable under incentive stock options may change based on other specified circumstances, this provision is permissible only if the shareholders approve an immediately determinable maximum aggregate number of shares issuable under the plan at all times.[267]

[267] Treas. Reg. §1.422-2(b)(3)(ii).

Plans adopted before an initial public offering often have an evergreen provision for automatic increases to the plan's share reserve.[268] For example, a plan's share reserve increases at the beginning of each fiscal year for up to ten years by a stated percentage of the total shares outstanding on the last day of the preceding fiscal year, or a lesser number as determined by the board of directors. The evergreen provision would run afoul of the requirement that the plan designate the maximum number of shares issuable under incentive stock options. The traditional way to address this issue is for the plan to have an evergreen provision for equity awards other than incentive stock options, and a separate limit for incentive stock options. Alternatives 2 and 3 of Section 2(a) and Alternative 3 of Section 2(b) of the Model Plan use this approach.

[268] *See, e.g.*, Olivia Wakefield, James Dickinson, David Fitt & Joey Franks, Pay Governance, “Biotech Equity is Largely Underwater: Now What?,” *Viewpoint on Executive Compensation*, at 2 (March 14, 2023) (“Annual equity grant rates across the biotech sector increased in 2022 with select public, pre-commercial biotechs granting as high as 8+% of common shares outstanding. This trend has raised a yellow flag as the typical newly public biotech only has 4% to 5% of authorized shares available for equity grants annually under their approved evergreen provisions.”).

Furthermore, Institutional Shareholder Services may recommend an “Against” vote on an equity plan proposal if the plan has an evergreen feature that provides for automatic share replenishment without shareholder approval. Sunset provisions for evergreen features will not be considered a mitigating factor. Evergreen features bypass the shareholders’ ability to approve share increases, and may perpetuate plans with shareholder unfriendly features.[269]

[269] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 43, at 20 (Dec. 16, 2022).

Individual and Aggregate Limits on Awards and the Share Reserve

The current trend is for plans to place an annual limit on individual awards, especially on awards to nonemployee directors. The annual limit is often expressed as a dollar amount, and occasionally as a limit on the number of shares. In addition, the plan may place an annual limit on the aggregate value of all individual awards, which may be expressed as a dollar amount, a number of shares, or a percentage of common shares outstanding. Finally, the plan will place a limit on the aggregate number of shares subject to awards under the plan, otherwise known as the share reserve.

Use of a dollar amount provides consistent grant date value by adjusting the number of shares on the grant date to match the dollar amount, and consistent proxy disclosure regardless of fluctuations in share price.[270] It is often used at established companies with less share price volatility. However, when a plan limits awards by dollar amount, and the company's share price declines significantly, the price decline will result in larger number of shares per grant, which can put pressure on the plan's individual and aggregate share limits. Furthermore, if the company has experienced reduced cash flow, the company may shift from annual or long-term cash bonuses to equity compensation. In these situations, the plan's share reserve will be depleted more rapidly, and the plan's burn rate and level of shareholder dilution will increase.

[270] David A. Katz & Laura A. McIntosh, “Dealing With Director Compensation,” *New York Law Journal,* May 21, 2015, at 5; Alec Lentz & Ken Sparling, “Scrutiny And Standardization Of Director Pay,” *The Corporate Board,* at 8–9 (May/June 2016) (available at www.fwcookcom/alert. . .05-16_Scrutiny_And_Standardization_of_Director_Pay.pdf).

For example, if the company's share price declines by 25%, the number of shares needed to deliver the same value as before the decline increases by 33.3%. If the company's share price declines by 50%, the number of shares need to deliver the same value as before the decline increases by 100%.

When a plan limits awards by a dollar amount, and the company's share price declines significantly, the company can consider limiting awards by the number of shares. This approach is often used at recently public companies. The value of equity awards turns on the share price, and whether the award's value is competitive with peer companies turns on the share price at grant. This approach provides a more predictable and lower burn rate and dilution of shareholders, and can head off economic windfall claims by proxy advisors and institutional shareholders.

For example, the company may want to grant awards in 2023 covering the same number of shares as the 2022 awards, rather than granting awards in 2023 with the same value as the 2022 awards but with a larger number of shares. When the plan document does not limit awards by the number of shares, and the company wishes to amend the plan to provide for this limit, shareholder approval is generally not required by the NYSE and NASDAQ.

When the plan limits awards by a dollar amount, another approach to reduce the plan's burn rate and prevent greater shareholder dilution is to set a floor below which the price per share value used to determine the amount of shares in an award will not fall regardless of the share's market value. A variation on this approach is to use the same price used for a prior grant made in a less volatile market when share prices were higher. Since these approaches reduce the number of shares available for grant, it entails retention risk.

The company also has to consider how to calculate the annual dollar limit on awards. One method is the ASC Value. Another method is the fair market value on the grant date, such as the closing price. However, when shares are subject to substantial volatility, use of a single day spot price can reflect an extraordinary price fluctuation. One way to avoid this result is for the plan to use a thirty to sixty day trailing average of closing prices, which smooths out the effect of volatility. When a plan does not use a trailing average to determine the amount of grants, and the company wishes to amend the plan to provide for its use, shareholder approval is generally not required by the NYSE and NASDAQ.

When the plan places an annual limit on the aggregate value of all individual awards expressed as a percentage of common shares outstanding, this approach provides a more predictable burn rate and dilution of shareholders. It is often used at private companies and very recently public companies.

Alternative 1 of Section 2(c) of the Model Plan provides an annual individual limitation on the maximum number of Shares for which the Company may grant Awards to any Employee or Contractor. Alternative 2 of Section 2(c) provides an annual individual limitation on the maximum Grant Date ASC Values for which the Company may grant Awards to any Employee or Contractor. All three Alternatives of Section 2(d)(i) provide aggregate and annual individual limitations on the maximum Grant

Date ASC Values for Awards to Directors.

When a plan's burn rate increases, the plan may face the prospect of depleting its share reserve and being unable to make ordinary course annual equity grants. As a result, the company will need to obtain shareholder approval to add shares to the share reserve. The number of additional shares requested should take into account the decline in share price and any shift from cash compensation to equity compensation. The company should also assess the risk that if the share price recovers as part of a sector or other macroeconomic recovery, proxy advisors and institutional shareholders will view the grants as an economic windfall to directors and executives, rather than as an appropriate reward for company or individual performance.

Pending shareholder approval, a company should consider the following five approaches to making awards in the near term. First, the company can implement an across-the-board reduction on the number of shares to be used for grants.

Second, the company can make larger awards to key executives, and either forego grants to employees below a certain level or limit grants to those employees to a specified percentage of the employee population. In this situation, the company often uses RSUs for a greater portion of the annual equity awards. Unlike options, RSUs provide value in declining markets, and require fewer shares to deliver the same award value. However, RSUs provide less upside potential for value creation than options. This approach entails retention risk for the adversely affected employee population.

Third, a company can make cash-settled awards of phantom equity or SARs outside of a shareholder-approved plan. The disadvantage of cash-settled awards is that they are treated as liability awards subject to variable or mark-to-market accounting. Shareholder approval for cash-settled awards is generally not required by the NYSE and NASDAQ.

Fourth, a company can make inducement grants for newly hired employees. Under NYSE and NASDAQ rules, inducement grants do not require shareholder approval nor count against individual share limits or the share reserve for the shareholder-approved equity compensation plan.[271] To make inducement grants, a company can use a separate share pool under an existing equity compensation plan, adopt a separate equity compensation plan for only inducement grants, or make inducement grants outside of an equity compensation plan. The company should understand that proxy advisors consider inducement grants when assessing plan cost, burn rate, overhang, and future equity plan proposals. They treat inducement grants as outstanding awards when determining the number of shares available for future equity plan proposals.

[271] NYSE Listed Company Manual §303A.08; NASDAQ Listing Center, Rule 5635(c)(4) and *Frequently Asked Questions*, Identification Nos. 253, 258, and 259 (July 31, 2012).

If the company is reluctant to seek shareholder approval in the near term to add shares to the share reserve or for a repricing, it can also consider the foregoing four approaches for the intermediate term.

Fifth, for the near term, a company can make awards contingent on shareholder approval to add shares to the share reserve. In this situation, the company has to consider the Section 409A rules. Under the general rule for whether a nonqualified plan of deferred compensation exists, when the company creates a legally binding right before the shareholder meeting to grant awards once shareholder approval occurs at the meeting, and after the shareholder meeting the grants of awards occur in the same taxable year as the creation of the legally binding right, there is no nonqualified plan of deferred compensation.[272]

[272] Treas. Reg. §1.409A-1(b)(1).

In addition, for options and SARs, if the company imposes a condition on the grant of an option or SAR, such condition generally will be given effect. However, if the grant of an option or SAR is subject to shareholder approval, the date of grant is determined as if the option or SAR had not been subject to shareholder approval.[273] When a grant of options and SARs is subject to the condition of shareholder approval of the addition of shares to the share reserve, that condition should be given effect. Once this condition is satisfied and the grant of options and SARs is not otherwise subject to shareholder approval, whether under the terms of the grant or the foregoing rule, the grant is still likely not to be a nonqualified plan of deferred compensation. As long as the grant provides for the maximum number of shares subject to the option or SAR, the minimum exercise price is fixed or determinable, and the class of underlying stock and the identity of the grantee is designated, the creation of a legally binding right and the grant occur simultaneously in the same taxable year and there is no nonqualified plan of deferred compensation.[274]

[273] Treas. Reg. §1.409A-1(b)(5)(vi)(B)(2).

[274] Treas. Reg. §1.409A-1(b)(5)(vi)(B)(1).

For restricted stock, a legally binding right to receive property in a future taxable year in which the property will be substantially nonvested under Treasury Regulation Section 1.83-3(b) at the time of transfer will not provide for the deferral of compensation.[275] However, a legally binding right to receive property in a future taxable year in which the property will be substantially vested under Treasury Regulation Section 1.83-3(b) at the time of transfer may provide for the deferral of compensation.[276]

[275] Treas. Reg. §1.409A-1(b)(6)(ii).

[276] *Id.*

In the case of the transfer of vested shares, the company should ensure that the transfer satisfies Section 409A. When the company creates a legally binding right before the shareholder meeting to grant awards once shareholder approval occurs at that meeting, and the shareholder meeting and grants of awards occur in the following taxable year after March 15, the transfer of the vested shares must satisfy the specified time or fixed schedule rule.[277] Under this rule, the amount of a payment cannot be based all or in part on the occurrence of an event. Since shareholder approval may come within this prohibition, the arrangement should not provide for the transfer of shares at a time determined by reference to the date of shareholder approval. Rather, the arrangement should provide for the transfer of shares on a specified date without reference to the date of shareholder approval. For example, if the company creates a legally binding right in December, and the shareholder meeting occurs the following April, the arrangement should provide for the transfer of shares in June.

[277] Treas. Reg. §1.409A-3(a)(4) and (i)(1).

Alternatively, the arrangement can provide that the employee must be employed on the date of shareholder approval, and the transfer must occur within sixty days after the date of shareholder approval. This arrangement will be a short-term deferral exempt from Section 409A.[278]

[278] Treas. Reg. §1.409A-1(b)(4) and (d); *see also* Erica F. Schohn, “Equity Arrangements,” in *Section 409A Handbook* 14-1, 25 ex. 3 and 4 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023) (in hiring an employee, the employer awards the employee a legally binding right to receive fully vested common stock on the third anniversary of his date of hire so long as he remains employed through the grant date. The arrangement to transfer vested common stock in the future is a deferral of compensation that is not exempt from I.R.C. 409A by reason of being a transfer of property that is not vested under I.R.C. §83, but the arrangement is likely exempt from I.R.C. §409A as a short-term deferral).

The foregoing discussion does not address the determination of the fair market value of shares for the exercise price of options and SARs. Under the Section 409A regulations, for shares readily tradable on an established securities market, the exercise price fair market value may be determined using an average selling price during a specified period that is within thirty days before or thirty days after the valuation date. Average selling price means the arithmetic mean of the selling prices on all trading days during the specified period, or the average of such prices over the specified period weighted based on the volume of trading of the stock on each trading day.[279]

[279] Treas. Reg. §1.409A-1(b)(5)(iv)(A).

Average selling price can be used only if the plan irrevocably specifies the commitment to grant a nonqualified stock option or SAR with an exercise price using the average selling price before the beginning of the specified period.[280] In addition, the company must designate the recipient of the nonqualified stock option or SAR, the number and class of shares that are subject to the stock option or SAR, and the method for determining the exercise price, including the period over which the averaging will occur, before the beginning of the averaging period. If foreign law requires that a compensatory stock right be priced based on a specific price averaging method and period, a stock right granted in accordance with the foreign law will be treated as meeting the foregoing requirements as long as the averaging period does not exceed thirty days.[281]

[280] *Id.*

[281] *Id.*

STANDARD OF REVIEW FOR EXECUTIVE COMPENSATION DECISIONS OF DIRECTORS

The business judgment rule generally applies to a board's compensation decisions.[282] The rule presumes that in making a business decision, the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the corporation's best interest.[283]

[282] *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (en banc) (a board's decision on executive compensation is entitled to great deference; the decision of whether to award a person large amounts of money is the essence of business judgment; short of unconscionable cases, courts, which are ill-fitted to weigh the adequacy of consideration, must refrain from second-guessing the wisdom of executive compensation contracts even if in retrospect they appear disadvantageous); *Shabbouei v. Potdevin*, 2020 WL 1609177, at *12 (Del. Ch. April 2, 2020) (the size and structure of executive compensation are inherently matters of business judgment); *White v. Panic*, 793 A.2d 356, 369 (Del. Ch. 2000) (a court's deference to directors' business judgment is particularly broad in matters of executive compensation).

[283] *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1373 (Del. 1993). *See generally* Stephen M. Bainbridge, "The Business Judgment Rule as Abstention Doctrine," 57 *Vanderbilt Law Review* 83 (2004).

To obtain the protection of the business judgment rule, the directors must satisfy their duties of care and loyalty. The duty of care requires the directors to fully inform themselves of all material information reasonably available to them before making a decision. In addition, having become so informed, they must then act with appropriate care in carrying out their decisions. A director breaches this duty when the director acts outside the bounds of reason or with reckless indifference to or a deliberate disregard of the shareholders. The standard of review applied by Delaware courts to determine whether a breach of the duty of care has occurred is gross negligence.[284] Gross negligence means recklessness.[285]

[284] *McElrath v. Kalanick*, 224 A.3d 982, 991–92 (Del. 2020); *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 65 (Del. 2006) (en banc); *Rabkin v. Philip A. Hunt Chemical Corp.*, 547 A.2d 963, 970 (Del. Ch. 1986).

[285] *In re Lear Corp. Shareholder Litigation*, 967 A.2d 640, 652 n. 45 (Del. Ch. 2008) (the definition of gross negligence in corporate law is so strict that it imports the concept of recklessness); *Albert v. Alexander Brown Management Services, Inc.*, 2005 WL 2130607, at *4 (Del. Ch. Aug. 26, 2005) (gross negligence has a stringent meaning under Delaware corporate and partnership law, one that involves a devil-may-care attitude or indifference to duty amounting to recklessness).

The duty of care requires that the directors engage in a careful, deliberative process in determining the amount and components of an executive's compensation.[286] To engage in this process, directors should: (1) review all material information reasonably available to them; (2) obtain the advice of an independent compensation consultant and outside counsel; (3) ask questions and engage in robust discussions with officers, employees, the compensation consultant, and outside counsel; (4) evaluate alternative compensation structures and the cost and impact of each structure on the executive, corporation, and shareholders; and (5) take the time to make an informed decision.

[286] *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 56 (Del. 2006) (en banc); *Brehm v. Eisner*, 746 A.2d 244, 259–64 (Del. 2000) (en banc).

The duty of loyalty requires the directors to act in the corporation's best interest, and not in a director's personal interest. A director must act in a manner that the director honestly believes is in the best interests of the corporation and its shareholders.[287] As part of this duty, directors must act in good faith motivated by a true faithfulness and devotion to the interests of the corporation and its shareholders.[288] A breach of the duty of loyalty occurs when the directors approve executive compensation to advance their own interests at the expense of the corporation or its shareholders, act to advance the self-interest of an interested party from whom they cannot be presumed to act independently, or participate in a broader self-dealing transaction.[289]

[287] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("The duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer, or controlling shareholder and not shared by the stockholders generally."); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.").

[288] *In re the Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 755–72 (Del. Ch. 2005).

[289] *In re Cornerstone Therapeutics Inc. Shareholder Litigation*, 115 A.3d 1173, 1179–80 (Del. 2015) (Strine, C.J.); *Elburn v. Albanese*, 2020 WL 1929169, at *6 (Del. Ch. April 21, 2020), *certification denied*, *2020 WL 4194865* (Del. Ch. July 21, 2020), *appeal refused*, 237 A.3d 820 (Del. 2020); *Shabbouei v. Potdevin*, 2020 WL 1609177, at *1 (Del. Ch. April 2, 2020); *Needham v. Cruver*, *1993 WL 179336*, at *3 (Del. Ch. May 12, 1993) (an illicit *quid pro quo* occurs when a board agrees to award compensation only if its members receive some personal benefit or advantage in return).

A finding that directors acted in bad faith requires that they act with scienter, which means they had actual or constructive knowledge that their conduct was legally improper, there was an intentional dereliction of duty or a conscious disregard for their responsibilities, or they were motivated by an actual intent to violate applicable positive law or do harm.[290] For example, directors act in bad faith with scienter if they knowingly or deliberately fail to follow the terms of a stock incentive plan.[291]

[290] *McElrath v. Kalanick*, 224 A.3d 982, 991–92 (Del. 2020); *City of Birmingham Retirement & Relief System v. Good*, 177 A.3d 47, 55 (Del. 2017); *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 240 (Del. 2009); *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006); *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 64–67 (Del. 2006) (en banc); *Shabbouei v. Potdevin*, 2020 WL 1609177, at *7 (Del. Ch. April 2, 2020).

[291] *Knight v. Miller*, 2022 WL 1233370, at *7 (Del. Ch. April 27, 2022) (plaintiff challenged award of stock options in March 2020 to directors serving on a compensation committee; plaintiff "has attempted to make a showing of scienter, but what she pleads in connection with this cause of action is that the Compensation Committee Defendants consciously disregarded potential circumstances *arising from COVID-19*. There is no allegation that the Compensation Committee Defendants knowingly acted inconsistently with their fiduciary duties. If anything, under the facts pled, the Compensation Committee Defendants, perhaps, would have been wise to take into account external factors, such as

the macroeconomic effects of COVID-19 and the government's reaction thereto, in making their determination to grant awards on March 18. That is the Plaintiff's hindsight theory. But nothing in the pleadings indicates that the Compensation Committee Defendants knowingly acted against the corporate interest, or saw a duty to act or to refrain from acting, but refused") (footnote omitted); *Garfield v. Allen*, 277 A.3d 296, 331–35 (Del. Ch. 2022); *Pfeiffer v. Leedle*, 2013 WL 5988416, at *5–8 (Del Ch. Nov. 8, 2013) (plan prohibited any individual from receiving more than 150,000 options in a single calendar year; Leedle received over 400,000 options in 2011 and 285,000 options in 2012; court held that complaint supported a reasonable inference that Leedle knew or should have known that his receipt of the options violated the plan and as a result he acted in bad faith and breached his fiduciary duty); *Sanders v. Wang*, 1999 WL 1044880, at *7–9 (Del Ch. Nov. 10, 1999).

Once the business judgment rule applies, a plaintiff can succeed in challenging the board's compensation decision only by showing that the compensation is so disproportionately large as to be unconscionable and results in the waste of corporate assets.[292] The standard for waste is rarely met.[293]

[292] *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 74 (Del. 2006) (en banc); *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (en banc); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

See generally Harwell Wells, "The Life (and Death?) of Corporate Waste," 74 *Washington & Lee Law Review* 1239 (2017).

[293] *In re 3COM Corp. Shareholders Litigation*, *1999 WL 1009210*, at *4 (Del. Ch. Oct. 25, 1999).

When the directors determine their own compensation, they are conflicted.[294] In this situation, the courts do not apply the deferential business judgment rule, but the demanding entire fairness standard.[295] Courts also apply the entire fairness standard if the majority of directors who approve an executive compensation arrangement is not disinterested and independent. Under the entire fairness standard, the directors must show that the transaction was the product of both fair dealing and a fair price.[296] Not even an honest belief that the transaction was entirely fair will be sufficient to meet this standard. Rather, the transaction itself must be objectively fair independent of the board's beliefs.[297]

[294] *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869, at *3 (Del. Ch. June 26, 2014).

[295] *Telxon v. Meyerson*, 802 A.2d 257, 265 (Del. 2002); *Gottlieb v. Heyden Chemical Corp.*, 90 A.2d 660, 663 (Del. 1952); *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17, 44 (Del. Ch. 2013); *Valeant Pharmaceuticals International v. Jerney*, 921 A.2d 732, 745 (Del. Ch. 2007).

[296] *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, 115 A.3d 1173, 1180 (Del. 2015) (Strine, C.J.); *In re the Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 51–52 (Del. 2006) (en banc); *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360–61 (Del. 1993); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); *Williams v. Ji*, 2017 WL 2799156 (Del. Ch. June 28, 2017).

[297] *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17, 44 (Del. Ch. 2013); *Gesoff v. IIC Industries, Inc.*, 902 A.2d 1130, 1145 (Del. Ch. 2006).

There are two ways to avoid the entire fairness standard and have the business judgment rule apply. The first is for a majority of directors who are disinterested and independent to approve an executive compensation arrangement. For the approval to have this effect, the material facts of the director's relationship and interest in the transaction must be disclosed or made known to the disinterested and independent directors, and the majority of these directors approves the compensation in good faith.[298] Plaintiffs often seek to show that at least half of the directors who approved the compensation were not disinterested or independent.[299]

[298] *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 120 (Del. 2006); *Toedtman v. Turnpoint Medical Devices, Inc.*, *2019 WL 328559*, at *9 (Del. Super. Ct. Jan. 23, 2019); *In re Wheelabrator Technologies, Inc. Shareholders Litigation*, 663 A.2d 1194, 1200 (Del. Ch. 1995).

[299] *Lee v. Pincus*, 2014 Del. Ch. LEXIS 229, at *10 (Nov. 14, 2014); *Gentile v. Rossette*, 2010 Del. Ch. LEXIS 123, at *30 n. 36 (May 28, 2010) ("A board that is evenly divided between conflicted and non-conflicted members is not considered independent and disinterested.") (citations omitted).

The second is for a majority of informed, uncoerced, and disinterested shareholders to vote to approve the executive compensation arrangement. Shareholders are informed when the directors provide all material information within their control to the shareholders.[300]

[300] *In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1211 (Del. 2017); *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998); *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884, 899 (Del. Ch. 2016) (information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote; in other words, information is material if, from the perspective of a reasonable shareholder, there is a substantial likelihood that it significantly alters the total mix of information made available); *In re Tyson Foods, Inc.*, *2007 WL 2351071*, at *4 n. 18 (Del. Ch. Aug. 15, 2007) ("When directors speak out about their own compensation, or that of company managers, shareholders have a right to the full, unvarnished truth."); *Lewis v. Vogelstein*, 699 A.2d 327 , 333 (Del. Ch. 1997) (shareholder approval of a plan of compensation requires the disclosure or fair summary of all of the relevant terms and conditions of the proposed plan, together with any material extrinsic fact within the board's knowledge bearing on the issue).

See also Espinoza v. Zuckerberg, 124 A.3d 47 (Del. Ch. 2015) (ratification by shareholders, including a single controlling shareholder, of restricted stock units granted to directors must occur by voting at a shareholder meeting or by a written consent that satisfies Section 228 of the Delaware General Corporation Law).

Plaintiffs challenge executive compensation arrangements through derivative actions.[301] To bring a derivative action, a plaintiff must first demand that the board bring the action unless demand would be futile. A plaintiff can show demand futility by showing that there is reason to doubt that at least half of the current directors are not capable of bringing their impartial business judgment to bear on the litigation demand.[302]

[301] *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) (en banc) (the determination of whether a shareholder's claim is direct or derivative turns solely on the following questions: (1) who suffered the alleged harm (the corporation or the shareholders individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the shareholders individually).

[302] *United Food & Commercial Workers Union v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021) (en banc).

The test for demand futility has the following three prongs:[303] (1) whether the director received a material personal benefit from a transaction that the shareholders do not equally share in;[304] (2) whether the director would face a substantial likelihood of liability on any of the claims regarding the conduct at issue;[305] or (3) whether the director lacks independence from someone who received a material personal benefit from the conduct at issue, or who would face a substantial likelihood of liability on any of the claims regarding the conduct at issue. If the answer to any of these questions is yes for at least half of the current directors, demand is excused as futile.

[303] *Id.*

[304] *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) ("Classic examples of director

self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally."); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) ("Directorial interest exists whenever . . . a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders."); *Goldstein v. Denner*, 2022 WL 1671006, at *45–46 (Del. Ch. May 26, 2022) (Delaware courts are generally skeptical that director equity creates a disqualifying interest when the director receives the same per-share price as all other shareholders; accelerated vesting of $2.5 million of a director's unvested options and RSUs on the closing of a sale of the company conferred the additional benefit for the director of receiving consideration for unvested equity awards that might not have vested in the fullness of time and provided a benefit in terms of the time value of money).

[305] *Lenois v. Lewal*, 2017 WL 5289611, at *2 (Del. Ch. Nov. 7, 2017) (when directors are protected by an exculpatory charter provision, a plaintiff must allege that a majority of the board faces a substantial likelihood of liability for nonexculpated claims), *appeal dismissed*, 231 A.3d 396 (Del. 2020).

A director does not face a substantial likelihood of personal liability if the certificate of incorporation exculpates directors from personal monetary liability to the corporation and its shareholders for breaches of fiduciary duty to the fullest extent permitted by the Delaware General Corporation Law.[306] The exculpation applies to the breach of the duty of care, but does not apply to breaches of the duty of loyalty or actions taken in bad faith.[307] Since the standard of review to determine whether a breach of the duty of care has occurred is gross negligence,[308] an exculpatory clause covers acts of gross negligence.[309] Accordingly, to survive a motion to dismiss a plaintiff must plead with particularity that the directors breached their duty of loyalty or acted in bad faith.[310]

[306] Under Section 102(b)(7) of the Delaware General Corporation Law, a corporation may include an exculpatory provision in its certificate of incorporation that removes or limits a director's personal liability to the corporation and its shareholders for monetary damages for breach of fiduciary duty. Since the underlying breach is not eliminated, a third-party, such as a financial advisor or investment banker, is subject to liability for aiding and abetting a director's breach. *In re Rural Metro Corp.*, 88 A.3d 54, 86 (Del. Ch. 2014), *aff'd sub nom. RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 873 (Del. 2015).

[307] *In re Cornerstone Therapeutics Inc. Shareholder Litigation*, 115 A.3d 1173, 1180 (Del. 2015) (Strine, C.J.); *Shabbouei v. Potdevin*, 2020 WL 1609177, at *10 (Del. Ch. April 2, 2020).

[308] *McElrath v. Kalanick*, 224 A.3d 982, 991–92 (Del. 2020); *Rabkin v. Philip A. Hunt Chemical Corp.*, 547 A.2d 963, 970 (Del. Ch. 1986).

[309] *McElrath v. Kalanick*, 224 A.3d 982, 991–92 (Del. 2020); *In re Cornerstone Therapeutics Inc. Shareholder Litigation*, 115 A.3d 1173, 1180 (Del. 2015) (Strine, C.J.); *In re McDonald's Corporation Stockholder Derivative Litigation*, 2023 WL 2293575, at *27 (Del. Ch. March 1, 2023); *Shabbouei v. Potdevin*, 2020 WL 1609177, at *10 (Del. Ch. April 2, 2020); *Ryan v. Armstrong*, 2017 WL 2062902, at * 2 (Del. Ch. May 15, 2017).

[310] *See, e.g.*, *Rudd v. Brown*, 2020 WL 5494526 (Del. Ch. Sept. 11, 2020) (proxy contest threatened by activist investor with 14.6% stake in company to replace the board was insufficient to show that directors were conflicted and lacked disinterestedness or independence and therefore breached their duty of loyalty in approving sale of the company to Apollo); *In re Tangoe, Inc. Stockholders Litigation*, 2018 WL 6074435 (Del. Ch. Nov. 20, 2018) (stockholders sufficiently alleged breach of duty of loyalty by the combination of a threatened proxy contest to replace the board, severely delayed financial restatements, board recommendation of steadily decreasing offers from a private equity group that held 10.4% of the stock, and grant of equity awards with a $5 million payout a portion of which fully vested only on a change-in-control and a portion of which vested on achieving an undisclosed deal price).

As to the third prong, a director is not independent when the director may feel subject to an interested party's dominion or is otherwise beholden to that party.**[311]** A director is not independent of another person if the director has a material personal or financial relationship with the other person of a bias producing nature. If the other director is a controlling shareholder, a director is not independent of that shareholder if the directorship is materially important to the director.**[312]**

[311] *Marchand v. Barnhill*, 212 A.3d 805, 818 (Del. 2019) (en banc); *Sandys v. Pincus*, 152 A.3d 124, 130 (Del. 2016) (en banc) (Strine, C.J.) (plaintiff met pleading stage burden of showing a lack of independence by alleging that two families were extremely close and among each other's most important and intimate friends; "Co-ownership of a private plane involves a partnership in a personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship. In fact, it is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment") (footnote omitted); *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017, 1022 (Del. 2015) (en banc) (Strine, C.J.) (plaintiff met pleading stage burden of showing a lack of independence by alleging that director had a friendship of over fifty years with an interested party and the director's primary employment was as an executive of a company over which the interested party had substantial influence).

Goldstein v. Denner, 2022 WL 1671006, at *46–50 (Del. Ch. May 26, 2022) (relationship of two outside directors' with an activist investor who also served as an outside director showed that the two directors may not have been independent of the activist investor; the combination of the lack of independence and an apparently low price for the sale of the company led to a reasonable inference that the directors acted in their self-interest rather than in the interest of the shareholders; the two directors were likely grateful to the investor for their board seats and likely expected that the investor would provide them with future benefits of lucrative board seats at other companies, especially since the investor was a repeat player in finding directors for his hedge fund's portfolio companies in the biopharma and healthcare sector; "[W]hen an influential party has bestowed a directorship on an individual in the past or has the power to reward an individual with directorships in the future, then the individual may seek to serve the interests of that influential party. The desire to establish, maintain, or strengthen a relationship with the influential party could support an inference that the director was not independent or failed to act in good faith").

Knight v. Miller, 2022 WL 1233370 (Del. Ch. April 27, 2022) (two shareholders who held 87.6% of stock received grants of options that were not shared equally among the shareholders; one shareholder was the chairman of the board of directors and the other shareholder was the CEO; since the two shareholders were controllers, the entire fairness standard of review applied even though neither shareholder sat on the compensation committee; the independent committee members who pass on the transaction might perceive that disapproval may result in retaliation by the controlling shareholders; in addition, in the CEO compensation context, the decision maker knows that regardless of whether the controller CEO's compensation package is approved, the controller CEO is staying with the company, furthering the risk of retaliation).

In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104, at *12 (Del. Ch. Oct. 11, 2011) (allegation that director was not independent of Goldman because he was the CEO of an entity that had received large loans from Goldman was insufficient to show lack of independence when plaintiff failed to plead facts that showed anything other than that a series of market transactions occurred between the two companies).

D. Gordon Smith, "The Exit Structure of Venture Capital," 53 *UCLA Law Review* 315, 320 (2005) ("[I]n the event of conflict between the venture capitalist and the entrepreneur, such outside directors may have a natural inclination to side with the venture capitalist."); David I. Walker, "The Manager's Share," 47 *William & Mary Law Review* 587, 633 (2005) ("[T]he incentive to retain a board position generally outweighs the incentive to maximize shareholder value.").

For the director independence standards of Institutional Shareholder Services, see Institutional Shareholder Services, *United States Proxy Voting Guidelines Benchmark Policy Recommendations*, Voting on Director Nominees in Uncontested Elections, at 9–12 (Dec. 13, 2022).

For the director independence standards of Glass, Lewis & Co., see Glass, Lewis & Co., *2023 Policy Guidelines United States*, Election of Directors, at 12–17.

For the director independence standards of Blackrock, see BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 4 and 6–7.

See generally Robin Alexander, "Director Independence and the Impact of Business and Personal Relationships," 92 *Denver University Law Review Online* 63 (April 29, 2015); George W. Dent, Jr., "Independence of Directors in Delaware Corporate Law," 54 *University of Louisville Law Review* 73 (2016); Martin Edwards, "Expert Directors," 90 *University of Colorado Law Review* 1051 (Fall 2019); Bernice Grant, "Independent Yet Captured: Compensation Committee Independence After Dodd-Frank," 65 *Hastings Law Journal* 761 (2014); Randy J. Holland, "Delaware Independent Directors A Judicial Contextual Evolution," 24 *University of Pennsylvania Journal of Business Law* 781 (2022); Da Lin, "Beyond Beholden," 44 *Journal of Corporate Law* 515 (Spring 2019); Yaron Nili, "Board Gatekeepers," 72 *Emory Law Journal* 91 (2022); Yaron Nili, "The Fallacy of Director Independence," 2020 *Wisconsin Law Review* 491; Usha Rodrigues, "The Fetishization of Independence," 33 *Iowa Journal of Corporation Law* 447 (Winter 2008); Giovanni Strampelli, "How to Enhance Directors' Independence at Controlled Companies," 44 *Journal of Corporate Law* 103 (Fall 2018); Urska Velikonja, "The Political Economy of Board Independence," 92 *North Carolina Law Review* 855 (March 2014).

David A. Katz & Laura A. McIntosh, "So You're Thinking of Joining a Public Company Board," *Harvard Law School Forum on Corporate Governance and Financial Regulation*, Feb. 1, 2016 (available at https://corpgov.law.harvard.edu/2016/02/01/so-youre-thinking-of-joining-a-public-company-board/); Victor I. Lewkow, "Compensation Committees and Adviser Independence Under Dodd-Frank," *Harvard Law School Forum on Corporate Governance and Financial Regulation*, July 16, 2012 (available at https://corpgov.law.harvard.edu/2012/07/16/compensation-committees-and-adviser-independence-under-dodd-frank/); Matthew C. Ryan, Susan P. Serota & Brian M. Wong, "SEC Approves NYSE and Nasdaq Independence Standards for Compensation Committees and Advisers," *Business Law Today,* Feb. 2013 (available at http://apps.americanbar.org/buslaw/blt/content/2013/02/keepingcurrent.shtml).

312 *See United Food & Commercial Workers Union v. Zuckerberg*, 262 A.3d 1034 (Del. 2021) (en banc) (a director does not lack disinterestedness and independence when the director: (1) was recruited to the board by the CEO-controlling shareholder; (2) works in a venture capital firm that benefits from deal flow generated by the CEO-controller; (3) has a business relationship with the company; director was a cofounder of Netflix, its CEO, and board chair, and Netflix purchased advertising from Facebook and received special data sharing benefits; in the absence of allegations as to how Netflix relied on the business relationship or how valuable it was to Netflix, court could not find a lack of independence; (4) had a shared interest with the CEO-controller in the belief that founders should remain in control of their companies; (5) has a track record of donating to similar charitable causes as the CEO-controller; (6) continues on the board due to the CEO-controller's support in the midst of negative publicity from public scandals unless the continued service was financially or personally material to the director; (7) served on the board of the financial advisor that advised the company on the challenged stock reclassification unless the director received a material personal benefit from the advisor's engagement); or (8) received a waiver from the board of the mandatory retirement age for directors).

In re BGC Partners, Inc. Derivative Litigation, 2021 WL 4271788, at *8 (Del. Ch. Sept. 20, 2021) (director's board compensation created a genuine issue of material fact as to his independence from the controlling shareholder; director's service alongside the controller gave him more than half of his household income from 2010 to 2017; the portion of his annual income attributable to BGC steadily increased from 46.9% to 64.3% between 2014 to 2017).

See also Leo E. Strine. Jr., “The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face,” 30 *Delaware Journal of Corporate Law* 673, 678 (2005) (Delaware courts are “most suspicious when the fiduciary who is interested is a controlling stockholder”).

Being nominated or elected by a director who controls the outcome is insufficient to create a reasonable doubt as to a director's independence because that is the usual way a person becomes a director.[313] In addition, appointment to the board in a power struggle and the director's potential loyalty to the person who made the appointment does not without more allow a reasonable inference that their relationship is of a bias producing nature. Otherwise, a director would be automatically disqualified if appointed during a board conflict.[314]

[313] *In re Camping World Holdings, Inc. Stockholder Derivative Litigation*, 2022 WL 288152, at *17–18 (Del. Ch. Jan. 31, 2022), *aff'd on opinion below*, 285 A.3d 1204 (Table) (Del. 2022); *Friedman v. Dolan* , 2015 WL 4040806, at * 6 (Del. Ch. June 30, 2015).

[314] *McElrath v. Kalanick*, 224 A.3d 982, 995–96 (Del. 2020).

For shareholder approval to result in the business judgment rule as the standard of review, the equity compensation plan presented to the shareholders must provide for: (1) awards of a specified number of shares or a number of shares based on a mathematical formula;[315] or (2) nondiscretionary self-executing awards that use time based or fixed criteria with the specific amounts and terms approved by the shareholders.[316]

[315] *In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1211 (Del. 2017); *Gottlieb v. Heyden Chemical Corp.*, 90 A.2d 660 (Del. 1952); *Kerbs v. California Eastern Airways, Inc.*, 90 A.2d 652 (Del. 1952); *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014) (court upheld grants of options to directors under the company's stock incentive plan conditioned on shareholder approval of the grants; although the plan did not set forth the specific compensation that directors would receive, the shareholders voted in favor of specific awards; shareholders approved the grant of up to 100,000 options to two of the company's outside directors, and subsequently approved the grant of up to 45,000 stock-based awards to six of the company's outside directors); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (court upheld grants of options to directors of Mattel, Inc. under a shareholder-approved plan that provided for one-time grants of 15,000 options per director, and annual grants of up to 10,000 options per director depending on length of service).

[316] *In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1211 (Del. 2017); *In re 3COM Corp. Shareholders Litigation*, *1999 WL 1009210*, at *3 and n. 9 (Del. Ch. Oct. 25, 1999) (option plan for directors provided specific ceilings on the awards of options each year; ceilings varied based on specific categories of service, such as service on a committee, position as a lead director, and chairing the board; by operation of the plan's initial shareholder approval and the director specific ceilings, the shareholders approved the subsequent grants of options to directors; court applied the business judgment rule and upheld the grants); *Steiner v. Meyerson*, 1995 Del. Ch. LEXIS 95, at *21 to 24 (Del. Ch. July 19, 1995) (outside director stock option plan granted each nonemployee director an option to purchase 25,000 shares upon election to Telxon board, and an additional 10,000 shares on the anniversary of the election while the director remained on the board; since the plan set forth the specific awards to be granted, the upfront shareholder approval of the plan ratified the subsequent awards made under the plan).

Counsel can also take the position that the business judgment rule applies when the shareholders approve a plan that has the following two limitations: (1) ceilings on the total awards during the term of the plan to all directors or specified categories of directors, such as chairman of the board, lead director, and chairman or member of a particular committee; and (2) the maximum dollar amount of shares to be awarded to any director annually or any director in a specified category annually, or the maximum number of shares to be awarded to any director annually or any director in a specified category annually.[317]

[317] *See In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1222 (Del. 2017) ("When stockholders know precisely what they are approving, ratification will generally apply.").

When shareholders approve an equity compensation plan that gives directors discretion to grant themselves awards within general parameters, and a shareholder alleges facts with a pleading stage reasonable inference that the directors inequitably exercised their discretion, the directors will not prevail on a motion to dismiss based on shareholder approval. Rather, the entire fairness standard will apply.[318]

[318] *In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1211 (Del. 2017); *Knight v. Miller*, 2022 WL 1233370 (Del. Ch. April 27, 2022) (plaintiff sufficiently alleged some facts implying a lack of entire fairness to withstand motion to dismiss claim for breach of duty of loyalty in compensation committee's grant of options to outside directors including themselves on the same day that the stock hit its lowest point during the COVID-19 pandemic of $67.69 and with that strike price; plaintiff alleged that: (1) the compensation committee disregarded certain considerations related to the emergence of the COVID-19 pandemic; (2) the company's peers in its self-selected peer group received significantly less compensation; (3) the company, speaking through its CFO, considered the stock a "buy" even at a price over $20 in excess of the strike price; (4) one analyst identified a year-end price target of $127 using a model that purported to incorporate the effects of COVID-19; and (5) the chairman of the board of directors and a major shareholder was actively lobbying the federal government via his work with the Federation of American Hospitals and therefore knew or had reason to know of the timing and extent of federal grants including relief that the company might reasonably expect to receive).

Stein v. Blankfein, 2019 WL 2323790 (Del. Ch. May 31, 2019) (to withstand a motion to dismiss, a plaintiff challenging director compensation and seeking entire fairness review must plead some facts showing the unfairness of the compensation beyond allegations of director self-interest; plaintiff satisfied her low pleading burden by alleging that the board's average compensation was nearly twice that of its peer companies' directors; that Goldman's directors managed an entity no larger or more profitable than its peers, and achieved no better results; when shareholders were not informed of the contemplated self-interested awards, a provision in an equity compensation plan that directors were not liable for any action taken in good faith was insufficient to bind the shareholders and avoid entire fairness review); *Solomon v. Pathe Communications Corp.*, 1995 WL 250374, at *5 (Del. Ch. April 21, 1995) (to state a claim in a self-interested transaction a shareholder must allege some facts that tend to show the transaction was not fair).

See generally Lewis H. Lazarus & Brett M. McCartney, "Standards of Review in Conflict Transactions on Motions to Dismiss: Lessons Learned in the Past Decade," 36 *Delaware Journal of Corporate Law* 967, 974–75 (2011).

Under the entire fairness standard, the directors must show that the transaction was the product of fair dealing and a fair price. The fair dealing prong addresses the "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained."[319] The fair price prong ensures that the transaction was substantively fair by examining the economic and financial factors of assets, earnings, future prospects, market value, and any other elements that affect the intrinsic or inherent value of a company's stock.[320]

[319] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

320 *Id.*

In determining whether the directors satisfy the entire fairness standard, courts consider the following factors: (1) whether the directors received the advice of an independent compensation consultant;[321] (2) the company's historical compensation practices; (3) the compensation at peer companies,[322] and whether the board determined the peer group in consultation with an independent compensation consultant; (4) the number of meetings the board or compensation committee held, the timing of the meetings,[323] and the quality of the materials considered at the meetings; (5) whether the board or compensation committee used a separate process for grants to the nonemployee directors and grants to the executive directors and executives;[324] (6) the manner in which the directors disclosed the plan to shareholders;[325] and (7) the degree to which the award is performance-based rather than service-based, and the difficulty in attaining the performance goals.[326]

321 *The Ravenswood Investment Co., L.P. v. Estate of Bassett S. Winmill*, 2018 WL 1410860, at *15 n. 143 (Del. Ch. March 22, 2018) ("[A]voiding the cost of a consultant is not a proper justification for a process that is unfair to the Company and its stockholders and that may result in excessive compensation."), *aff'd*, 210 A.3d 705 (Del. 2019) (Table); *In re the Walt Disney Co. Derivative Litigation* , 907 A.2d 693, 769 (Del. Ch. 2005) (court upheld compensation committee's use of consultants), *aff'd*, 906 A.2d 27, 65 (Del. 2006) (en banc).

Majority Staff of House Committee on Oversight & Government Reform, 110th Cong., "Executive Pay: Conflicts of Interest Among Compensation Consultants," at 9–15 (Comm. Print 2007) (available at https://www.gpo.gov/fdsys/pkg/CHRG-110hhrg46535/pdf/CHRG-110hhrg46535.pdf); Statement of Houman B. Shadab, Senior Research Fellow, Mercatus Center at George Mason University, "Executive Pay and the Role of Compensation Consultants: Hearing Before the House Committee on Oversight & Government Reform," 110th Cong., at 44 (2007) (available at https://www.gpo.gov/fdsys/pkg/CHRG-110hhrg46535/pdf/CHRG-110hhrg46535.pdf).

See also Glass, Lewis & Co., *2023 Policy Guidelines United States*, Compensation Consultant Independence, at 62 ("We believe compensation consultants are engaged to provide objective, disinterested, expert advice to the compensation committee. When the consultant or its affiliates receive substantial income from providing other services to the company, we believe the potential for a conflict of interest arises and the independence of the consultant may be jeopardized. Therefore, Glass Lewis will, when relevant, note the potential for a conflict of interest when the fees paid to the advisor or its affiliates for other services exceed those paid for compensation consulting.").

322 *See In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208 (Del. 2017) (plaintiff adequately alleged a breach of fiduciary duty by the directors when the nonemployee director awards averaged $2,159,400 in 2015 and the aggregate grant date value for the awards of all twelve board members was approximately $51.5 million; this amount was higher than the director pay at every Wall Street firm that year; it exceeded the nonemployee director's compensation in 2014, which averaged $133,340 and ranged from $97,200 to $207,005; it also exceeded the $198,000 median pay at similarly sized companies and the $260,000 median pay at larger companies; awards were also more than 23 times the $87,556 median award granted to other companies' nonemployee directors after a mutual-to-stock bank conversion that the company underwent in 2015; court also permitted the plaintiff to challenge the awards to management members of the board when the board's approvals of their awards occurred in the same meetings and deliberations as the board's decisions on the nonemployee directors); *Tornetta v. Musk*, 250 A.3d 793, 812–13 (Del. Ch. 2019) (plaintiff adequately alleged that award of option to controlling shareholder was not entirely fair to the corporation by alleging that the fair value of the award was $2.6 billion or $3.7 billion, dwarfing the compensation of the world's most successful technology companies); *Calma v. Templeton*, 114 A.3d 563, 589–90 (Del. Ch. 2015) (court denied directors' motion to dismiss on whether grants of restricted stock units to directors satisfied the entire fairness standard; directors claimed that the corporation's peer group was the fourteen companies identified by the corporation as its peers in its filings with the SEC, and plaintiff claimed that

the peer group should be limited to five of the fourteen companies based on comparable market capitalization, revenue, and net income metrics).

See also David A. Katz & Laura A. McIntosh, “Dealing With Director Compensation,” *New York Law Journal*, May 21, 2015, at 5, 7 (“Boards that intend to rely heavily on the practices of peer companies as a basis for their own compensation are strongly encouraged to engage a compensation consultant to help determine the appropriate group and to periodically re-evaluate the composition of the group.”) (footnote omitted).

For a discussion of choice of the appropriate peer group, see *supra* notes 176 to 181 and accompanying text.

[323] *In re Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208, 1214–15 (Del. 2017) (shareholders approved Equity Incentive Plan at the company's annual meeting on June 9, 2015; three days later the Compensation and Benefits Committee held the first of four meetings; the Committee and the entire board approved the awards to all board members at the Committee's final meeting on June 23, 2015).

[324] *Id.* at 1225–26.

[325] *Id.* at 1224.

[326] *Tornetta v. Musk*, 250 A.3d 793, 813 (Del. Ch. 2019).

Finally, when a corporation grants an award of equity compensation to a controlling shareholder, the standard of review is entire fairness.[327] A controlling shareholder is a person who owns a majority interest in the corporation, or who owns less than a majority interest but exercises control over the business of the corporation. In the latter situation, the controller has a combination of voting power and managerial authority that enables him or her to control the corporation if he or she so wishes.[328]

[327] *In re Ezcorp Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) (entire fairness governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit); *In re Crimson Exploration Inc. Stockholder Litigation*, *2014 WL 5449419*, at *12 (Del. Ch. Oct. 24, 2014) (entire fairness is not triggered solely because a company has a controlling stockholder; the controller must also engage in a conflicted transaction); *In re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022, 1024 (Del. Ch. 2012) (Delaware does not require a controlling shareholder to penalize itself and accept less than the minority and thereby give the minority better treatment; rather, pro-rata treatment is a form of safe harbor); *In re BHC Communications, Inc. Shareholder Litigation*, 789 A.2d 1, 11 (Del. Ch. 2001) (fact that controlling shareholder proposed transaction or participated in negotiations does not ordinarily support a claim of breach of fiduciary duty unless there are well-pleaded allegations that it had an interest in the transaction that differed from that of the other shareholders and exercised control over approval of the transaction).

[328] *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1113 (Del. 1994); *Delman v. GigAcquisitions3, LLC*, 288 A.3d 692, 716–17 (Del. Ch. 2023); *In re Tesla Motors, Inc. Shareholder Litigation*, 2018 WL 1560293, at *12 and 19 (Del. Ch. March 28, 2019); *In re Cysive, Inc. Shareholders Litigation*, 836 A.2d 531, 553 (Del. Ch. 2003).

See generally Ann M. Lipton, “The Three Faces of Control,” 77 *Business Lawyer* 801 (Summer 2022).

To shift the standard of review from entire fairness to the business judgment rule, the award must be approved by a fully functioning, independent special committee of the board, and also by an informed, uncoerced vote of a majority of the minority shareholders.[329] Furthermore, the board must precondition the award on these approvals, and establish these preconditions upfront before any substantive economic negotiations with the controlling shareholder begin.[330]

329 *Olenik v. Lodzinsky*, 208 A.3d 704, 715 (Del. 2019); *Tornetta v. Musk*, 250 A.3d 793, 811–12 (Del. Ch. 2019).

330 *Id.*

These approvals are necessary to protect the directors and minority shareholders from coercion or retaliation by the controlling shareholder. Without the requirement of these approvals, the controlling shareholder can remove or decline to reappoint directors, and can retaliate against unaffiliated minority shareholders, such as through a squeeze-out merger or slashing dividends.[331]

331 *See Knight v. Miller*, 2022 WL 1233370 (Del. Ch. April 27, 2022) (two shareholders who held 87.6% of stock received grants of options that were not shared equally among the shareholders; one shareholder was the chairman of the board of directors and the other shareholder was the CEO; since the two shareholders were controllers, the entire fairness standard of review applied even though neither shareholder sat on the compensation committee; the independent committee members who pass on the transaction might perceive that disapproval may result in retaliation by the controlling shareholders; in addition, in the CEO compensation context, the decision maker knows that regardless of whether the controller CEO's compensation package is approved, the controller CEO is staying with the company, furthering the risk of retaliation); *In re Viacom Inc. Stockholders Litigation*, 2020 WL 7711128, at *21–25 (Del. Ch. Dec. 29, 2020) (controlling shareholder's history of ouster of directors and threats of removal were important factors at the pleading stage in showing lack of independence of current directors from controlling shareholder).

An individual director's personal liability for failure to satisfy the entire fairness standard turns on whether the director breached the duty of care or the duty of loyalty. When the duty of care is at issue and the corporation's certificate of incorporation has an exculpatory clause under Section 102(b)(7) of the Delaware General Corporation Law, a director will not have liability for breach of this duty.

When the duty of loyalty is at issue, regardless of whether there is an exculpatory clause, a director can have personal liability in three situations. First, the director promotes the director's self-interest that is adverse to the shareholders.

Second, a director advances the self-interest of an interested party from whom the director lacks independence. Under this test, lack of independence is insufficient, and the director must also take steps to advance the conflicted party's self-interest. Accordingly, a director can have a claim dismissed when there is an exculpatory clause if the director is independent from the conflicted party, or did not take steps to advance the conflicted party's self-interest.[332]

332 *In re BGC Partners, Inc. Derivative Litigation*, 2021 WL 4271788, at *10 (Del. Ch. Sept. 20, 2021).

Third, a director who is disinterested and independent of a controlling shareholder approves the transaction in bad faith.[333]

333 *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, 115 A.3d 1173, 1179–81 (Del. 2015) (Strine, C.J.).

Section 2(d) of the Model Plan is intended to receive the protection of the business judgment rule. All three Alternatives of Section 2(d)(i) provide for the maximum aggregate Grant Date ASC Values of Awards granted to Directors during the term of the Plan. Alternative 1 provides that the maximum ASC Values of Awards that the Company may grant in a year cannot exceed a specified dollar amount. Alternative 1 provides a separate specified dollar amount for the Board Chair, and a separate specified dollar amount for any other Director. Alternative 2 of Section 2(d)(i) provides that the sum of the maximum ASC Values of Awards that the Company may grant in a year and all other compensation for that year cannot exceed a specified dollar amount. Alternative 2 provides a separate specified dollar amount for the Board Chair, and a separate specified dollar amount for any other Director. Alternative 3 of Section 2(d)(i) follows the terms of Alternative 2, but applies only to Nonemployee Directors.

Section 2(d)(iii) provides that the Administrator or Board shall determine the Grant Date ASC Values of Awards as of each Grant Date.

GRANT OF AWARDS FOR SHARES THAT EXCEED THE PLAN'S SHARE RESERVE OR OTHER PLAN LIMIT

If the employer grants Awards for shares that exceed the plan's share reserve or any other plan limit and then wishes to cancel the excess shares, the employer needs to address the issue of whether it must obtain the grantee's consent to the cancellation. The argument for obtaining the grantee's consent is that the grant of the excess shares is a contractual obligation, and cancellation of the excess shares without the grantee's consent would be a breach of contract. The argument for not obtaining the grantee's consent is that since the grant of the excess shares violates the plan and the grantee is bound by the plan's terms, the grant does not provide the grantee with an enforceable contract right to the excess shares.

To avoid this issue, the plan document or award agreement should contain a provision that either invalidates an excess grant, or allows the employer to cancel an excess grant. Section 3(b)(ix) of the Model Plan provides the Administrator or Board with the discretion to cancel any Award for which the Administrator or Board determines that the number of Shares subject to the Award exceeds any of the limits under section 2 of the Model Plan.

With respect to a company's failure to comply with a plan's limits on grants to individual participants, the courts treat the failure in two ways: (1) a breach of fiduciary duty that does not receive the protection of the business judgment rule;[334] or (2) a breach of contract as an equity compensation plan is a contract between the board of directors and shareholders.[335]

[334] For cases applying a business judgment rule and breach of fiduciary duty analysis, *see Donnawell v. Hamburger*, 803 F.3d 912 (7th Cir. 2015) (Posner, J.) (Delaware law); *Garnitschnig v. Horovitz*, 48 F. Supp. 3d 820, 831 (D. Md. 2014) (Delaware law); *Reith v. Lichtenstein*, 2019 WL 2714065 (Del. Ch. June 28, 2019) (company told stockholders in its 2010 proxy statement that the 2010 incentive award plan limited full value awards to three million, but in 2017 the company awarded more than three million full value awards; business judgment rule is not appropriate when a plaintiff pleads particularized facts showing that the board knowingly or deliberately failed to adhere to the terms of a stock incentive plan; one way for a plaintiff to make this showing is to demonstrate that the alleged action was a clear and unambiguous violation of the stock incentive plan); *Pfeiffer v. Leedle*, 2013 WL 5988416, at *5–8 (Nov. 8, 2013) (plan prohibited any individual from receiving more than 150,000 options in a single calendar year; Leedle received over 400,000 options in 2011 and 285,000 options in 2012; court held that complaint supported a reasonable inference that Leedle knew or should have known that his receipt of the options violated the plan and as a result he acted in bad faith and breached his fiduciary duty).

[335] For cases applying a breach of contract analysis, *see Allen v. El Paso Pipeline GP Co.*, 90 A.3d 1097, 1108 (Del. Ch. 2014) ("Boards of directors have no discretion to exceed the intra-entity limitations on their authority. The possession of discretionary authority is a prerequisite for the policy-based deference of the business judgment rule. Without authority to take the action in question, a board has no business judgment to exercise."); *Ryan v. Gifford*, 918 A.2d 341, 354 (Del. Ch. 2007).

See also Friedman v. Khosrowshahi, 2015 WL 1001009, at *1 (March 6, 2015) (Table) (en banc) (Strine, C.J.) ("Analytically, a contract claim under [a stock and annual incentive] plan could be subject to distinctive treatment for demand excusal purposes as a breach of fiduciary duty claim, because directors arguably have no discretion to violate the terms of a stockholder-adopted compensation plan whose terms cannot be amended without the stockholders' approval.") (dictum) (unpublished disposition).

Cf. Largo Legacy Group, LLC v. Charles, 2021 WL 2692426, at *18 (Del. Ch. June 30, 2021) (LLC manager allegedly used LLC assets for his personal benefit in a manner not shared by the other LLC members; to permit a fiduciary duty claim based entirely on a breach of contract to proceed alongside the primary contract claim would undermine the primacy of contract law over fiduciary law in matters involving contractual rights and obligations).

In *Garfield v. Allen*,[336] an equity compensation plan set 3.5 million shares as the maximum number of shares that the company may grant as performance share awards to any individual in the same fiscal year. In March 2020, a board committee of four outside directors made two awards of performance shares to the CEO, who was also a director. The awards entitled the CEO to receive a variable number of performance shares, with the amount of the ultimate number of shares turning on the company's performance against stated goals over a three year performance period ending in 2023. The number of performance shares for attaining target goals came within the 3.5 million share limitation. However, if the company attained the maximum performance payout level, the CEO would receive 4,733,840 shares, which exceeded the 3.5 million share limitation.

[336] 277 A.3d 296 (Del. Ch. 2022).

A shareholder sent the board a demand letter claiming that the awards exceeded the performance share limitation, and demanded that the board remedy the excess awards. In response, the board committee, relying on its authority under the plan document to interpret the plan, interpreted the performance share limitation to apply only to the target goals for free cash flow and total shareholder return.

In denying the directors' motion to dismiss, the court held that under the plaintiff's complaint it was reasonably conceivable that: (1) the committee directors, including independent and disinterested directors, breached their fiduciary duties by granting the excess awards; (2) the committee directors, including independent and disinterested directors, contractually breached the performance share limitation by granting the excess awards; (3) the CEO breached his fiduciary duties by accepting the excess awards; (4) all the directors, including those who did not approve the excess award grant, breached their fiduciary duties by not fixing the awards after the demand letter brought the violation of the performance share limitation to their attention; and (5) all the directors, including those who did not approve the excess award grant, contractually breached the performance share limitation by interpreting the limitation to apply only to the free cash flow and total shareholder return target goals.

Since the plan set forth the performance share limitation in plain and unambiguous language, and the maximum number of shares to which the CEO was entitled if the company attained the maximum performance payout level violated the limitation, the failure of the directors who granted the excess awards to comply with the limitation supported a reasonable inference that they acted knowingly and intentionally in bad faith.[337] In addition, since an equity compensation plan is treated as a contract between the board and shareholders,[338] the directors who granted the excess awards could be liable for breach of contract for exceeding a plain and unambiguous limitation on their authority under the plan document.[339]

[337] *Pfeiffer v. Leedle*, 2013 WL 5988416, at *9 (Nov. 8, 2013); *Desimone v. Barrows*, 924 A.2d 908, 929, 933 (Del. Ch. 2007); *Ryan v. Gifford*, 918 A.2d 341, 354–55 (Del. Ch. 2007).

[338] *Sanders v. Wang*, 1999 WL 1044880, at *6 (Del Ch. Nov. 10, 1999).

[339] *Allen v. El Paso Pipeline GP Co.*, 90 A.3d 1097, 1108 (Del. Ch. 2014); *Ryan v. Gifford*, 918 A.2d 341, 354 (Del. Ch. 2007).

The court also held that it was reasonably conceivable that the CEO acted in bad faith and breached his fiduciary duties. The CEO was on the board when the plan was adopted, and the company's proxy statement described the performance share limitation as a material term. In light of the importance of the limitation and the CEO's role in the company and his status as a board member, it was reasonable to infer that the CEO knew about the limitation and that the award violated the limitation. Since the excess awards violated a clear and unambiguous limitation in the plan document, the CEO may have acted in bad faith and breached his fiduciary duties by accepting the awards.[340]

[340] *Pfeiffer v. Leedle*, 2013 WL 5988416, at *10 (Nov. 8, 2013); *Weiss v. Swanson*, 948 A.2d 433, 449 (Del. Ch. 2008).

The court also held that the directors' failure to fix the problem after learning about it from the demand letter was a potential breach of fiduciary duties by all the directors. The court relied on the principle that "Delaware law treats a conscious failure to act as the equivalent of action, so if a plaintiff brings a clear violation to the directors' attention and they do not act, then it is reasonably conceivable that the directors' conscious inaction constitutes a breach of duty."[341] The plan set forth the performance share limitation in plain and unambiguous language, and the maximum number of shares to which the CEO was entitled under his awards exceeded this limitation. The failure to comply with a plain and unambiguous restriction in a shareholder approved equity compensation plan supported an inference that the directors acted in bad faith. Furthermore, there was an easy fix for the board since the CEO was a fellow fiduciary who faced the same obligation to fix the flawed awards as the other members of the board.

[341] *277 A.3d at 306–07*.

In addition, the court held that the directors' failure to fix the problem after learning about it was a potential breach of contract by all the directors. The potential breach was to invoke authority they lacked by adopting a policy not contemplated by the plan document: the performance share limitation applied only to the free cash flow and total shareholder return target goals.

Furthermore, the court held that the plan's grant of discretion to the committee to interpret the plan did not permit the committee to avoid the plain meaning of the performance share limitation. The grant of discretion permitted the committee to interpret only ambiguous provisions; the committee lacked the authority to take any action that violated an express and unambiguous limitation in the plan document.[342]

[342] *JER Hudson GP XXI LLC v. DLE Investors, L.P.*, 275 A.3d 755, 786–87 (Del. Ch. 2022); *Sanders v. Wang*, 1999 WL 1044880, at *1 (Del Ch. Nov. 10, 1999).

In adopting the policy that the performance share limitation applied only to the target goals for free cash flow and total shareholder return, the committee relied on the plan's share pool rule. This rule addressed the administration of the plan's limit on the maximum number of shares that could be issued over the plan's term. This rule referred to target level of achievement to determine the number of performance shares that were counted against the share pool limitation at the time of grant, and that number was trued up when the actual level of performance was determined. The court held that the committee's use of the share pool rule to interpret the performance share limitation was an impermissible rewriting of the plan that was outside the committee's authority.

Finally, the court held that the business judgment rule did not protect the decision to grant the excess awards, or the decision to interpret the performance share limitation as applying only to the free cash flow and total shareholder return target goals. First, the business judgment rule applies only when directors make a discretionary judgment that comes within their authority. It does not protect a decision that exceeds their authority. Allegations that the directors knowingly exceeded their authority are sufficient to state a claim that the directors breached their duty of loyalty and thereby lost the protection of the business judgment rule.[343] Since the directors lacked the authority to exceed the performance share limitation, the business judgment rule did not protect their decision to grant the excess awards.

[343] *Allen v. El Paso Pipeline GP Co.*, 90 A.3d 1097, 1108 (Del. Ch. 2014).

Second, when the allegations of a complaint support a reasonable inference that a fiduciary violated a plain and unambiguous restriction on the fiduciary's authority, the plaintiff has asserted a claim for breach of the duty of loyalty that rebuts the protection of the business judgment rule.[344] The loyalty violation is the failure to act in good faith to comply with a plain and unambiguous restriction on the fiduciary's authority, which creates the inference that the fiduciary acted knowingly.

[344] *Pfeiffer v. Leedle*, 2013 WL 5988416, at *9 (Nov. 8, 2013); *Ryan v. Gifford*, 918 A.2d 341, 354–55 (Del. Ch. 2007); *Sanders v. Wang*, 1999 WL 1044880, at *1, 5 (Del Ch. Nov. 10, 1999).

SHARE WITHHOLDING FOR PAYMENT OF WITHHOLDING TAXES

Under Accounting Standards Update ("ASU") No. 2016-09 (March 2016), the Financial Accounting Standards Board amended Financial Accounting Standards Board Accounting Standard Codification Topic 718 to permit share withholding up to the maximum individual income tax rate in the applicable jurisdiction without triggering treatment of the equity award as a liability award subject to variable accounting. Before this amendment, this treatment was triggered when a plan permitted withholding in excess of a grantee's minimum statutory withholding rate. As a result, plans often limited share withholding to the minimum statutory withholding rate.

Since most executives' marginal tax rate was higher than this rate, this limitation forced the executives to raise the cash necessary to pay their tax liability from a source other than share withholding. The executives often wanted to sell the shares received on exercise of the award, and had to navigate an array of insider trading rules, short-swing profit rules, and the employer's stock ownership requirements.

In addition, share withholding can negatively impact an employer's cash flow. Since share withholding is essentially a cash settlement of a portion of an equity award with the cash remitted to the tax authorities, any increase in share withholding reduces the employer's cash flow. Before an employer adopts a plan amendment that permits an increase in share withholding, the employer should evaluate the effect of the increase on its cash flow.

The New York Stock Exchange has issued guidance that an amendment to an equity compensation plan to provide for withholding of shares up to an award recipient's maximum tax obligation is not a material amendment that requires shareholder approval as long as the withheld shares are never issued and regardless of whether the withheld shares are added to the plan's share reserve.[345]

[345] New York Stock Exchange, *Frequently Asked Questions on Equity Compensation Plans*, Q&A C-1 (Aug. 18, 2016).

For restricted stock, which is treated as issued on the grant date, the New York Stock Exchange guidance provides that an amendment to add shares that are withheld from restricted stock upon vesting to cover taxes to the plan's share reserve is a material amendment that requires shareholder approval. Shareholder approval is not required if the withheld shares are cancelled immediately upon vesting.[346]

[346] *Id.*

Three commentators point out that the New York Stock Exchange guidance permits an amendment to increase share withholding without shareholder approval only up to an employee's maximum tax obligation, rather than the maximum individual income tax rate in the applicable jurisdictions provided by ASU 2016-09. For example, under ASU 2016-09, an employer can withhold shares with a fair market value equal to the maximum combined federal, state, and local income tax rate even if this rate is greater than the employee's highest rate in a particular jurisdiction. If an employer wishes to have the ability to withhold at a rate greater than the employee's highest rate in a particular jurisdiction, and its shares are listed on the New York Stock Exchange, it should obtain shareholder approval of an amendment that provides for the maximum share withholding under ASU 2016-09.[347]

[347] Anne Batter, Eric Biscopink & Victor Flores, "FASB Update to ASC 718 Raises Questions About Methods for Withholding on Equity Awards," *Corporate Taxation* 37, 40 (Jan./Feb. 2017).

NASDAQ has issued more liberal guidance than the New York Stock Exchange on the shareholder approval issue. An amendment to increase the withholding rate to satisfy tax obligations is not a material amendment that requires shareholder approval. Allowing the grantee to surrender unissued shares to pay tax withholding is similar to settling the award in cash at market price, and neither transaction materially increases benefits to participants or increases the number of shares to be issued under the plan. This rule applies regardless of whether the plan allows the shares surrendered for tax withholding to be added back to the plan's share reserve for future awards.[348]

[348] NASDAQ Listing Center, *Frequently Asked Questions*, Identification No. 1269 (Oct. 19, 2016).

The NASDAQ guidance does not address the treatment of restricted stock. For an employer whose shares are listed on NASDAQ, the prudent approaches are not to provide for the recycling of restricted stock in excess of the minimum required withholding amount, or to obtain shareholder approval of any amendment to increase the withholding rate to satisfy tax obligations.

Section 7(c)(iii) and (iv) of the Model Plan provides three alternatives for the employer to withhold Shares to be issued on exercise, or accepting Shares tendered on exercise, for the payment of withholding taxes. The first alternative provides that the Company in its exclusive discretion may withhold from the Shares to be issued to a Grantee, or accept a Grantee's tender of Shares, Shares with a Fair Market Value that satisfies all or a portion of the Company's statutory minimum Tax withholding obligations. The second alternative provides that the Company in its exclusive discretion may withhold from the Shares to be issued to a Grantee, or accept a Grantee's tender of Shares, Shares with a Fair Market Value that satisfies all or a portion of the Company's statutory minimum Tax withholding obligations, or if greater, a Grantee's election for Tax withholding up to an amount determined under the maximum individual statutory Tax rates in the applicable jurisdictions. The third alternative provides that the Company in its exclusive discretion may withhold from the Shares to be issued to a Grantee, or accept a Grantee's tender of Shares, Shares with a Fair Market Value that satisfies all or a portion of the Company's statutory minimum Tax withholding obligations, or if greater, a Grantee's election for Tax withholding up to an amount equal to the Grantee's maximum Tax obligation.

For companies that have securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, its officers and directors have to be wary of running afoul of the short-swing profit prohibition of Section 16(b) of the Exchange Act.[349] If the withholding of shares for payment of withholding taxes triggers the prohibition, there is the issue of whether the board approval exemption of SEC Rule 16b-3(e) applies. This exemption applies to dispositions from officers or directors that are nondiscretionary and approved in advance by the issuer's board of directors or a board committee consisting of two or more nonemployee directors.

[349] 15 U.S.C. §78p(b). Section 16(b) prohibits directors and officers, and 10% shareholders of U.S. public companies to profit from the purchase or sale, or sale and purchase, of the company's equity securities within a period of less than six months.

In *Olagues v. Muncrief*,[350] an RSU agreement provided that shares that become payable to plan participants will be paid by the delivery of shares equal to the number of shares payable less the number of shares having a fair market value, as of the date the withholding tax obligation arises, equal to the minimum statutory withholding requirements. The court held that the exemption's requirements of a nondiscretionary transaction and advance board or committee approval were met.

[350] 760 F. App'x 620 (10th Cir. 2019).

Under *Rule 16(b)-3(b)*, the transaction was nondiscretionary because the RSU agreement, mandated the tax withholding transactions. In calculating the number of shares that would be paid, the issuer was required to: determine the minimum statutory withholding requirements associated with each award; compute the number of shares equal to that withholding amount; and withhold that number of shares from the shares to be paid to plan participants.

Under Rule 16(b)-3 n. 3, approval of a plan pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan, is satisfactory. In addition, when the terms of a subsequent transaction, such as the provision of a tax withholding right to the company, are provided for by the board or committee in its initial approval of the plan, the subsequent transaction will not require further board or committee approval.

The court held that compensation committee's approval of the RSU agreement adequately provided for and fixed in advance the terms and conditions of the tax withholding transactions. The RSU agreement fixed: the relevant time, which was the conversion of the RSUs into shares; the relevant manner, which was withholding in shares; and the relevant amount, which were shares having a fair market value equal to the minimum statutory withholding requirements. In light of this approval, no further approval was necessary for the tax withholding transactions.

Alternatives 2 and 3 of Section 7(c)(iii) of the Model Plan are intended to satisfy the SEC Rule 16(b)-3(e) exemption. These Alternatives provide that if the Shares are registered under Section 12 of the Exchange Act, the withholding of Shares is permissible for Insiders only if the Board or Director and Officer Committee requires in the Award Agreement that the Insider use the withholding of Shares method for all Shares subject to the Award. The Award Agreement must specify whether the withholding amount will be the Company's statutory minimum Tax withholding obligations, or the amount determined under the maximum individual statutory Tax rates in the applicable jurisdictions (Alternative 2), or the amount of the Insider's maximum Tax obligations (Alternative 3). The Board or Director or Officer Committee in its exclusive discretion may permit exceptions to these requirements only in advance of issuance of Shares.

Alternatives 1 and 2 of Section 7(b)(i) provide for similar language for the withholding of Shares method for Insiders to pay for the Shares issued on an Option's exercise, and on the grant or vesting of Restricted Stock.

Finally, the Final Regulations provide that it is not a modification of a stock right to add a feature providing for the ability to withhold or have withheld shares of stock to facilitate the payment of the exercise price, employment taxes or required withholding taxes resulting from exercise of the stock right, or the ability to tender previously acquired stock for the stock purchasable under the stock right.[351]

[351] Treas. Reg. §1.409A-1(b)(5)(v)(B). For a discussion of the definition of modification and its consequences under Section 409A, see *supra* notes 46 to 60 and accompanying text.

TAX TREATMENT OF RESTRICTED STOCK UNDER SECTIONS 83 AND 409A

An important issue in an award of restricted stock is its tax treatment under code Sections 83 and 409A. The threshold question is whether a transfer of stock on the grant date occurs. If a transfer on this date occurs, Section 83 governs the tax treatment,[352] and the restricted stock is exempt from Section 409A.[353]

[352] *See* Department of the Treasury, Internal Revenue Service, “Property Transferred in Connection With the Performance of Services Under Section 83, Summary of Comments,” 79 Fed. Reg. 10,663, 10,663 (Feb. 26, 2014).

[353] See discussion of the requirements of the exemption for restricted stock from Section 409A *supra* notes 61 to 67 and accompanying text.

If a transfer on the grant date does not occur, a plan under which an employee obtains a legally binding right to receive property in a future taxable year in which the property will be substantially vested (as defined in Treasury Regulation Section

1.83-3(b)) at the time of transfer may provide for the deferral of compensation and be a nonqualified deferred compensation plan.[354] A legally binding right to receive property in a future taxable year in which the property will be substantially nonvested (as defined in Treasury Regulation Section 1.83-3(b)) at the time of transfer will not provide for the deferral of compensation and will not be a nonqualified deferred compensation plan unless offered in conjunction with another legally binding right that is a deferral of compensation.[355]

[354] Treas. Reg. §1.409A-1(b)(6)(ii).

[355] *Id.*

When a transfer does not occur on the grant date and the arrangement is a nonqualified plan of deferred compensation subject to Section 409A the issues are whether: (1) a transfer occurs after the grant date; (2) the transfer occurs before or after a vesting date; and (3) on the employee's separation from service, the employer has a redemption obligation or a discretionary call right, or the employee has a discretionary put right.

Thus, the definition of transfer is at the heart of the determination of whether the exemption from Section 409A for restricted stock applies. The Final Regulations rely on the definition of transfer under Section 83.[356] The Section 83 regulations provide that a “transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in §1.83-3(i)).”[357] The grant of an option to purchase property is not a transfer of the property.[358]

[356] Treas. Reg. §1.409A-1(b)(6)(i); Department of the Treasury, Internal Revenue Service, “Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments,” §III.E (first paragraph), 72 Fed. Reg. 19,234, 19,243 (April 17, 2007).

See also Regina Olshan, “Coverage,” in *Section 409A Handbook* 2-1, 11–12 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023); Erica F. Schohn, “Equity Arrangements,” in *Section 409A Handbook* 14-1, 24–25 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

[357] Treas. Reg. §1.83-3(a)(1); *see also United States v. Tuff*, 469 F.3d 1249, 1252 (9th Cir. 2006) (option holder acquired beneficial ownership of stock on exercise of the option when the employer issued the shares to the employee, who then held legal title to the shares and was entitled to receive dividends; employee also had the rights to vote the shares, immediately sell the shares, and pledge the shares as collateral); PLR 200820010 (transfer of stock did not occur and Section 83(b) election was invalid when employer granted employee stock under a restricted stock agreement, but subsequently informed the employee that the employer did not have authorized employer stock available for grant); PLR 8028048 (transfer of stock to employees occurred when employer delivered shares to escrow agent to hold while restrictions on the stock continued in effect).

[358] Treas. Reg. §1.83-3(a)(2).

Similarly, the Final Regulations define the transfer of a share of stock on the exercise of an option or SAR as “the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation. A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal, or a right to acquire the share at the share's fair market value at the time of the sale.”[359]

[359] Treas. Reg. §1.409A-1(b)(5)(vi)(F). For the Delaware common law principles used to construe the contractual definition of transfer, see *Borealis Power Holdings Inc. v. Hunt Strategic Utility Investment, L.L.C.*, 233 A.3d 1 (Del. 2020) (en banc).

Section 5(l) and the definition of Grant Date under section 25(x) of the Model Plan contain the provisions for a grant of

Restricted Stock so that a transfer occurs on the Grant Date.

In determining whether a person acquires a beneficial ownership interest, the Section 83 regulations apply two broad criteria. The first is the extent to which the terms of an arrangement are similar to an option.[360] The second is whether the arrangement contains terms that require the return of property upon the happening of an event that is certain to occur, such as the employee's separation from service.[361]

[360] Treas. Reg. §1.83-3(a)(2) and (4).

[361] Treas. Reg. §1.83-3(a)(3).

For the criterion of similarity to an option, the Section 83 regulations provide that if the amount paid for the property is nonrecourse debt secured by the transferred property on which there is no personal liability to pay all or a substantial part of the indebtedness, the transaction's economic substance may be the same as the grant of an option.[362] The determination of a transaction's economic substance will be based on all the facts and circumstances, including: (1) the type of property involved; (2) the extent to which the risk that the property will decline in value has shifted to the purchaser; and (3) the likelihood that the purchase price will be paid.[363]

[362] Treas. Reg. §1.83-3(a)(2).

[363] *Id.*; *see also United States v. Tuff*, 469 F.3d 1249, 1254 (9th Cir. 2006) (arrangement was not similar to an option when after the employee exercised the option, he held title to publicly-traded shares, had the right to receive dividends, and could vote, sell, and pledge the shares; employee paid the purchase price in full, and obtained the funds for payment by pledging the shares and obtaining a margin loan from a brokerage firm; client account agreement with the brokerage firm provided that if the value of the collateral in the employee's account fell below a certain level, he had to deposit additional assets or the brokerage firm would sell the shares to satisfy the debt; since the sale of shares could only occur if they declined in value, the employee bore some risk that their value would decline; the client account agreement also provided that the employee was personally liable for any deficiency remaining after the brokerage firm sold the shares).

One commentator provides the following thoughtful analysis of how the purchase of property with nonrecourse debt is similar to an option. An option holder's decision of whether to exercise the option turns on whether the underlying property's value is greater or less than the exercise price. If the value of the property is greater than the exercise price, the option holder can exercise the option and realize the appreciation in value of the property over the exercise price without additional cost. If the value of the property is less than the exercise price, the option holder will not exercise the option and will walk away from the option.[364]

[364] Eickman, Portfolio 384-5th, *Restricted Property — Section 83*, Detailed Analysis, Section II.C, at 6 (Bloomberg Law 2023).

Similarly, when a person purchases property with a nonrecourse note, the purchaser's decision of whether to pay the note turns on the property's value. When the property's value is equal to or greater than the principal amount of the nonrecourse note, the purchaser will pay the note and realize the appreciation in value over the note's principal amount. When the property's value is less than the note's principal amount, the purchaser will not pay the note and will walk away from the transaction. The purchaser's position is similar to that of an option holder, with the principal amount of the nonrecourse note analogous to the option's exercise price. In other words, if the property declines in value neither the purchaser of property with a nonrecourse note nor the option holder bears the risk of loss.[365]

[365] *Id.* at 6–7

The factor of the extent to which the risk that the property will decline in value has shifted to the purchaser usually turns on whether the purchaser has capital at risk. A purchaser who uses a nonrecourse note does not have any risk that the property will decline in value until the purchaser invests his or her capital into the property. Once the purchaser has sufficient capital at risk, a transfer of the property occurs because the purchaser will pay the note to avoid losing the capital invested if the lender were to foreclose on the property. Even if the property declines in value, the purchaser will pay the note. As the purchaser pays the note, a transfer of the property occurs and the risk of the decline in value of the property shifts to the purchaser. The practical difficulty is determining how much of the note the purchaser needs to pay before a transfer of the property occurs.[366]

[366] *Id.* at 8.

The Section 83 regulations provide the following example of how the use of a nonrecourse note to purchase stock affects the determination of whether a transfer has occurred:

> *Example (2)*. On November 17, 1972, W sells to E 100 shares of stock in W corporation with a fair market value of $10, 000 in exchange for a $10,000 note without personal liability. The note requires E to make yearly payments of $2,000 commencing in 1973. E collects the dividends, votes the stock and pays the interest on the notes. However, he makes no payments towards the face amount of the note. Because E has no personal liability on the note, and since E is making no payments towards the face amount of the note, the likelihood of E paying the full purchase price is in substantial doubt. As a result, E has not incurred the risks of a beneficial owner that the value of the stock will decline. Therefore, no transfer of the stock has occurred on November 17, 1972, but an option to purchase the stock has been granted to E.[367]

[367] Treas. Reg. §1.83-3(a)(7), ex. 2; *see also United States v. Tuff*, 469 F.3d 1249, 1254 (9th Cir. 2006) (Example 2 did not apply when on the employee's exercise of the option, the employer received the full purchase price for the shares in exchange for transferring unconditional ownership of the shares to the employee; although the employee used debt to pay the exercise price, he borrowed the money through a margin loan from a brokerage firm, rather than a debt to the employer; if the employee failed to pay the loan, his shares were subject to forfeiture to the brokerage firm, rather than the employer).

The criterion of the return of property upon the happening of an event that is certain to occur depends on all the facts and circumstances.[368] Factors that indicate the absence of a transfer of the property are: (1) the extent to which the conditions relating to the transfer are similar to an option;[369] (2) the extent to which the amount to be paid to the grantee on surrender of the property does not approach fair market value at the time of surrender;[370] and (3) the extent to which the grantee does not incur the risk of loss of a beneficial owner that the value of the property at the time of transfer will decline substantially.[371]

[368] Treas. Reg. §1.83-3(a)(3).

[369] Treas. Reg. §1.83-3(a)(4).

[370] Treas. Reg. §1.83-3(a)(5).

[371] Treas. Reg. §1.83-3(a)(6).

Risk of loss is not limited to the risk of loss of any amount paid for the property.[372] One commentator points out that if there is a bargain element in the property at the time of grant that is subject to loss due to a decline in the property's value, the employee has the risk of loss of a beneficial owner.[373] This risk is shown by the following example:

[372] *Id.*

[373] Eickman, Portfolio 384-5th, *Restricted Property — Section 83*, Detailed Analysis, Section II.C, at 10–11 (Bloomberg Law 2023).

In 2018, P grants F 1,000 shares of its common stock for $5 per share. The stock is subject to the restriction that it must be returned to P on F's separation from service. On separation from service, F is entitled to the greater of $5 per share, and the fair market value of the stock at that time. The value of the P stock in 2018 is $10 per share. Even though F must return the stock on separation from service (the condition is certain to occur), the IRS is likely to find a transfer because the amount that F will receive for the P stock approaches its fair market value. F has a risk of loss because F can lose the bargain element at the time of grant in 2018 of $5 per share. F cannot lose the amount paid, but the risk of loss is broader than that in the Section 83 regulations.[374]

[374] *Id.*

The factor of payment of fair market value on surrender of the property is especially important in the equity compensation arrangements of privately-held companies. These arrangements often provide that on an employee's separation from service, the employer has the obligation to redeem the stock. Alternatively, these arrangements grant the employer a discretionary call right to redeem the stock, or the employee a discretionary put right for the employer to redeem the stock.

In determining fair market value, the nonlapse restriction rules under Treasury Regulation Section 1.83-5(a)(1) apply. The existence of a nonlapse restriction under Treasury Regulation Section 1.83-5(a)(1) is not a factor indicating that a transfer has not occurred.[375] A nonlapse restriction that does not come within Treasury Regulation Section 1.83-5(a)(1) can be a factor that shows the absence of a transfer.[376]

[375] Treas. Reg. §1.83-3(a)(5).

[376] *See Riverton Investment Corp. v. United States*, 170 F. Supp. 2d 608 (W.D. Va. 2001) (no transfer of stock occurred on the grant date because of a nonlapse restriction that prevented employees from selling the stock for more than 60% of book value and prohibited a sale to anyone other than the employer).

The Section 83 regulations provide the following examples of how the employer's obligation to redeem stock from the employee affects the transfer determination:

Example (1). On January 3, 1971, X corporation sells for $500 to S, a salesman of X, 10 shares of stock in X corporation with a fair market value of $1,000. The stock is nontransferable and subject to return to the corporation (for $500) if S's sales do not reach a certain level by December 31, 1971. Disregarding the restriction concerning S's sales (since the restriction is a lapse restriction), S's interest in the stock is that of a beneficial owner and therefore a transfer occurs on January 3, 1971.[377]

[377] Treas. Reg. §1.83-3(a)(7), ex. 1.

Example (3). On January 3, 1971, X corporation purports to transfer to E, an employee, 100 shares of stock of X corporation. The X stock is subject to the sole restriction that E must sell such stock to X on termination of employment for any reason for an amount which is equal to the excess (if any) of the book value of the X stock at termination of employment over book value on January 3, 1971. The stock is not transferable by E and the restrictions on transfer are stamped on the certificate. Under these facts and circumstances, there is no transfer of the X stock within the meaning of section 83.[378]

[378] Treas. Reg. §1.83-3(a)(7), ex. 3.

Example (4). Assume the same facts as in example (3) except that E paid $3,000 for the stock and that the restriction required E upon termination of employment to sell the stock to M for the total amount of dividends that have been declared on the stock since September 2, 1971, or $3,000, whichever is higher. Again, under the facts and circumstances, no transfer of the X stock has occurred.[379]

[379] Treas. Reg. §1.83-3(a)(7), ex. 4.

Example (5). On July 4, 1971, X corporation purports to transfer to G, an employee, 100 shares of X stock. The stock is subject to the sole restriction that upon termination of employment G must sell the stock to X for the greater of its fair market value at such time or $100, the amount G paid for the stock. On July 4, 1971 the X stock has a fair market value of $100. Therefore, G does not incur the risk of a beneficial owner that the value of the stock at the time of transfer ($100) will decline substantially. Under these facts and circumstances, no transfer has occurred.[380]

[380] Treas. Reg. §1.83-3(a)(7), ex. 5.

Example (3) focuses on the amount of the payment on termination of employment. One commentator points out that the employee does not have any risk of loss. If the stock declines in value below the book value on January 3, 1971, the employee does not lose anything. Finally, the commentator points out that the IRS would find that no transfer occurs if the employer paid the excess of the fair market value of the stock on termination of employment over the fair market value on the grant date.[381]

[381] Eickman, Portfolio 384-5th, *Restricted Property — Section 83*, Detailed Analysis, Section II.C, at 9 (Bloomberg Law 2023).

The commentator also points out that the restricted stock arrangement in Example (3) is similar to a performance share or phantom stock arrangement. A performance share or phantom stock arrangement and a restricted stock arrangement give the employee the increase in the value of the employer's stock. With a performance share or phantom stock arrangement, no stock is issued and the payment of the increase in value is always ordinary compensation income.[382]

[382] *Id.* at 9–10 n. 73.

With a restricted stock arrangement that transfers beneficial ownership of stock on the grant date, the employee can make a Section 83(b) election to convert the increase in value from ordinary compensation income to capital gain. The criteria for determining whether a transfer occurs seek to prevent an employee from using a restricted stock arrangement that does not transfer beneficial ownership of the stock to convert the ordinary compensation income in a performance share or phantom stock arrangement to capital gain.[383]

[383] *Id.* at 9.

Under Section 83, the tax stake of whether a transfer occurs is whether the employee can close the compensation element of an award of restricted stock by making a Section 83(b) election within thirty days after the grant date.[384] In the absence of a transfer, the Section 83(b) election is ineffective.[385] If a transfer occurs and the employee does not make a Section 83(b) election, the compensation element closes on vesting.[386] The closing of the compensation element, whether with a Section 83(b) election or on vesting, results in ordinary compensation income to the employee,[387] and a compensation deduction to the employer.[388]

[384] I.R.C. §83(b); Treas. Reg. §1.83-2; *see also* Rev. Proc. 2012-29, I.R.B. 2012-28, at 49 (July 9, 2012) (revenue procedure provides sample language for a Section 83(b) election and examples of the election's income tax consequences).

[385] Treas. Reg. §1.83-2(a).

[386] I.R.C. §83(a); Treas. Reg. §1.83-1(a)(1).

[387] I.R.C. §83(a); Treas. Reg. §§1.83-1(a)(1) and 1.83-3(c)(4), ex. 3 and 4.

[388] I.R.C. §83(h); Treas. Reg. §1.83-6(a)(1)–(4).

Once the compensation element closes and the employee later realizes the appreciation in the stock's fair market value on a redemption or sale, the amount of the appreciation realized is taxed as capital gain. After the employee satisfies any holding period requirement, the gain will be long-term capital gain taxed at favorable rates.

When a transfer does not occur on the grant date but occurs later, then as the stock vests at the time of transfer and thereafter, the employee recognizes ordinary compensation income.[389] As a result, any increase in fair market value between the grant date and the date of vesting will result in ordinary compensation income, rather than capital gain.

[389] I.R.C. §83(a); Treas. Reg. §§1.83-1(a)(1) and 1.83-3(c)(4), ex. 3 and 4.

The following four scenarios illustrate the application of these rules. For the first scenario, assume that a privately-held employer grants restricted stock to an employee. The employee vests in one-third of the stock on each anniversary of the grant date. On the employee's separation from service, the employer must redeem the vested stock for its then fair market value. The fair market value of the stock on the grant date is $1,000, on the first anniversary of the grant date, $1,100, on the second anniversary, 1,200, and on the third anniversary, $1,300.

Under Section 83, a transfer occurs on the grant date. The tax consequences to the employee are that the employee does not recognize any income on the grant date, and recognizes ordinary compensation income of $366.30 on the first anniversary of the grant date. This amount is equal to the product of $1,100 (the fair market value of the stock on the first vesting date) multiplied by .333 (the vesting percentage on the first vesting date), which is $366.30. The employee recognizes $555.24 of ordinary compensation income on the second anniversary. This amount is equal to the product of the difference between $1,200 minus $366.30 (the fair market value of the stock of $1,200 on the second vesting date minus the amount of income previously recognized) multiplied by .666 (the vesting percentage on the second vesting date). The difference is $833.70, and the product of $833.70 multiplied by .666 is $555.24. The employee recognizes $377.86 of ordinary compensation income on the third anniversary. This amount is equal to the difference between $1,300 minus $366.30 minus $555.24 (the fair market value of $1,300 on the third vesting date minus the amount of income previously recognized) multiplied by 1.00 (the vesting percentage on the third vesting date). The difference is $377.86, and the product of $377.86 multiplied by 1.00 is $377.86.

If the employee has a separation from service on the seventh anniversary of the grant date when the stock's fair market value is $2,000, on the mandatory redemption for $2,000 the employee recognizes long-term capital gain of $700. This amount is equal to the difference between $2,000 (the fair market value redemption price) and $1,300 (the sum of the amounts of income previously recognized on the vesting dates).

Since a transfer occurs on the grant date, all the transactions are exempt from Section 409A. When an arrangement is exempt from Section 409A, and the employer has a discretionary call right on separation from service and at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A. Similarly, if the employee has a discretionary put right on separation from service and at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A.

If the employee makes a Section 83(b) election on grant, the employee would recognize the fair market value of the stock on grant, $1,000, as ordinary compensation income. The employee would not recognize any income on any of the vesting dates.[390] If the employee has a separation from service on the seventh anniversary of the grant date when the stock's fair market value is $2,000, on the mandatory redemption for $2,000 the employee recognizes long-term capital gain of $1,000. The $1, 000 of gain is equal to the difference between $2,000 (the fair market value redemption price) and $1,000 (the amount of income previously recognized on the Section 83(b) election). As a result of the Section 83(b) election, an additional $300 in appreciation in value after the grant date is taxed as long-term capital gain rather than as ordinary compensation income.

[390] I.R.C. §83(b)(1); Treas. Reg. §1.83-2(a).

For the second scenario, assume that a privately-held employer grants restricted stock to an employee. The employee vests in one-third of the stock on each anniversary of the grant date. On the employee's separation from service, the employer must redeem the vested stock for an amount equal to the excess (if any) of the book value of the stock on separation from service over the book value on the grant date. The fair market value of the stock on the grant date is $1,000, on the first anniversary of the grant date, $1,100, on the second anniversary, $1,200, and on the third anniversary, $1,300. The book value on the grant date is $500.

Under Section 83, no transfer occurs on grant or at any time thereafter, and the employee cannot make a Section 83(b) election. As a result, there is an unfunded promise to pay the redemption price on separation from service. The employee does not recognize any income on the grant date or on any vesting date.[391] In addition, the absence of a transfer means that the exemption from Section 409A for restricted stock does not apply, and the arrangement is subject to Section 409A.

[391] Treas. Reg. §1.451-2(a); Rev. Rul. 60-31, 1960-1 C.B. 174, *modified by* Rev. Rul. 70-435, 1970-2 C.B. 100.

If the employee has a separation from service on the seventh anniversary of the grant date when the stock's fair market value is $2,000 and its book value is $800, the employee recognizes ordinary compensation income of $300. The amount of the income is equal to the difference between $800 (the book value on separation from service) minus $500 (the book value on grant). Since separation from service is a permissible payment event under Section 409A,[392] as long as the arrangement satisfies the timing rule for designation of permissible payment events by the plan or the employer,[393] and the timing rule for payments on separation from service,[394] the arrangement satisfies Section 409A. If the arrangement does not satisfy these rules, it runs afoul of Section 409A.

[392] I.R.C. §409A(a)(2)(A)(i); Treas. Reg. §1.409A-1(h); Treas. Reg. §1.409A-3(a)(1).

[393] Treas. Reg. §1.409A-2(a)(2).

[394] Treas. Reg. §1.409A-3(b).

Alternatively, if the employer does not have a redemption obligation on the employee's separation from service, but has a discretionary call right on separation from service and at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy the timing rule for designation of permissible payment events, or the timing rule for payments on separation from service. As a result, the arrangement runs afoul of Section 409A. Similarly, if the employer does not have a redemption obligation on the employee's separation from service, but the employee has a discretionary put right on separation from service and at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy these rules, and runs afoul of Section 409A.

For the third scenario, assume that a privately-held employer grants restricted stock with a fair market value of $1,000 to an employee for a $1,000 nonrecourse note. The note requires the employee to make annual principal payments of $200 commencing one year after the grant date. The employee votes the stock and pays interest on the note, but does not make any payments of principal. The employee vests in one-third of the stock on each anniversary of the grant date. On the employee's separation from service, the employer must redeem the vested stock for its then fair market value. The fair market value of the stock on the grant date is $1,000, on the first anniversary of the grant date, $1,100, on the second anniversary, $1,200, and on the third anniversary, $1,300.

Under Section 83, no transfer occurs on grant or at any time thereafter, and the employee cannot make a Section 83(b) election. As a result, the arrangement is an unfunded promise to pay the redemption price on separation from service. The employee does not recognize income on the grant date or on any vesting date, but on the date the employee receives payment of the redemption price. In addition, the absence of a transfer means that the exemption from Section 409A for restricted stock does not apply, and the arrangement is subject to Section 409A.

If the employee has a separation from service on the seventh anniversary of the grant date when the stock's fair market value is $2,000, the employee recognizes ordinary compensation income of $2,000. Since separation from service is a permissible payment event under Section 409A, as long as the arrangement satisfies the timing rule for designation of permissible payment events, and the timing rule for payments on separation from service, it satisfies Section 409A. If the arrangement does not satisfy these rules, it runs afoul of Section 409A.

Alternatively, if the employer does not have a redemption obligation on the employee's separation from service, but has a discretionary call right on separation from service and at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy the timing rule for designation of permissible payment events, or the timing rule for payments on separation from service. As a result, the arrangement runs afoul of Section 409A. Similarly, if the employer does not have a redemption obligation on the employee's separation from service, but the employee has a discretionary put right on separation from service and at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy these rules, and runs afoul of Section 409A.

For the fourth and final scenario, assume that a privately-held employer grants restricted stock with a fair market value of $1, 000 to an employee for a $1,000 nonrecourse note. The note requires the employee to make a principal payment of $500 on the fifth anniversary of the grant date, and $500 on the tenth anniversary. On the employee's separation from service, the payments of principal are accelerated pro-rata based on the employee's then vested percentage in the stock. The employee votes the stock and makes annual payments of interest, and timely makes the $500 principal payment on the fifth anniversary. On the employee's separation from service, the employer must redeem the vested stock for its then fair market value.

The employee vests in one-third of the stock on each anniversary of the grant date. The fair market value of the stock on the grant date is $1,000, on the first anniversary of the grant date, $1,100, on the second anniversary, $1,200, and on the third anniversary, $1,300. The fair market value on the fifth anniversary is $1,700.

The IRS can take the position that under Section 83 no transfer occurs on the grant date, and a transfer occurs on the fifth anniversary of the grant date when the employee makes the $500 principal payment. Since the transfer occurs after vesting, the employee should recognize ordinary compensation income of $700 on the fifth anniversary, which is equal to the difference between the $1,700 fair market value of the stock, and the $500 payment on the note and the $500 remaining principal of the note. If the employee has a separation from service on the seventh anniversary of the grant date when the stock's fair market value is $2,000, on the mandatory redemption for $2,000 the employee recognizes long-term capital gain of $300. This amount is equal to the difference between $2,000 (the fair market value redemption price) and $1,700 (the sum of the $700 in income previously recognized on the transfer of the vested stock, the $500 payment on the note, and the $500 remaining principal of the note. The $500 remaining principal of the note is due on the employee's separation from service.

In addition, the IRS can take the position that the arrangement is a promise to transfer vested stock in a future taxable year subject to Section 409A.[395] Since the transfer does not occur until after the short-term deferral period for payment after vesting, the short-term deferral exemption does not apply. The parties can then take the position that the fifth anniversary of the grant date is a permissible specified time for payment.[396] As long as the arrangement satisfies the timing rule for designation by the employer of a specified time for payment,[397] and the timing rule for payment at that specified time,[398] the arrangement satisfies Section 409A. If the arrangement does not satisfy these rules, it runs afoul of Section 409A.

[395] Treas. Reg. §1.409A-1(b)(6)(ii).

[396] I.R.C. §409A(a)(2)(A)(iv); Treas. Reg. §1.409A-3(a)(4) and (i)(1)(i).

[397] Treas. Reg. §1.409A-2(a)(2).

398 Treas. Reg. §1.409A-3(d).

When the arrangement is subject to Section 409A, and the employer has a mandatory redemption obligation on separation from service, and the separation from service occurs before the year of the transfer of stock or in the year of the transfer of stock, the arrangement can satisfy Section 409A. Since separation from service is a permissible payment event, as long as the arrangement satisfies the timing rule for designation by the employer of permissible payment events,[399] and the timing rule for payments on separation from service,[400] the arrangement satisfies Section 409A.

399 Treas. Reg. §1.409A-2(a)(2).

400 Treas. Reg. §1.409A-3(d).

If the employer does not have a redemption obligation on the employee's separation from service, but has a discretionary call right on separation from service and at any time thereafter, or during a specified window period after separation from service, the likely tax treatment under Section 409A is as follows. For the taxable year in which the grant date occurs, and for the second, third, and fourth taxable years thereafter before a transfer occurs, the arrangement does not satisfy the timing rule for designation of permissible payment events, or the timing rule for payments on separation from service. As a result, for these taxable years the arrangement violates Section 409A. When the transfer of vested stock occurs in the fifth taxable year, the compensation element of the arrangement closes. As a result, for the sixth taxable year and thereafter, Section 409A should no longer apply.

For the fifth taxable year in which the transfer occurs, the IRS can take the position that since the arrangement violated Section 409A for the period in the fifth taxable year before the transfer, a violation of Section 409A occurs in that year. In Chief Counsel Advisory 201518013, the IRS concluded that an employer's correction of a Section 409A document failure in the year of vesting but made before the vesting date in that year did not prevent income inclusion of the deferred amount under Section 409A. The IRS relied on Section 409A(a)(1)(A)(i), which provides that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of Section 409A, all compensation deferred under the plan for the taxable year and all preceding taxable years are includible in the employee's gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Since the transfer of vested stock that closes the compensation element in an arrangement that violates Section 409A is analogous to the correction of a Section 409A document failure in the year of vesting, the consequences of a Section 409A violation should apply in the year of transfer.

Similarly, if the employer does not have a redemption obligation on the employee's separation from service, but the employee has a discretionary put right on separation from service and at any time thereafter, or during a specified window period after separation from service, the foregoing analysis for the first four taxable years, the fifth taxable year, and the sixth taxable year and thereafter should apply.

When the employer has a redemption obligation on the employee's separation from service, but the arrangement does not satisfy the timing rule for designation by the employer of permissible payment events, or the timing rule for payments on separation from service, the foregoing analysis for the first four taxable years, the fifth taxable year, and the sixth taxable year and thereafter should also apply.

Alternatively, for the fourth scenario the arrangement provides for 100% cliff vesting on the eighth anniversary of the grant date when the stock's fair market value is $2,100. The employee has a separation from service on the tenth anniversary of the grant date when the stock's fair market value is $2,500. Again, the IRS can take the position that under Section 83 no transfer occurs on the grant date, but on the fifth anniversary of the grant date when the employee makes the $500 principal payment. Since the stock is unvested on transfer, the employee does not recognize any income at that time. Upon vesting on the eighth anniversary of the grant date, the employee recognizes ordinary compensation income of $1,100, which is equal to the difference between the $2,100 fair market value of the stock, and the $500 payment on the note and the $500 remaining principal of the note. On the mandatory redemption for $2,500 on separation from service, the employee recognizes capital gain of $400. This amount is equal to the difference between $2,500 (the fair market value redemption price) and $2,100 (the sum of the amount of $1,100 in income previously recognized on vesting, $500 payment on the note, and $500 remaining principal of the note). The $500 remaining principal of the note is due on the employee's separation from service.

If the employee makes a Section 83(b) election when the transfer occurs on the fifth anniversary of the grant date, the employee recognizes ordinary compensation income of $1,700. The employee does not recognize any income on vesting on the eighth anniversary of the grant date. On the mandatory redemption for $2,500 on separation from service, the employee recognizes capital gain of $800. This amount is equal to the difference $2,500 (the fair market value redemption price) and $1,700 (the amount of income previously recognized on the Section 83(b) election). As a result of the Section 83(b) election, an additional $400 in appreciation in value after the date of transfer is taxed as long-term capital gain rather than ordinary compensation income.

For this last alternative of the fourth scenario, the parties can take the position that the arrangement is exempt from Section 409A as a promise to transfer unvested stock in a future taxable year.[401] They can also take the position that the arrangement is exempt from Section 409A as a short-term deferral.[402] The short-term deferral exemption should apply because the employee recognizes income on vesting on the eighth anniversary of the grant date for stock previously transferred on the fifth anniversary.[403]

[401] Treas. Reg. §1.409A-1(b)(6)(ii).

[402] *See* Erica F. Schohn, "Equity Arrangements," in *Section 409A Handbook* 14-1, 24–25 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

[403] See discussion of the short-term deferral exemption *infra* notes 571 to 579 and accompanying text.

When the arrangement is exempt from Section 409A, and the employer has a discretionary call right on separation from service and at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A. Similarly, if the employee has a discretionary put right on separation from service and at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A.

ELIGIBLE ISSUER OF SERVICE RECIPIENT STOCK

The Final Regulations define "eligible issuer of service recipient stock" as the corporation for which the employee provides direct services on the grant date, or a parent corporation of that corporation.[404] The Proposed Regulations define "eligible issuer of service recipient stock" as the corporation or other entity for which the employee provides direct services on the grant date, or a parent corporation or other parent entity of that corporation or other entity.[405]

[404] Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1).

[405] Prop. Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1) (as proposed at 81 Fed. Reg. 40,569, 40,579 (June 22, 2016)).

The Proposed Regulations also provide that an eligible issuer of service recipient stock includes a corporation or other entity for which it is reasonably anticipated that the employee will begin providing direct services within 12 months after the grant date of the stock right, or a parent corporation or other parent entity of that corporation or other entity. The employee must commence service within this 12-month period. If the employee does not commence service within this 12-month period, the employee must forfeit the stock right.[406]

[406] Prop. Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1) (as proposed at 81 Fed. Reg. 40,569, 40,579 (June 22,

2016)).

It is important to note that neither the Final Regulations nor the Proposed Regulations provide an exemption from Section 409A for stock rights that are granted after the date of the employee's separation from service as part of a separation agreement.

Section 4(a) of the Model Plan satisfies the requirements of the Final Regulations and Proposed Regulations by providing for the grant of nonqualified stock options and SARs to employees of the Company or a Related Entity (as defined in section 25(pp) of the Model Plan) on the Grant Date. Section 4(a) of the Model Plan also satisfies the requirements of the Proposed Regulations by providing for the grant of these stock rights to prospective Employees of the Company or a Related Entity, and that if the prospective Employee does not commence service within 12 months of the Grant Date, the prospective Employee forfeits the stock right.

The service requirement does not prevent subsequent transfers of the stock right by the grantee. The Final Regulations provide that when the grantor corporation exercises discretion specifically reserved to it under a stock right with respect to its transferability, a modification of the stock right does not occur.[407] Section 5(j)(iii)-(iv) of the Model Plan grants the Administrator the discretion to permit transfers of Nonqualified Stock Options, SARs, and Restricted Stock by lifetime gift to members of the Grantee's Immediate Family, or by domestic relations order to members of the Grantee's Immediate Family.

[407] Treas. Reg. §1.409A-1(b)(5)(v)(B). For a discussion of the definition of modification and its consequences under Section 409A, see *supra* notes 46 to 60 and accompanying text.

Under the incentive stock option rules, transfers are not permitted other than by will or the laws of descent and distribution.[408] Section 5(j)(i)–(ii) and (v)–(vi) of the Model Plan satisfies this requirement. The incentive stock option regulations permit a pledge of the stock purchasable under an option as security for a loan that is used to pay the option price.[409] In addition, the transfer of an option to a trust is permissible if, under code Section 671 and applicable state law, the transferor is considered the sole beneficial owner of the option while held in the trust.[410] Finally, if an option is transferred incident to divorce under code Section 1041, or pursuant to a domestic relations order, the option no longer qualifies as an incentive stock option as of the date of the transfer.[411]

[408] I.R.C. §422(b)(5); Treas. Reg. §§1.421-1(b)(2) and 1.422-2(a)(2)(v).

[409] Treas. Reg. §1.421-1(b)(2).

[410] *Id.*

[411] *Id.*

Definition of Grant Date

Since the date for determining the status of an eligible issuer of service recipient stock is the grant date, the definition of grant date is critical. The Final Regulations define the grant date as the date on which the granting corporation completes the corporate action necessary to create the legally binding right constituting the stock right.[412] The action is not considered complete until the date on which the maximum number of shares that can be purchased under the stock right and the minimum exercise price are fixed and determinable, and the class of underlying stock and the identity of the employee are designated.[413] Section 25(x) of the Model Plan defines Grant Date using this definition.

[412] Treas. Reg. §1.409A-1(b)(5)(vi)(B)(1) and (H).

[413] *Id.*

The Final Regulations also provide that if the corporate action provides for an immediate offer to sell stock to an employee, or specifies a date on which the offer is to be made, the grant date is the date of the corporate action in the case of an immediate offer, or the date specified for the offer. An unreasonable delay in notifying the employee of the offer indicates that the corporation made the offer on the subsequent date it gave notice.[414] If the fair market value of the underlying stock increases between the date of the corporate action and the date of the notice, and the stock right uses the fair market value on the date of the corporate action as the exercise price, a Section 409A violation occurs. Accordingly, when an employer grants a stock right, it should promptly notify the grantee.[415]

[414] *Id.*

[415] *See* Chief Counsel Advisory 201521013 (when an option agreement and the parent corporation's approval of the plan and option provided for the grant of the option to be made on a particular date, the option did not provide for an immediate grant, but a grant on the date provided in the option agreement).

If a corporation imposes a condition on granting a stock right, as distinguished from a condition on the exercise of the stock right, that condition will generally be given effect. However, if the grant of a stock right is subject to approval by shareholders, the grant date will be determined as if the stock right had not been subject to this approval. A condition that does not require corporate action, such as approval of, or registration with, a regulatory or government agency (for example, a stock exchange or the SEC), is usually considered a condition on the exercise of the stock right unless the corporate action clearly indicates that the stock right is not to be granted until that condition has been satisfied.[416] In general, a condition imposed on the exercise of a stock right will not make the grant of the stock right ineffective.[417]

[416] Treas. Reg. §1.409A-1(b)(5)(vi)(B)(2) and (H).

[417] Treas. Reg. §1.409A-1(b)(5)(vi)(B)(3) and (H).

The incentive stock option regulations have a similar definition of the grant date.[418] These regulations also provide that if an option is granted to an individual on the condition that the individual will become an employee of the corporation granting the option or a related corporation, the option is not granted prior to the date that the individual becomes an employee.[419] The definition of Grant Date in section 25(x) of the Model Plan contains this provision for grants of Incentive Stock Options.

[418] Treas. Reg. §1.421-1(c).

[419] Treas. Reg. §1.421-1(c)(2).

Stock rights intended to be exempt from Section 409A are eligible for correction under IRS Notice 2008-113 of the operational failure of an exercise price erroneously established at less than the fair market value of the underlying stock on the grant date.[420] The exercise price may be corrected by resetting it to an amount not less than the fair market value of the underlying stock on the grant date.

[420] Notice 2008-113, 2008-2 C.B. 1305, §§IV.D and V.E.

Generally, the correction must occur before the stock right is exercised and not later than the last day of the employee's taxable year in which the employer granted the stock right.[421] For employees who are not insiders during the employee's taxable year of the grant date or during the immediately following taxable year, the employer can correct the exercise price as follows. Before the stock right is exercised and not later than the last day of the employee's taxable year after the employee's taxable year in which the employer granted the stock right, the exercise price is reset to equal or exceed the fair market value of the underlying stock on the grant date, and at all times before the increase in the exercise price the stock right would not have provided for a deferral of compensation.[422]

[421] Notice 2008-113, 2008-2 C.B. 1305, §IV.D.

[422] Notice 2008-113. 2008-2 C.B. 1305, §V.E.

An “insider” means: (1) a director or officer of the employer; or (2) the direct or indirect beneficial owner of more than 10% of any class of equity security of the employer. These determinations are made in accordance with the rules of the SEC under Section 16 the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78p (the “Act”), without regard to whether the employer has any class of equity securities registered under Section 12 of the Act. In the case of an employer that is not a corporation, these rules apply by analogy.[423]

[423] Notice 2008-113, 2008-2 C.B. 1305, §III.G; 17 C.F.R. §240.16a-1(a) and (f) (definition of beneficial owner and officer).

Stock rights that have been exercised before the employer corrects the exercise price are ineligible for relief under Notice 2008-113. These rights are subject to Section 409A, and since the rights will likely grant the employee the discretion to exercise the right upon vesting and at any time thereafter, will violate Section 409A.

The relief under Notice 2008-113 applies only to operational failures that are inadvertent and unintentional.[424] The Notice elliptically defines an inadvertent and unintentional operational failure as a failure to comply with plan provisions that satisfy the requirements of Section 409A(a), or an inadvertent unintentional failure to follow the requirements of Section 409A(a) in practice, due to one or more inadvertent and unintentional errors in the operation of the plan.[425]

[424] Notice 2008-113, 2008-2 C.B. 1305, §III.D.

[425] *Id.*

In addition, the employer must take commercially reasonable steps to avoid having the operational failure recur. If the same or a substantially similar operational failure has occurred previously, the relief will be unavailable for any taxable year of the employee beginning after December 31, 2009, unless the employer or employee shows that the employer had established practices and procedures reasonably designed to ensure that such an operational failure would not recur and had taken commercially reasonable steps to avoid having the operational failure recur, and the operational failure occurred despite the employer's diligent efforts.[426]

[426] *Id.* at §III.B.

The relief under Notice 2008-113 is unavailable if a federal income tax return of the employee for the employee's taxable year in which the operational failure occurred is under examination with respect to the plan. An employee is considered under examination with respect to the plan if the employee is under examination for his or her federal income tax return (for example, Form 1040) for the taxable year.[427]

[427] *Id.* at §III.C.

Finally, Notice 2008-113 has information and reporting requirements.[428]

[428] *Id.* at §IX.

Notice 2008-113 does not prohibit the employer from compensating the employee for the loss in value of the stock right resulting from the increase in the exercise price. As a matter of prudence, the employer should not condition any compensation for this loss on the employee's exercise of the stock right.

Subsidiary Stock and Incentive Stock Options

Under the definition of eligible issuer of service recipient stock, nonqualified stock options for subsidiary stock cannot be granted to the employees of a parent. Under the incentive stock option rules, incentive stock options for subsidiary stock can be granted to employees of a parent.[429] Accordingly, section 4(b) of the Model Plan permits grants of Incentive Stock Options for the stock of the Company to employees of an Employer Corporation (as defined in section 25(r)) when the Company is an ISO Subsidiary (as defined in section 25(cc)) of the Employer Corporation. If an incentive stock option for stock of an ISO Subsidiary held by an employee of the Employer Corporation no longer qualifies as an incentive stock option and becomes a nonqualified stock option, that option is not granted by an eligible issuer of service recipient stock, and the IRS can take the position that a violation of Section 409A has occurred.

[429] I.R.C. §422(a)(2).

The $100,000 per year first exercisable limitation for incentive stock options can cause the loss of qualification as an eligible issuer of service recipient stock.[430] Under this limitation, options are not treated as incentive stock options to the extent that the aggregate fair market value of stock for which incentive stock options are exercisable for the first time during any calendar year exceeds $100,000. Fair market value is determined as of the grant date.[431] When the grantee holds more than one incentive stock option, the options are taken into account in the order granted, with the options granted first accorded incentive stock option status.[432]

[430] I.R.C. §422(d); Treas. Reg. §1.422-4(a).

[431] I.R.C. §422(d)(3); Treas. Reg. §1.422-4(b)(2).

[432] I.R.C. §422(d)(2).

For example, on July 1, 2012, ABC grants an employee of a parent an incentive stock option for 1,000 shares of ABC common stock with a fair market value of $90 per share. Half of the shares vest on July 1, 2013, and the remainder vests on July 1, 2014. The shares that vest on July 1, 2013 are valued at $45,000, and they all qualify as an incentive stock option. On July 1, 2013, ABC grants that parent employee an option for an additional 1,000 shares of ABC common stock with a fair market value of $100 per share; those shares vest on July 1, 2014. The remaining 500 shares from the July 1, 2012 grant that vest on July 1, 2014 are valued at $45,000, and they all qualify as an incentive stock option. But only the portion of the shares from the July 1, 2013 grant that vest on July 1, 2014 with a value of $55,000 qualifies as an incentive stock option. The remaining shares, with a value of $45,000, do not qualify and become a nonqualified stock option. Since the stock is subsidiary stock, the IRS can take the position that a violation of Section 409A has occurred.

In addition, the employer and employee will not always know on the grant date whether an option runs afoul of the $100,000 limitation. If the employer accelerates vesting of the option after the grant date, the option can lose its status as an incentive stock option on the date of acceleration. For example, assume that in the previous example the second grant provides for vesting on July 1, 2015. If on June 1, 2014 the employer accelerates vesting from July 1, 2015 to July 1, 2014, the same result as in the previous example occurs.

If vesting is accelerated, the parties can take the position that since the eligible issuer of service recipient stock is determined on the grant date, and on that date the exemption for incentive stock options applied, no violation occurred. But this is uncharted territory, so relying on this position is risky business.

Moreover, if an incentive stock option is not immediately exercisable in full, changing its terms to accelerate the exercise date for all or any portion of the option is not a modification treated as the grant of a new option that must satisfy the requirements for an incentive stock option anew on the date of the modification. In addition, a modification does not occur if a provision accelerating the exercise date is removed before the year when it would have been triggered. For example, if an acceleration provision is timely removed to avoid exceeding the $100,000 limitation, a modification does not occur.[433]

[433] Treas. Reg. §1.424-1(e)(2) and (4)(ii).

Furthermore, the IRS has two anti-abuse rules in its arsenal to address the acceleration of vesting issue. First, the Final Regulations contain an anti-abuse rule for an eligible issuer of service recipient stock. An eligible issuer of service recipient stock does not include any corporation within a group of entities treated as a single employer if a purpose of that ownership structure, or a purpose of a significant transaction between two or more entities comprising that single employer, is to provide deferred compensation not subject to Section 409A.[434]

[434] Treas. Reg. §1.409A-1(b)(5)(iii)(E)(3).

Second, the Final Regulations contain a general anti-abuse rule. If a principal purpose of a plan is to achieve a result for the deferral of compensation that is inconsistent with the purposes of Section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan under Section 409A and the Final Regulations.[435]

[435] Treas. Reg. §1.409A-1(a)(1).

Section 20(c)(iv) of the Model Plan addresses these scenarios by providing that if due to the conversion of an Incentive Stock Option to a Nonqualified Stock Option, the Option no longer satisfies the requirements of Section 409A or any exemption thereto, the Incentive Stock Option will terminate on the date that it no longer qualifies as an Incentive Stock Option.

Definition of Service Recipient Stock

“Service recipient stock” means a class of stock that, as of the grant date, is common stock of an eligible issuer under code Section 305.[436] Service recipient stock does not include a class of stock that has any preference as to distributions other than distributions on liquidation.[437] Section 25(aaa) of the Model Plan defines “Share” as a share of common stock.

[436] Treas. Reg. §1.409A-1(b)(5)(iii)(A).

[437] Treas. Reg. §1.409A-1(b)(5)(iii)(A).

The incentive stock option rules permit common stock and preferred stock.[438] If an incentive stock option for preferred stock loses its status as an incentive stock option, such as by running afoul of the $100,000 per year first exercisable limitation, the IRS can take the position that a violation of Section 409A has occurred.

[438] I.R.C. §422(b).

In addition, service recipient stock acquired on exercise of the stock right excludes stock that is subject to a mandatory repurchase obligation other than a right of first refusal, or that is subject to a put or call right that is not a lapse restriction under Treasury RegulationSection 1.83-3(i), if the purchase price is based on a measure other than fair market value determined by disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i).[439]

[439] Treas. Reg. §1.409A-1(b)(5)(iii)(A). For the Delaware common law of contracts dealing with the exercise of put and call rights, see *Backus v. U3 Advisors, Inc.*, 2017 WL 3600430 (S.D.N.Y. Aug. 18, 2017); *Boardwalk Pipeline Partners, LP v. Bandera Master Fund LP*, 288 A.3d 1083 (Del. 2022) (en banc); *Blaustein v. Lord Baltimore Capital Corp.*, 84 A.3d 954 (Del. 2014) (en banc); *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010) (en banc); *Delman v. GigAcquisitions3, LLC*, 288 A.3d 692 (Del. Ch. 2023); *Weinberg v. Waystar, Inc.*, *2022 WL 2452141* (Del. Ch. July 6, 2022); *Tetragon Financial Group Ltd. v. Ripple Labs Inc.*, 2021 WL 1053835 (Del. Ch. March 19, 2021); *Walsh v. White House Post Productions, LLC*, 2020 WL 1492543 (Del. Ch. March 25, 2020); *In re CVR Refining, LP Unitholder Litigation*, 2020 WL 506680 (Del. Ch. Jan. 31, 2020); *PECO Logistics, LLC v. Walnut Investment*

Partners, L.P., 2015 WL 9488249 (Del. Ch. Dec. 30, 2015); *Clean Harbors, Inc. v. Safety-Kleen, Inc.*, 2011 Del. Ch. LEXIS 184 (Dec. 9, 2011).

Under the Proposed Regulations, the stock price may be less than fair market value to the extent that the amount payable on an employee's involuntary separation from service for cause, or due to the occurrence of a condition within the employee's control, is determined by a measure that results in a purchase price of less than fair market value.[440] The condition may be specified on the grant date or at any later time. A permissible condition is failure to comply with noncompetition or nondisclosure covenants.[441] Failure to comply with a nonsolicitation covenant should also be a permissible condition.[442]

[440] Prop. Treas. Reg. §1.409A-1(b)(5)(iii)(A) (as proposed at 81 Fed. Reg. 40,569, 40,579 (June 22, 2016)).

[441] *Id.* The Federal Trade Commission has issued a proposed rule that it is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker or maintain with a worker a non-compete clause. The proposed rule defines a non-compete clause as a contractual term between an employer and a worker that prevent the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer. Under this definition, a non-compete clause would generally not include a nondisclosure agreement or a client or customer nonsolicitation agreement. These agreements generally do not prevent a worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer. However, such agreements would be considered non-compete clauses if they are so unusually broad in scope that they serve as *de facto* non-compete clauses. Federal Trade Commission, Notice of Proposed Rulemaking, “Non-Compete Clause Rule,” 88 Fed. Reg. 3,482, 3,484, and 3509–10 (Jan. 19, 2023).

[442] *Cf.* Department of the Treasury, Internal Revenue Service, “Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments,” §V.A, 72 Fed. Reg. 19,234, 19,251 (April 17, 2007) (“Generally, conditions under the discretionary control of the service provider (other than the decision whether or not to continue providing services) are not treated as creating a substantial risk of forfeiture.”).

Section 5(c)(i) of the Model Plan satisfies the requirements for the determination of the repurchase price for Shares acquired on the exercise of a Nonqualified Stock Option or SAR.

The Final Regulations do not require that an award of restricted stock be subject to a mandatory repurchase obligation, or put or call right, at a price equal to fair market value.[443] However, the IRS did not provide employers and employees with a free pass on this issue. The use of a repurchase price of other than fair market value raises the issue under the Section 83 regulations of whether a transfer of stock from the employer to the employee has occurred.[444]

[443] Treas. Reg. §1.409A-1(b)(6).

[444] See discussion of the transfer issue *supra* notes 352 to 401 and accompanying text.

Section 6(b)–(c) of the Model Plan satisfies the requirement that the exercise price of a nonqualified stock option or SAR be the fair market value of the underlying stock on the Grant Date. The Final Regulations provide rules for determining the fair market value of stock readily tradable on an established securities market,[445] and stock that is not so tradable.[446] The Model Plan's definitions of Fair Market Value in section 25(t) and Securities Market in section 25(yy) comply with these rules.

[445] Treas. Reg. §1.409A-1(b)(5)(iv)(A) and (vi)(G).

[446] Treas. Reg. §1.409A-1(b)(5)(iv)(B).

Sections 3(b)(iii) and 25(t) of the Model Plan grant the Administrator or Board the exclusive authority and discretion to reasonably determine the Fair Market Value of Shares. In addition, Section 3(a)(v) provides that the actions of the Administrator and Board will be final, conclusive, and binding on all Persons. Under these provisions, a Grantee should be bound by the Administrator's or Board's reasonable determination of Fair Market Value.[447]

[447] *See PECO Logistics, LLC v. Walnut Investment Partners, L.P.*, 2015 WL 9488249 (Del. Ch. Dec. 30, 2015); *JPMorgan Chase & Co. v. American Century Cos., Inc.*, 2012 Del. Ch. LEXIS 89 (April 26, 2012); Aviva F. Diamant, Christopher Ewan, Steven J. Steinman & Gail Weinstein, "*PECO v. Walnut*: Firm Valuation," *Harvard Law School Forum on Corporate Governance and Financial Regulation*, Jan. 19, 2016 (available at https://corpgov.law.harvard.edu/2016/01/19/peco-v-walnut-firm-valuation/).

Stock Readily Tradeable on an Established Securities Market

An established securities market means an established securities market under Treasury Regulation Section 1.897-1(m).[448] Under this regulation, an established securities market means: (1) a national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §78f; (2) a foreign national securities exchange that is officially recognized, sanctioned, or supervised by government authority; or (3) any over-the-counter market, which is any market that uses an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of that broker or dealer.

[448] Treas. Reg. §1.409A-1(k).

In Chief Counsel Advisory 201603025, the IRS addressed the effect of the listing of stock on the determination of fair market value for stock readily tradeable on an established securities market. Under Treasury Regulation Section 1.409A-1(b)(5)(vi)(G), stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in the stock. Therefore, stock is readily tradeable if brokers or dealers make the stock available to trade by listing it on an established securities market; the readily tradeable standard requires only the ability to buy and sell through a third-party.

Under Treasury Regulation Section 1.409A-1(b)(5)(iv)(A), stock does not need to exchange hands on the trading date; rather, the regulation requires only that there are actual transactions in the stock on the trading date. Even assuming that only contracts to purchase the stock were purchased on the grant date, the contracts provided for the transfer of stock. The buyers were contractually obligated to complete their when-issued purchases of stock if the [redacted data] occurred, and the [redacted data] had already occurred on the grant date before the over-the-counter market opened for that trading date. The buyers were contractually obligated to pay the auction price that applied at the time that they purchased the stock on the grant date regardless of the auction prices of the stock on the settlement date.

In Chief Counsel Advisory 201521013, the IRS addressed the determination of fair market value for stock traded on a when, as and if issued basis ("when-issued") on an established securities market. The IRS found that a nonqualified stock option was a nonqualified deferred compensation plan subject to Section 409A when its exercise price was less than the fair market value of stock traded on a when-issued basis on an over-the-counter market on the grant date. A when-issued trade is made between a seller and a buyer contingent on the stock's actual issuance. Once the issuance occurs, the trade is settled.

Under Treasury Regulation Section 1.409A-1(b)(5)(iv)(A), fair market value must be determined based on a reasonable method that uses actual transactions in the stock as reported by the when-issued, over-the-counter market. The over-the-counter market was an established securities market since the stock was traded on an interdealer quotation system in which the stock was regularly quoted by brokers or dealers making a market in the stock. The fact that the stock was traded in anticipation of, and contingent on, the actual issuance of the stock did not negate that the when-issued public trading reflected the stock's fair market value on the trading date. In addition, the when-issued trading volumes were among the highest recorded for the stock over [redacted data]. The plan document provided that for stock traded on an over-the-counter market, the stock's fair market value on any valuation date was the value reported by an over-the-counter bulletin board. However, this method did not comply with the Final Regulations because the value under this method was less than the lowest, when-issued over-the-counter trading price. Accordingly, the option's exercise price was less than the stock's fair market value, and as a result the option was a nonqualified deferred compensation plan subject to Section 409A.

The lesson of Chief Counsel Advisory 201603025 and Chief Counsel Advisory 201521013 is that for options to have an exercise price equal to the price on the pricing date of an initial public offering and be exempt from Section 409A, the employer must grant the options on the IPO pricing date or the following day, and the grants cannot be contingent on the IPO's closing. The closing date of the IPO usually occurs three days after the pricing date. If the employer wants the options to be contingent on the IPO's closing and be exempt from Section 409A, the exercise price must be at least equal to the fair market value of the stock on the IPO closing date. The value on the closing date may be higher than the price on the IPO pricing date.

Stock Not Readily Tradable on an Established Securities Market

For stock that is not readily tradable on an established securities market, fair market value means a value determined by the reasonable application of a reasonable valuation method based on the facts and circumstances as of the valuation date.[449] The use of a value previously calculated is not reasonable if it was calculated for a date that is more than twelve months earlier than the date for which the valuation is being used.

[449] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(1). Under Accounting Standards Update No. 2021-07 (Oct. 2021), the Financial Accounting Standards Board amended Financial Accounting Standards Board Accounting Standard Codification Topic 718 to provide that as a practical expedient, a nonpublic entity can determine the current price input of equity-classified share-based awards using the reasonable application of a reasonable valuation method. A reasonable valuation performed in accordance with Treas. Reg. §1.409A-1(b)(5)(iv)(B) is an example of a way to achieve the practical expedient. This rule allows private companies to satisfy the requirements of Section 409A and Topic 718 with one valuation.

See generally Chris Cumming, “Tougher Valuation Standards Raise the Bar for Managers and Investors,” *WSJ.com* (Dec. 23, 2019) (available at https://wsj.com/articles/tougher-valuation-standards-raise-the-bar-for-managers-and-investors-11577105136).

The Final Regulations provide for a presumption of a reasonable valuation for certain valuations.[450] One of the valuations to which the presumption applies is a valuation of illiquid stock of a start-up corporation that satisfies the requirements of Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(2)(iii). However, the presumption does not apply if the employer or employee may reasonably anticipate, as of the time the valuation is applied, that the employer will: (1) undergo a change-in-control under Treasury Regulation Section 1.409A-3(i)(5)(v) (a change in stock ownership) or 1.409A-1(i)(5)(vii) (a change in the ownership of a substantial portion of a corporation's assets) within 90 days after the action to which the valuation is applied, such as the grant date of a stock option or SAR; or (2) make a public offering within 180 days after the action to which the valuation is applied.[451]

[450] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(2).

[451] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(2)(iii).

Another valuation to which the presumption of a reasonable valuation applies is a valuation of a class of stock determined by an independent appraisal that satisfies the requirements of Section 401(a)(28)(C) and the regulations thereunder as of a date that is no more than twelve months before the transaction to which the valuation is applied.[452]

[452] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(2)(i).

A valuation method is not reasonable if it does not take into account in applying its methodology all available information material to the value of the corporation.[453] A valuation method is not reasonably applied if the valuation is not updated to reflect information that becomes available after the initial valuation that may materially affect the corporation's value. Since an initial valuation must take into account recent arm's length transactions involving the sale or transfer of stock, an updated valuation must also take into account recent arm's length transactions. This principle is reflected in Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(3), which provides that a reasonable method that uses actual transactions in the stock as reported by the established securities market must be used once a stock becomes readily tradeable on an established securities market.[454]

[453] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(1).

[454] Chief Counsel Advisory 201603025.

Under the requirement that a valuation take into account all available information material to the value of the corporation, the valuation should take into account an anticipated initial public offering. This rule likely applies in addition to the limitation on the presumption of a reasonable valuation of illiquid stock of a start-up corporation for a reasonably anticipated initial public offering.

Finally, the Commissioner of Internal Revenue can rebut the presumption of a reasonable valuation upon a showing that either the valuation method, or its application, was grossly unreasonable.[455]

[455] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(2).

When a valuation is incorrect, either an undervaluation or an overvaluation occurs. An undervaluation means that the exercise price is below the fair market value of the underlying stock on the grant date; in other words the option or SAR is a discounted option or SAR that results in the loss of exemption from Section 409A.

An overvaluation means that the exercise price is greater than the fair market value of the underlying stock on the grant date; in other words the option or SAR is underwater. An overvaluation does not cause a loss of exemption from Section 409A.[456] Similar rules apply to incentive stock options.[457]

[456] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1) (exercise price for nonqualified option cannot be less than the fair market value of the underlying stock on grant date); Treas. Reg. §1.409A-1(b)(5)(i)(B)(2) (exercise price for SAR cannot be less than the fair market value of the underlying stock on grant date).

[457] I.R.C. §422(b)(4) (for incentive stock options, exercise price cannot be less than the fair market value of the underlying stock on grant date); Treas. Reg. §1.422-2(e)(2) (for incentive stock options, good faith standard applies for the determination of fair market value of the underlying stock on grant date).

When a privately-held corporation anticipates an initial public offering, grants of options and SARs made before the offering have the risk of undervaluation. To avoid an undervaluation and loss of exemption from Section 409A, a conservative approach is for the corporation to stop granting options and SARs in the twelve months before an anticipated initial public offering. The corporation can then resume making grants after the initial public offering. Alternatively, the corporation can grant full-value awards, such as restricted stock and RSUs. For full-value awards that vest before the initial public offering when there is no public market to sell the stock, the corporation must make the appropriate arrangements to satisfy its withholding obligations.

If the corporation wants to grant options or SARs during these twelve months, corporation must determine whether the most recent valuation reflects all information that may materially affect the corporation's value, including the anticipated initial public offering. If that valuation does not, the corporation will need to obtain a new contemporaneous independent valuation.[458]

[458] Latham & Watkins LLP, *US IPO Guide* 29 (2022 ed. June 15, 2022). *See generally* Gregg D. Polsky & Brant J. Hellwig, "Examining the Tax Advantage of Founders' Stock," 97 *Iowa Law Review* 1085 (May 2012).

DISCOUNTED NONQUALIFIED STOCK OPTIONS SUBJECT TO SECTION 409A

In *Sutardja v. United States*,[459] the United States Court of Claims addressed the Section 409A treatment of discounted nonqualified stock options, which are options granted with an exercise price of less than the fair market value of the stock on the grant date.[460] Under the Final Regulations, discounted stock options are ineligible for the exemption for nonqualified options and are subject to Section 409A.

[459] 109 Fed. Cl. 358 (2013).

[460] *See generally* David I. Walker, "The Non-Option: Understanding the Dearth of Discounted Employee Stock Options," 89 *Boston University Law Review* 1505 (2009).

Under general tax principles, when an option is granted with an exercise price equal to or greater than the fair market value of the stock, the grant is not a taxable event. The taxable event occurs when the grantee exercises the option, rather than the grant date or vesting.[461] The IRS continued this tax treatment under Section 409A for options with an exercise price equal to or greater than the fair market value of the stock on the grant date. However, the IRS did not provide for this treatment under Section 409A for discounted options.[462] Rather, discounted options are treated as a deferral of compensation and included in income in the taxable year to the extent they are not subject to a substantial risk of forfeiture.

[461] *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945).

[462] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

The Court of Claims held that Section 409A is triggered when a legally binding right to compensation is created. In determining whether a legally binding right is created, courts look to state law to determine the rights and interests of the taxpayer in the property that the government seeks to reach.[463] Once this determination is made, federal tax law determines which rights and interests are subject to tax.[464]

[463] *Drye v. United States*, 528 U.S. 49, 51 (1999); Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §III.B (first paragraph), 72 Fed. Reg. 19,234, 19,236 (April 17, 2007).

[464] *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940).

Under California law, vested options give the optionee the legally binding right to purchase shares at a designated price. The next inquiry is whether this right is a legally binding right to compensation under federal tax law. Under general tax principles, the grant of the option is a legally binding right to compensation without regard to when the grantee realizes compensation from the option. The realization event generally occurs on the option's exercise.[465]

[465] *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945); *Racine v. Commissioner*, T.C. Memo. 2006-162 (2006).

The Final Regulations do not require vesting for a legally binding right to compensation to exist. Moreover, a legally binding right to compensation includes a contractual right, even if the right is conditional or contingent, that is enforceable under the law governing the contract. It also includes an enforceable right created by the governing law, such as a statute. For example, an agreement to pay an employee a bonus equal to a percentage of the amount that the employer receives on sale of a property is a legally binding right to compensation. The requirement that the property be sold is a condition to the right to the payment, but the right to payment is a legally binding right created when the parties enter into the agreement.[466]

[466] Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §III.B (first and second paragraphs), 72 Fed. Reg. 19,234, 19,236 (April 17, 2007).

Finally, the Court of Claims held that when an option agreement permits exercise of vested options beyond the fifteenth day of the third month of the taxable year after the taxable year in which the option vests, the short-term deferral exemption does not apply regardless of whether the grantee exercises the option before this date.[467] In addition, the thirty-day period provided to an employee to exercise the option after the date of termination of employment does not create a rolling thirty day short-term deferral period.

[467] Treas. Reg. §1.409A-1(b)(4)(i)(D); IRS Notice 2005-1, 2005-1 C.B. at 280.

ACCELERATION OF VESTING ON SEPARATION FROM SERVICE

A major benefit of exemption from Section 409A is a release from the unforgiving clutches of its prohibition on the acceleration of the time or schedule of any payment.[468] If an option or SAR is subject to Section 409A, acceleration of vesting of the employee's right to exercise the option or SAR would run afoul of this prohibition.[469] Similarly, if restricted stock is subject to Section 409A, acceleration of the vesting and transfer date would run afoul of this prohibition.

[468] I.R.C. §409A(a)(3); Treas. Reg. §1.409A-3(j)(1).

[469] The payment with respect to a nonqualified stock option or SAR generally occurs upon exercise of the stock right. When a nonqualified stock option or SAR designates a fixed exercise date, the stock right will be deemed to have been paid at that date if the exercise and payment occur on that date or a later date within the same taxable year of the employee, or if later by the 15th day of the third calendar month after the exercise date specified under the plan. Treas. Reg. §§1.409A-1(l) and 1.409A-3(d).

The Final Regulations permit accelerated vesting for nonqualified stock options and SARs that satisfy the requirements for exemption from Section 409A.[470] Under the incentive stock option regulations, accelerated vesting of these options, which are exempt from Section 409A, is permissible.[471] When restricted stock is exempt from Section 409A, whether as a transfer under Section 83 or as a short-term deferral, accelerated vesting is also permissible.[472]

[470] Treas. Reg. §1.409A-1(b)(5)(v)(E).

[471] Treas. Reg. §1.424-1(e)(4)(ii).

[472] Under I.R.C. §83 and its regulations, accelerated vesting of restricted stock is permissible. I.R.C. §83(a)(1) and (c)(1); Treas. Reg. §§1.83-1(a)(1) and 1.83-3(c). Since a short-term deferral is exempt from I.R.C. §409A, accelerated vesting of a short-term deferral is permissible. Treas. Reg. §1.409A-1(b)(4)(i).

The primary events for which equity compensation plans, employment agreements, severance plans and agreements, and change-in-control plans and agreements provide for accelerated vesting are: (1) involuntary separation from service without cause; (2) separation from service for good reason; (3) separation from service on death or disability; (4) the single-trigger event of a change-in-control; and (5) the double-trigger events of a change-in-control followed within a specified period by an involuntary separation from service without cause or a separation from service for good reason.

For plans of deferred compensation subject to Section 409A, separation from service is a permissible payment event.[473] A key issue in the determination of separation from service is the reference groups of the service recipient employer. The reference group for an eligible issuer of service recipient stock is not as broad as the reference groups of the service recipient employer on a separation from service.

[473] I.R.C. §409A(a)(2)(A)(i) (separation from service as determined by the Secretary is a permissible payment event); I.R.C. §409A(a)(2)(B)(i) (mandatory six month delay in payment to a specified employee on separation from service); Treas. Reg. §1.409A-1(h) (definition of separation from service); Treas. Reg. §1.409A-3(a)(1) (separation from service is a permissible payment event); Treas. Reg. §1.409A-3(i)(2) (mandatory six month delay in payment to a specified employee on separation from service).

The reference group for an eligible issuer of service recipient stock is a single parent-subsidiary chain of corporations or other entities based on 50% ownership of voting power or the value of all classes of stock.[474] When there are legitimate business criteria, a 20% to 50% ownership test is permissible. Whether there are legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the employee and the issuer of the stock right so that the grant serves a legitimate nontax business purpose other than simply providing the employee with compensation exempt from Section 409A.[475]

[474] Treas. Reg. §1.409A-1(b)(5)(iii)(E)(1).

[475] *Id.*

There are two reference groups for separation from service from the service recipient employer.[476] The first reference group is all parent-subsidiary chains of corporations and other entities with a common parent based on at least 50% ownership of voting power or the value of all classes of stock.[477] A plan may also use a greater than 50% but not greater than 80% ownership test. In addition, when there are legitimate business criteria, a 20% to 50% ownership test is permissible. When a percentage other than 50% is used, the plan must designate in writing the alternate definition no later than the last date at which the time and form of payment of the amount deferred must be elected under Treasury Regulation Section 1.409A-2(a). Any change in the definition for the amounts deferred will be a change in the time and form of payment subject to the rules for subsequent deferral elections under Treasury Regulation Section 1.409A-2(b), and the prohibition on acceleration of payments under Treasury Regulation Section 1.409A-3(j).[478]

[476] Treas. Reg. §1.409A-1(g) and (h)(3). In addition, the service provider generally must terminate service both as an employee and independent contractor for a separation from service to occur. Treas. Reg. §1.409A-1(h)(5). In contrast, under the incentive stock option regulations, a change in status from employee to independent contractor is a termination of employment. Treas. Reg. §1.421-1(h)(2).

[477] Treas. Reg. §§1.409A-1(g) and (h)(3), and 1.414(b)-1(a).

[478] Treas. Reg. §1.409A-1(h)(3).

The second reference group is a group of trades or businesses under common control, or a combined group of trades or businesses under common control, each one based on at least 50% ownership of voting power or the value of all classes of stock.[479] A group of trades or businesses under common control can be a parent-subsidiary group as defined under Treasury Regulation Section 1.414(c)-2(b), a brother-sister group as defined under Treasury Regulation Section 1.414(c)-2(c), and a combined group of trades or businesses under common control as defined under Treasury Regulation Section 1.414(c)-2(d).[480] The rules discussed in the prior paragraph for adjusting the ownership percentages also apply in determining the controlled group under Treasury Regulation Section 1.414(c)-2.[481]

[479] Treas. Reg. §1.409A-1(g) and (h)(3).

[480] *Id.*

[481] *Id.*

Section 25(zz) of the Model Plan defines Separation From Service by termination of service with both reference groups by use of the phrase of termination of service with the Company and its Broader Related Entities. Section 25(g) of the Model Plan defines Broader Related Entity using the definition under the Final Regulations for service recipient employer.

Section 5(e)(i)–(v) of the Model Plan grants the Administrator or Board the discretion to: (1) accelerate the vesting of Options, SARs, and Restricted Stock; (2) extend the exercise dates of Options and SARs; (3) waive any vesting requirement or attainment of any performance goal; and (4) waive clawback and forfeiture provisions, or any other restrictions. Section 5(e)(v) provides that these provisions will not apply on an Involuntary Separation From Service for Cause, or a voluntary Separation From Service Without Good Reason.

Under the *Equity Plan Scorecard* of Institutional Shareholder Services, a plan administrator's full discretion to accelerate the vesting of an award unrelated to death or disability is a factor in scoring an equity compensation plan. The grant of this discretion does not receive any points, and the absence of this discretion receives full points.[482]

[482] Institutional Shareholder Services, *U.S. Equity Compensation Plans Frequently Asked Questions*, Q&A 37 and 38, at 16–18 (Dec. 16, 2022); *see also* BlackRock Investment Stewardship, *Proxy Voting Guidelines for U.S. Securities January 2023*, at 16 ("We may oppose plans that provide for the acceleration of vesting of equity awards even in situations where an actual change of control may not occur. We encourage companies to structure their change of control provisions to require the termination of the covered employee before acceleration or special payments are triggered (commonly referred to as 'double trigger' change of control provisions).").

Section 7(d)(ii)–(iv) of the Model Plan provides for accelerated vesting on: (1) Separation From Service for Good Reason; (2) Involuntary Separation From Service Without Cause;[483] (3) Separation From Service due to Disability; and (4) death. These provisions also have the introductory proviso, "Except as provided in an Award or Award Agreement." Accordingly, the employer can use an Award or Award Agreement to limit an employee's right to accelerated vesting provided under the Model Plan.[484]

[483] In the absence of a contractual obligation for the employer to accelerate vesting on a separation from service without cause or for good reason, an at-will employee does not vest in unvested equity awards on these separations. *See, e.g.*, *Ghuge v. Virtusa Corp.*, *2020 WL 6490876* (S.D.N.Y. Nov. 3, 2020); *Ferdinando v. Intrexon Corp.*, 2016 WL 6947060 (S.D. Cal. Nov. 28, 2016); *Timian v. Johnson & Johnson*, 2015 WL 6454766 (W.D.N.Y. Oct. 26, 2015); *Schachter v. Citigroup, Inc.*, 218 P.3d 262 (Cal. 2009).

But see Crane v. Rave Restaurant Group, Inc., *2021 WL 3403681* (S.D. Tex. Aug. 4, 2021) (restricted stock unit agreements of CEO of two pizza restaurant brands provided that to vest in awards CEO had to remain continuously employed through certain dates, and would forfeit unvested awards if he ceased to be employed for any reason; the continuous employment requirement was a condition precedent that had to be satisfied or its fulfillment excused; under governing Texas law, if one party prevents another from performing a condition precedent or renders its fulfillment impossible, then the condition may be considered fulfilled; in denying employer's motion for summary judgment, the court held there was a fact question regarding the reason why the employer fired the CEO and whether the employer's intent behind the firing was to prevent the CEO from vesting in the awards; forfeiture provision did not entitle employer to summary judgment when the language of the restricted stock unit agreements and the long term incentive plan document showed that the purpose of the awards was to encourage employees to stay with the company long term, and that this purpose appears to be frustrated when the employer terminates its employees before the incentives have had a chance to vest).

[484] *See Green v. Delphi Financial Group, Inc.*, *2014 WL 3545463* (E.D. Pa. July 16, 2014) (equity compensation plan provided that unless otherwise provided by the Compensation Committee at the time an award was granted, a participant's awards vested on a Change of Ownership; court found that the Compensation Committee provided otherwise in a participant's award agreement, which stated that if the participant terminated employment during the performance period other than for good reason, death, or disability, the participant forfeited the award; subsequent merger agreement in a Change of Ownership provided for the deemed satisfaction of performance-based vesting requirements, but maintained the requirement of continued employment; since the participant resigned before the end of the performance period, he was not entitled to accelerated vesting), *appeal dismissed*, No. 14-3577 (3d Cir. 2014).

When a nonqualified plan of deferred compensation is subject to Section 409A, payments on an involuntary separation from service or a separation from service for good reason can qualify for the exceptions to Section 409A for short-term deferrals[485] and involuntary separation agreements.[486] These exceptions permit acceleration of benefits on these separations[487] and enable specified employees of publicly-traded corporations to escape the six month delay requirement for payments on separation from service.[488]

[485] Treas. Reg. §1.409A-1(b)(4).

[486] Treas. Reg. §1.409A-1(b)(9)(iii).

[487] Treas. Reg. §1.409A-3(j)(1).

[488] I.R.C. §409A(a)(2)(B)(i); Treas. Reg. §§1.409A-1(c)(3)(v) and 1(i), and 1.409A-3(a)(1) and (i)(2).

The definition of “Involuntary” in section 25(ff) of the Model Plan satisfies the definition in the Final Regulations.[489] This regulation provides that if the parties designate a separation from service as voluntary or a resignation, but the facts and circumstances show that absent the voluntary separation the employer would have terminated the employee's services, and the employee had knowledge that his or her services would be terminated, the separation is involuntary.[490]

[489] Treas. Reg. §1.409A-1(n)(1).

[490] For the Delaware case law holding that a forced resignation is an involuntary termination, see *Andersen v. Mattel, Inc.*, 2017 WL 218913 (Del. Ch. Jan. 19, 2017); *Friedman v. Maffei*, 2016 WL 1555331 (Del. Ch. April 13, 2016).

Definition of Good Reason

The definition of “Good Reason” in Alternative 1 of section 25(v) of the Model Plan is intended to satisfy the safe harbor definition of good reason in the Final Regulations.[491] The definition of “Good Reason” in Alternative 2 of section 25(v) of the Model Plan is intended to satisfy the general definition of good reason in the Final Regulations.[492]

[491] Treas. Reg. §1.409A-1(n)(2)(ii).

[492] Treas. Reg. §1.409A-1(n)(2)(i).

Both Alternatives of section 25(v)(ii) require the Grantee to provide written notice to the employer of the Good Reason event within 90 days after its occurrence, and the opportunity for the employer to cure within thirty days after receipt of the notice. Under the safe harbor definition of good reason, the notice and opportunity to cure are mandatory.[493] Under the general definition of good reason, whether an employee must provide the notice and opportunity to cure is a factor in determining whether a separation from service for good reason is effectively an involuntary separation from service.[494]

[493] Treas. Reg. §1.409A-1(n)(2)(ii)(C).

[494] Treas. Reg. §1.409A-1(n)(2)(i).

When an employment agreement or plan document requires an employee to give an employer written notice of the occurrence of a good reason event and the opportunity to cure, the employee's failure to provide the notice generally precludes the employee from claiming that the employee resigned for good reason.[495]

[495] *See, e.g.*, *Wall v. Alcon Laboratories Inc.*, 551 F. App'x 794 (5th Cir. 2014), *cert. denied*, 573 U.S. 948 (2014); *Barney v. Zimmer Biomet Holdings, Inc.*, *2018 WL 6179392* (N.D. Ind. Nov. 26, 2018); *Kvinlaug v. Claire's Stores, Inc.*, 2013 WL 1195702 (N.D. Ill. March 22, 2013); *USI Insurance Services LLC v. Miner*, 801 F. Supp. 2d 175, 181–82 (S.D.N.Y. 2011); *Needham v. Candie's, Inc.*, 2002 U.S. Dist. LEXIS 15144, at *10–11 (S.D.N.Y. Aug. 16, 2002), *aff'd*, 65 F. App'x 339 (2d Cir. 2003).

For the effect of an employer's failure to provide an employee with the required notice of the occurrence of a termination for cause event and the opportunity to cure, see *infra* note 514 and accompanying text.

Counsel should be wary of the risk that in specifying the events that are a subset of a Good Reason event, a court will apply the principle of contract construction of *ejusdem generis*. Under this principle, when a general phrase precedes or follows a list of specific items, the general phrase is interpreted to refer to items of the same ilk as those specifically listed.[496] For example, a court can apply *ejusdem generis* to find that a list of specified events limits the scope of a Material diminution in authority, duties, and responsibilities to events similar to the specified events. The purpose of specifying the events is to provide greater protection for the Grantee's ability to Separate From Service for Good Reason, but if a court applied *ejusdem generis* the specification would limit the scope of a Good Reason event.

[496] *See, e.g.*, *VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC*, 735 F.3d 25, 31 (1st Cir. 2013) (a subsequent specification impliedly limits the meaning of terms in preceding general language) (Massachusetts law); *Malmsteen v. Universal Music Group, Inc.*, 940 F. Supp. 2d 123, 133 (S.D.N.Y. 2013); *Aspen Advisors LLC v. United Artists Theater Co.*, 861 A.2d 1251, 1265 (Del. 2004); *Seibold v. Camulos Partners LP*, 2012 Del. Ch. LEXIS 216 (Sept. 17, 2012); *Kel Kim Corp. v. Central Markets, Inc.*, 524 N.Y.S.2d 384 (1987); *Camperlino v. Bargabos*, 946 N.Y.S.2d 814, 816 (App. Div. 2012); *Volpe v. The Interpublic Group of Companies*, 2013 N.Y. Misc. LEXIS 3431 (Sup. Ct. Aug. 2, 2013), *aff'd*, 987 N.Y.S.2d 137 (App. Div. 2014), *leave to appeal denied*, 995 N.Y.S.2d 714 (2014); *Strohm v. ClearOne Communications, Inc.*, 308 P.3d 424, 435–36 (Utah 2013), *rehearing denied*, Aug. 1, 2013.

See also McDonnell v. United States, 579 U.S. 550 (2016) (Court applied the canon of statutory construction of *noscitur a sociis*, a word is known by the company it keeps, in a unanimous decision to vacate the conviction of former Virginia Governor Robert McDonnell on federal bribery charges); *Yates v. United States*, 574 U.S. 528 (2015) (Court issued three opinions that applied the canons of statutory construction of *ejusdem generis* and *noscitur a sociis* in construing the scope of a federal criminal statute; opinions reached different conclusions); *Bullock v. BankChampaign, N.A.*, 569 U.S. 267 (2013) (Court applied the cannons of statutory construction of *noscitur a sociis* and *ejusdem generis* in a unanimous decision to construe the exceptions from a bankruptcy discharge from a debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny); *United States v. Kaluza*, 780 F.3d 647, 662 (5th Cir. 2015) (court applied the canon of statutory construction of *ejusdem generis* to construe a federal criminal statute not to apply to defendants).

As another example, Alternative 2 of Section 25(v)(i)(I) provides that any other conduct that is a Material breach of the agreement under which the Grantee provides services is a Good Reason event. After specifying events that are Good Reason events in Section 25(v)(i)(A)–(H), a court can apply *ejusdem generis* to have the specific Good Reason events limit the scope of Material breach as a Good Reason event.

To address the risk of a court applying *ejusdem generis*, the Model Plan uses two drafting conventions. First, each alternative in Alternative 2 of section 25(v)(i)(B) and (C) provides that the specification is in furtherance of, and not in limitation of, the Material diminution determination.[497] Second, each alternative provides the following rule of construction: "The principle of *ejusdem generis* will not apply in determining whether an event is a Material diminution."[498]

[497] *See* Nancy M. Persechino, "Force Majeure," in *Negotiating and Drafting Contract Boilerplate* 319, 332–33 (Tina L. Stark ed., ALM 2003).

[498] *See* Marvin Garfinkel, *Real World Document Drafting* ¶4.17 (2d ed. ALI-*ABA 2010*) (to avoid application of *ejusdem generis,* the document can contain a general provision that the rule of *ejusdem generis* does not apply in the interpretation of any provision); Tina L. Stark, *Drafting Contracts* ¶23.6 (2d ed. Wolters Kluwer 2014) ("Parties can attempt to overcome the application of *ejusdem generis* by stating that it does not apply."); Nancy M. Persechino, "Force Majeure," in *Negotiating and Drafting Contract Boilerplate* 319, 332–33 (Tina L. Stark ed., ALM 2003).

Cf. Senior Housing Capital, LLC v. SHP Senior Housing Fund, LLC, 2013 WL 1955012, at *27 n. 264 (Del. Ch. May 13, 2013) (Strine, V.C.) (court enforced provision in operating agreement that waived the doctrine of contractual construction that an ambiguous provision is construed against the drafter); *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715, 739 (Del. Ch. 2008) (parties can allocate by contract which party bears the burden of proof to show the occurrence of a material adverse effect; in absence of clear language in the contract to the contrary, the burden of proof rests on the party seeking to excuse its performance under the contract).

But cf. J. Travis Laster & Kenneth A. Adams, "Nice Try. When Contracts Seek to Preempt Judicial Discretion," 101 *Judicature* 32, 34 (Autumn 2017) ("We haven't found case law on whether provisions that purport to neutralize *ejusdem generis* are enforceable, but we suspect that some courts would be skeptical. For one thing, courts are partial to invoking *ejusdem generis*. For another, a court might be confused about how far to go when applying such a provision: does it preclude ever limiting a general statement, or does it just preclude rote application of *ejusdem generis*? If the latter, a court could still limit a general statement if the context suggests that's what the parties intended. So as not to give a court an excuse to apply *ejusdem generis*, and to avoid any risk involved in attempting to neutralize *ejusdem generis*, specify an appropriate general class and rely on it — don't also list members of the general class.") (footnotes omitted).

In addition, in other provisions the Model Plan uses the drafting convention of "including without limitation." To address the risk of a court applying the principle of *ejusdem generis* to limit the effect of this drafting convention, section 24 of the Model Plan provides the following rule of construction:

> The Administrator and Board shall not construe or interpret the terms "includes," "including," "includes without limitation," and "including without limitation" to limit any provision or item that precedes or follows these terms to the specific or similar provisions or items that follow these terms. The principle of *ejusdem generis* will not apply when the Plan or any Award or Award Agreement uses these terms.[499]

[499] *See* Marvin Garfinkel, *Real World Document Drafting* ¶4.17 (2d ed. ALI-*ABA 2010*); Bryan A. Garner, *Garner's Guidelines for Drafting & Editing Contracts* §149, at 423 (West Academic Publishing 2019) (the cautious phrase of *including but not limited to* avoids the associated-words canon and the *ejusdem generis* rule, and is therefore a useful habitual phrase when pairing general words with specific ones; "Ensure that the general words preceding the phrase constitute a genus, and that the specific words following the phrase constitute species. If that is not so, then edit out the phrase *including but not limited to*").

Ross Guberman & Gary Karl, *Deal Struck: The World's Best Drafting Tips*, at 71 (2014) (In everyday communication, *includes* and *including* mean that the list that follows is partial and illustrative, also known as 'nonexhaustive.' 'The places I'd like to visit *include* France and Germany' suggest that you'd like to visit other places, too. But *include* can also reflect a complete or 'exhaustive list' ('His name *includes* two words derived from Spanish'), and it can signify that one element is simply a component of another ('The device *includes* a lever'). Some courts have construed *includes* and *including* in this way. • Many drafters thus add 'without limitation' or 'but not limited to' after *includes* and *including*. • Make sure to insert commas around 'without limitation' and around 'but not limited to.' Also consider simply defining *includes* and *including* to mean '*includes (or including)* without limitation' to avoid having to repeat this cumbersome construction."); Tina L. Stark, *Drafting Contracts* ¶23.5.5 (2d ed. Wolters Kluwer 2014).

Cf. Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶ 13.377 (5th ed. *ABA 2023*) ("[I]f you're relying on the general word to convey its everyday meaning, use *includes* or *including* only to make it clear that the preceding noun in fact includes something that otherwise might not fall within its scope—*fruit, including tomatoes*. (Are tomatoes a fruit or a vegetable? Your answer might depend on whether you're a botanist or a cook.) Doing so leaves little possibility for mischief—because *tomatoes* lurks at the margins of *fruit*, a court couldn't reasonably conclude that *fruit* in fact means only tomatoes or tomato-like produce.").

For an example of this approach, see *Sharp v. Navistar Int'l Corp.*, *2020 WL 7062557*, at *16 (N.D. Ill. Nov. 30, 2020) (a portion of the definition of change-in-control in an executive severance plan provided that "a director whose initial assumption of office is in connection with an actual or threatened election contest, including, but not limited to, a consent solicitation" was not treated as a director initially serving on the board as of the effective date of the executive's participation in the plan; court rejected the company's argument that the phrase "threatened election contest" was modified by the reference to a consent solicitation; company argued that "because a consent solicitation, like a proxy fight, requires an investor to take several substantial, objective, concrete steps to commence the solicitation, a 'threatened' election contest should be understood to occur only if such steps are taken; otherwise there would be no reason to refer to consent solicitation immediately after 'threatened election contest.' This contention is unpersuasive. There is an obvious reason for the [plan] to use the consent solicitation exemplar preceded by the phrase 'including, but not limited to,' and that is to make clear that an election contest may occur by way of a consent solicitation. By itself, an election contest is ordinarily understood to require a vote; whereas a consent solicitation, by definition, does not. *See* Del. Code Ann. tit. 8 §228. Thus, to avoid confusion, the [plan] lists a consent solicitation as an example to broaden the meaning of election contest to include similar procedural mechanisms that do not require a vote").

For another example of this approach, many of the events in the definition of Cause in section 25(h)(i) of the Model Plan require that the Grantee's conduct harm or threaten to harm any business of the Company or a Broader Related Entity. Section 25(h)(i)(AA) defines harm to include without limitation the Company's or any Broader Related Entity's restatement of one or more of its financial statements for a completed fiscal period after the statement or statements were filed with the SEC. Without Section 25(h)(i)(AA), the restatement of financial statements might not be a covered harm.

Mr. Adams also takes the position that when a drafter determines that a nonexclusive list of examples is necessary, the drafter should not use "*including*" or "*including without limitation*." Rather, the drafter should carefully select the general word and place it last to block any implication that the specific items limit the general word, as in "*oranges, lemons, grapefruit, and other fruit, whether or not citrus*." If the drafter tries to express the same meaning using *including,* a comparable adjustment would be clumsier — *citrus and noncitrus fruit, including oranges, lemons, and grapefruit*. Moreover, if oranges, lemons, and grapefruit loom so large for the drafter's client, the drafter should lead with them. Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶13.384 (5th ed. *ABA 2023*).

But see JN Contemporary Art LLC v. Phillips Auctioneers LLC, 29 F.4th 118, 124 (2d Cir. 2022) (force majeure clause provided that if an art auction "is postponed for circumstances beyond our or your reasonable control, including, without limitation, as a result of natural disaster, fire, flood, general strike, war, armed conflict, terrorist attack or nuclear or chemical contamination, we may terminate this Agreement with immediate effect;" the COVID-19 pandemic, coupled with the state government's orders restricting the activities of nonessential businesses, were an occurrence beyond the parties' reasonable control, allowing the auction house to end its agreement to auction a painting by Rudolph Stingel; the pandemic and government shutdown orders were the same type of events listed in the force majeure cause, which include, "without limitation," natural disaster, terrorist attack, and nuclear or chemical contamination; each of the enumerated events were of a type that cause large-scale societal disruptions, were beyond the parties' control, and were not due to the parties' fault or negligence; to hold otherwise would render meaningless both the catchall phrase the and the clause's explicit statement that the non-exhaustive list of events following the catchall phrase did not limit it).

Eastern Airlines, Inc. v. McDonnell Douglas Corp., 532 F.2d 957, 988–89 & n. 90 (5th Cir. 1976) (excusable delay clause for manufacturer's delivery of jet aircraft excused delays "due to causes beyond Seller's control and not occasioned by its fault or negligence, including but not limited to . . . any act of government, governmental priorities, allocation regulations or orders affecting materials, equipment, facilities or completed aircraft;" application of the doctrine of *ejusdem generis* would make superfluous the unambiguous words "including but not limited to" that precede the specifically listed excuses for delay; parties intended to excuse all delays coming within the general description regardless of their similarity to the listed excuses; *ejusdem generis* applies only if the general terms follow a more specific listing of excused events, and here the general terms of the excusable delay clause precede the more specific provisions).

For cases treating the use of including without limitation as nonlimiting language, see *Federal Land Bank of St. Paul v. Bismarck Lumber Co.*, 314 U.S. 95, 99 –100 (1941); *JN Contemporary Art LLC v. Phillips Auctioneers LLC,* 29 F.4th 118, 124 (2d Cir. 2022); *Epsilon Electronics, Inc. v. United States Department of the Treasury*, 857 F.3d 913, 922 (D.C. Cir. 2017); *VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC*, 735 F.3d 25, 31 (1st Cir. 2013); *Eastern Airlines, Inc. v. McDonnell Douglas Corp.*, 532 F.2d 957, 988–89 & n. 90 (5th Cir. 1976); *Emcon Associates, Inc. v. Zale Corp.*, 2016 WL 7232772, at *8 (D.N.J. Dec. 14, 2016); *Jackson v. O'Leary,* 689 F. Supp. 846, 849 (N.D. Ill. 1988); *Coast Oyster Co. v. Perluss,* 32 Cal. Rptr. 740, 746 (Ct. App. 1963); *In re Estate of Meyer*, 668 N.E.2d 263, 265 (Ind. Ct. App. 1996); *Jones v. St. Paul Insurance Co*., 725 S.W.2d 291, 292 (Tex. App. 1987).

For cases treating the use of including without limitation as subject to the principle of *ejusdem generis*, see *Shelby County State Bank v. Van Diest Supply Co.*, 303 F.3d 832 (7th Cir. 2002); *In re IAC/Interactive Corp.*, 948 A.2d 471, 482 n. 16, 494–96 (Del. Ch. 2008); *Horse Cave State Bank v. Nolin Production Credit Association*, 672 S.W.2d 66 (Ky. Ct. App. 1984); *Berlanger v. Warren Consolidated School District*, 443 N.W.2d 372, 375–76 (Mich. 1989); *Board of Chosen Freeholders v. State*, 732 A.2d 1053, 1059 (N.J. 1999); *Holy Angels Academy v. Hartford Insurance Group*, 487 N.Y.S.2d 1005, 1007 (Sup. Ct. 1985).

See generally Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶13.374 (5th ed. *ABA 2023*) ("That some courts disregard *but not limited* to shouldn't come as a surprise. A court handling a contract dispute will want to determine the meaning intended by the drafter. In the process, it might elect to disregard any language it considers irrelevant. Given that it's routine for drafters reflexively to add *without limitation or but not limited to* each instance of *including* (and *without limitation* or *but is not limited to to* each instance of *includes*), a court could conclude that such phrases are essentially meaningless.”).

In *Shaev v. Adkerson*,[500] as part of the acquisition of Plains Exploration & Production Co. (“PXP”) by Freeport-McMoran Copper & Gold Inc. (“Freeport”), the Freeport board limited Richard Adkerson's authority as CEO of Freeport to the mining business conducted by Freeport prior to the acquisition, and amended Freeport's bylaws to subject Adkerson's authority to the board chairman. Adkerson's Employment Agreement allowed him to terminate his employment for Good Reason and receive a $46 million severance package. The Employment Agreement defined Good Reason to include any action that resulted in a diminution in Adkerson's position, authority, duties or responsibilities, and provided that any determination of Good Reason made by Adkerson in good faith and based upon his reasonable belief and understanding was conclusive. To resolve Adkerson's Good Reason claim and retain him as CEO, and after consulting an outside compensation expert, the board granted Adkerson one million RSUs that had a grant date fair value of $35.19 million.

[500] 2015 WL 5882942 (Del. Ch. Oct. 5, 2015).

The court upheld the grant of the RSUs under Delaware's business judgment rule. The business judgment rule applied because Adkerson had an arguable claim for Good Reason termination, and the board retained an outside compensation expert and met multiple times to consider the potential Good Reason claim. The board reached an agreement that resolved the Good Reason claim, reduced Freeport's potential obligation to Adkerson from $46 million to $35.19 million, and deferred Freeport's cash outlay until six months after Adkerson's retirement.

Although the issue was not before the court, the provision of Adkerson's Employment Agreement that any determination of Good Reason made by Adkerson in good faith and based upon his reasonable belief and understanding was conclusive raises the issue of whether this provision runs afoul of either the safe harbor or general definition of good reason in the Final Regulations.[501]

[501] *See also Covanta Energy Group, Inc. v. Sarkar*, 80 F. App'x 221 (3d Cir. 2003) (employment agreement defined Good Reason as a “change in Executive's responsibilities, status, title, or position, which, in Executive's reasonable judgment, represents a diminution of the Executive's responsibilities, status, title, or position”); *Carter v. Warren Five Cents Savings Bank*, 564 N.E.2d 579 (Mass. 1991) (severance agreement provided for payment on “in the judgment of the Executive (such judgment being exercised in good faith), a significant change in the Executive's responsibilities and/or duties which constitutes, when compared to the Executive's responsibilities and/or duties before the ‘change of control’ . . . a demotion”); *Worth v. Huntington Bancshares, Inc.*, 540 N.E.2d 249 (Ohio 1989) (employment agreement provided, “In the event that Employee should determine in good faith that his status or responsibilities with the Company or UCB has or have diminished subsequent to a change in control, and shall for that reason resign from his employment with the Company or UCB within two years after such change in control, Employee shall be entitled to receive all of the payments and enjoy all of the benefits specified in Section 2 hereof.”); *Gray v. Shoney's, LLC*, 2006 WL 3093217 (Tenn. Ct. App. Oct. 31, 2006) (Management Retention Agreement defined Good Reason if “there is a reasonable determination by Executive that, as a result of a change in circumstances significantly affecting his or her position, Executive is unable to exercise the authority, powers, function or duties attached to his or her position.”).

The safe harbor definition provides that a voluntary separation from service for good reason will be treated as involuntary if the separation occurs under certain express conditions. One of the conditions is a material diminution in the employee's authority, duties, or responsibilities. [502] The safe harbor appears to use an objective determination of the occurrence of material diminution in authority, duties, or responsibilities.

[502] Treas. Reg. §1.409A-1(n)(2)(ii)(A)(2).

The general definition states that the plan must define good reason to require actions taken by the employer resulting in a material negative change to the employee in the service relationship, such as the duties to be performed, or the conditions under which such duties are to be performed. [503] The general definition also appears to use an objective determination of material negative change.

[503] Treas. Reg. §1.409A-1(n)(2)(i).

If the Final Regulations require an objective determination of the occurrence of good reason events, the IRS can take the position that the provision in Adkerson's Employment Agreement that any determination of Good Reason made by Adkerson in good faith and based upon his reasonable belief and understanding was conclusive runs afoul this requirement. As a result, a termination for Good Reason would not be involuntary. For arrangements subject to Section 409A, the absence of an involuntary separation from service means that the arrangement cannot use the short-term deferral and involuntary separation agreement exceptions to escape the requirement of a six month delay for payments on a separation from service of a specified employee.[504] For arrangements exempt from Section 409A, the absence of an involuntary separation from service does not make a difference. It is important to note that Freeport did not make payments under Adkerson's RSUs until six months after his retirement.

[504] I.R.C. §409A(a)(2)(B)(i); Treas. Reg. §§1.409A-1(c)(2)(v) and 1.409A-3(i)(2).

Definition of Disability

For accelerated vesting and the exercise period on Separation From Service due to Disability or death, section 7(d)(iii)-(iv) of the Model Plan provides for full vesting and an exercise period of one year after the date of Separation From Service. Section 25(p) of the Model Plan provides three alternative definitions of "Disability." Each of the definitions in Alternatives 1 and 2 is one of the permissible definitions under the Final Regulations that a nonqualified deferred compensation plan subject to Section 409A can use when disability is a payment event.[505] The definition in Alternative 3 is the definition that the Final Regulations use to determine an employee's date of separation from service when the employee has a disability and is on a bona fide leave of absence.[506]

[505] I.R.C. §409A(a)(2)(A)(ii) and (C); Treas. Reg. §1.409A-3(a)(2) and (i)(4)(i)(A) and (B). Under the Final Regulations, a plan subject to I.R.C. §409A can also provide that an employee will be deemed disabled if determined to be: (1) totally disabled by the Social Security Administration or Railroad Retirement Board; or (2) disabled in accordance with a disability insurance program as long as the definition of disability under the program satisfies Treas. Reg. §1.409A-3(i)(4). Treas. Reg. §1.409A-3(i)(4)(iii).

[506] Treas. Reg. §1.409A-1(h)(1)(i). The rule for determination of the date of termination of employment when the employee has a disability and is on a bona leave of absence under the incentive stock option regulations is different from the rule under the Final Regulations. Treas. Reg. §1.421-1(h)(2) and (h)(4) , ex. 7.

The employer is free for two reasons to use any of the definitions of Disability in Alternatives 1, 2, or 3, or any other definition. First, the Model Plan is exempt from Section 409A. Second, the vesting and payment event is Separation From Service due to Disability, rather than the Disability itself.[507]

[507] *See* Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §VII.D, 72 Fed. Reg. 19,234, 19,264 (April 17, 2007); Audrey A. Fenske, "Disability," in *Section 409A*

Handbook 13-1, 15–16 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

Cf. Soto v. Disney Severance Plan, 26 F.4th 114 (2d Cir. 2022) (ERISA-governed severance plan provided for benefits on a Layoff; plan defined Layoff as the "involuntary termination of employment" and "in no event will an involuntary termination of employment be considered a Layoff if such involuntary termination does not qualify as a 'separation of service' within the meaning of Section 409A of the Code and Treasury Regulation Section 1.409A-1(h); majority held that the plan administrator reasonably construed Layoff to exclude a termination due to disability; under Treasury Regulation Section 1.409A-1(n)(1), an involuntary separation from service means a termination of employment "due to the independent exercise of the unilateral authority of the" employer when the employee "was willing and able to continue performing services;" since employee was unable to continue performing services due to her physical disability, an involuntary termination by the employer did not occur and the employee was not entitled to severance benefits) (dissenting judge argued that under the definition of Layoff, an involuntary termination had to be a separation from service within the meaning of Section 409A and Treasury Regulation Section 1.409A-1(h); under Treasury Regulation Section 1.409A-1(h)(1)(i), an "employee separates from service with the employer if the employee dies, retires, or otherwise has a termination of employment with the employer;" the regulations that define involuntary, Treasury Regulation Section 1.409A-1(n)(1), are "neither acknowledged by nor incorporated into the Plan and therefore provide no basis for the majority's extra-textual new definition of Layoff;" since the employer terminated the employee on short notice and without her consent, and the employee had a separation from service, a Layoff occurred and the employee was entitled to severance benefits).

An incentive stock option retains its status as an incentive stock option when the plan or award agreement provides that the grantee may exercise the option within three months after termination of employment.[508] When the plan or award agreement allows the option to be exercised beyond this period, the option loses its status as an incentive stock option and becomes a nonqualified stock option.[509] However, when termination of employment is due to disability, the plan or award agreement can provide that the grantee may exercise an incentive stock option for up to one year after termination of employment, and the option maintains its status as an incentive stock option.[510]

[508] I.R.C. §422(a)(2); Treas. Reg. §1.422-1(a)(1)(i)(B). The reference group for determination of termination of employment under the incentive stock option regulations is the granting corporation and its parents and subsidiaries. Treas. Reg. §1.421-1(h).

[509] Treas. Reg. §1.421-1(h)(2).

[510] Treas. Reg. §1.422-1(a)(3).

Under the incentive stock option regulations, termination of employment due to disability is determined by reference to the definition of disability under code Section 22(e)(3).[511] This definition provides that an individual is permanently and totally disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than twelve months. For purposes of determining the permissible term of an incentive stock option, Alternatives 2 and 3 of section 25(p) use the definition of Disability under code Section 22(e)(3).

[511] *Id.*

This definition is also one of the two permissible definitions of disability under code Section 409A(a)(2)(C)(i) and Treasury Regulation Section 1.409A-3(i)(4)(i)(A) as a permissible payment event for a plan subject to Section 409A. Alternative 1 of the definition of Disability in section 25(p) of the Model Plan uses this definition. Alternative 2 uses the definition under code Section 409A(a)(2)(C)(ii) and Treasury Regulation Section 1.409A-3(i)(4)(i)(B).

When the employer wishes to coordinate the vesting of equity awards on separation from service due to disability with the payments under its nonqualified deferred compensation plans subject to Section 409A on the same event, the employer should use the same definition of disability in the equity compensation plans as in the nonqualified deferred compensation plans.

In addition, when an employee dies while employed or within the three months after termination of employment, an incentive stock option can be exercised for the period provided by the plan or award agreement by the employee's estate, any person who acquires the option by bequest or inheritance, or by reason of the employee's death, such as a beneficiary designated by the employee under the plan.[512] Section 5(j)(v)–(vi) of the Model Plan contains the designation of beneficiary provisions.

[512] Treas. Reg. §1.421-2(c)(1).

Definition of Cause

For termination and forfeiture of Awards on an Involuntary Separation From Service for Cause, section 7(d)(i) of the Model Plan provides two alternatives. Alternative 1 provides for termination of the Grantee's unvested and unexercised vested Options and SARs, and forfeiture of unvested Restricted Stock. Alternative 2 provides for termination of unvested Options and SARs, and forfeiture of unvested Restricted Stock.

Section 25(h) of the Model Plan defines “Cause,” and has an extensive list of the events that constitute Cause. Counsel should review the list to determine which events are appropriate for the employer's business needs. The definition of Cause is important because equity compensation plans and employment agreements rarely provide for accelerated vesting of equity awards or other benefits on a separation from service for cause.[513]

[513] *See, e.g., Gilman v. Marsh & McLennan Cos., Inc.*, 826 F.3d 69, 74 (2d Cir. 2016), *petition for panel rehearing denied*, No. 15-603 (2d Cir. Aug. 12, 2016); *Schachter v. Citigroup, Inc.*, 218 P.3d 262, 266 (Cal. 2009); *Shabbouei v. Potdevin*, 2020 WL 1609177, at *2 (Del. Ch. April 2, 2020); *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 772, 783 (Del. Ch. 2016), *2022 WL 2309131* (Tex. App. 2022).

See also Craig Bonnist, “The Objectives of Employment Agreements and the Inclusion and Drafting of Effective Provisions to Fulfill Those Objectives,” in *Negotiating and Drafting Employment Agreements* 21, 25–26 (Aspatore 2015–2016 ed.) (“[A]n employment agreement often involves heavy negotiation concerning the definition of cause. An employee only wants cause to exist under very specific objective circumstances and only if those circumstances exist after the employer provides the employee with proper notice and a period in which to cure the deficiency. On the other hand, the employer wants to retain the discretion to determine whether the employee is effective and is fulfilling his or her obligations and wants to be able to make that decision subjectively with no or limited opportunity for the employee to cure the deficiencies.”).

Jeannemarie O'Brien, “Preparing for the Unexpected: A Change of Control in 2022,” in *Hot Issues in Executive Compensation*, at 173, 185 (PLI 2022) (“In a typical change-of-control severance agreement, the definition of ‘cause’ is narrowly drafted to include only objective and demonstrable acts such as a continued and material failure to perform duties after notice and an opportunity to cure, conviction of a felony, or the commission of willful misconduct that is materially and demonstrably injurious to the company, and contains a due process provision often permitting the executive to be heard before the board and requiring a super-majority vote of the board. Cause definitions are designed to be narrow to reduce the risk that an ‘unfriendly’ acquiror will take advantage of a broad definition of cause by terminating an executive's employment and contending that the termination is for cause, when no such event has occurred.”).

Section 25(h)(ii) of the Model Plan provides that if the Board, or board of directors or other governing body of the Broader

Related Entity to which the Grantee primarily provides services, determines that Cause exists due to the occurrence of an event under section 25(h)(i)(J), (K), or (L), the Board or board of directors or other governing body must give the Grantee written notice specifying in reasonable detail the conduct that constitutes Cause and an opportunity to cure.

When an employment agreement or plan document requires an employer to give an employee written notice of the employee's conduct or other event that permits termination for cause and gives the employee the opportunity to cure, but the employer terminates the employee without the notice, the employer's termination of the employee is a termination without cause. The employee then becomes entitled to the benefits under the employment agreement or plan document for a termination without cause.[514]

[514] *See, e.g.*, *Grippa v. St. Elizabeth Medical Center, Inc.*, 2012 U.S. Dist. LEXIS 12623 (E.D. Ky. Feb. 2, 2012); *Rebh v. Lake George Ventures, Inc.*, 636 N.Y.S.2d 504 (App. Div. 1996); *Hanson v. Capital District Sports, Inc.*, 630 N.Y.S.2d 429, 431 (App. Div. 1995); *O'Neil v. Clinically Home, LLC*, 2014 Tenn. App. LEXIS 416 (July 16, 2014), *appeal denied*, 2014 Tenn. LEXIS 993 (Nov. 19, 2014).

For the effect of an employee's failure to give an employer the required notice of the occurrence of a good reason event and the opportunity to cure, see *supra* note 495 and accompanying text.

In addition, the definition of Cause uses the term "intentional," rather than "willful," for a number of the events, such as the Grantee's intentional interference with the business of the Company or any Broader Related Entity. The term "willful" can mean intentional, or malicious.[515] To avoid this ambiguity, the Model Plan uses "intentional."

[515] *See Spies v. United States*, 317 U.S. 492, 497 (1943) ("[W]illful . . . is a word of many meanings, its construction often being influenced by its context."); *Johnson & Johnson v. Guidant Corp.*, 2014 U.S. Dist. LEXIS 101893 (S.D.N.Y. July 22, 2014) (Sullivan, J.) (merger agreement provided for payment of a $705 million termination fee as the exclusive remedy for the agreement's termination except that termination would not relieve any party "from any liability or damages resulting from the willful and material breach by a party of any of its representations, warranties, covenants or agreements set forth in this Agreement; court considered the extrinsic evidence of the negotiations between counsel and found that the parties intended willful "to require acting with knowledge that a breach would ensue, as opposed to mere intentionality"); *Johnson & Johnson v. Guidant Corp.*, 525 F. Supp. 2d 336, 349–50 (S.D.N.Y. 2007) (Lynch, J.) (on buyer's motion to dismiss on the ground that it did not act with malice or in bad faith, the court held, "'Willful' is a notoriously ambiguous word, which can indicate any of a number of mental states").

See generally Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶¶13.955–56 (5th ed. *ABA 2023*) (when drafters use *willful*, they usually don't make it clear whether the focus is on the party's action or on the consequences of the party's action; one can act intentionally without intending to cause damages; instead of *willful*, drafters should use *intentional* and specify that the party's intent relates to the consequences of its action, unless given the context it makes more sense to have the party's intent pertain to its taking that action); Marvin Garfinkel, *Real World Document Drafting* ¶5.6 (2d ed. ALI-*ABA 2010*) ("It is often not clear whether to be 'willful,' there must be a specific intent to injure or a venial [*sic*] [venal] motive.").

Section 25(h)(i)(T)(I) of the Model Plan provides that "any conduct of the Grantee intended to harm any business of the Company or any other member of the Broader Group" is a termination for Cause event. The Grantee's intent relates to the consequences of the Grantee's conduct.

For the definition of intentional, see *Lazard Technology Partners, LLC v. Qinetiq North America Operations LLC*, 114 A.3d 193, 195 n. 8 (Del. 2015) (en banc) (Strine, C.J.) (intention is a design, resolve, or determination with which persons act; a purpose to use particular means to effect a certain result); *Black's Law Dictionary*, definition of intentional act, at 31 (Thomson Reuters 11th ed. 2019)

("An act is intentional when it is foreseen and desired by the doer, and this foresight and desire resulted in the act through the operation of the will.").

On a Separation From Service other than an Involuntary Separation From Service for Cause, departing employees often seek an extension of the period to exercise vested nonqualified options and SARs. The Final Regulations permit an extension of the exercise period to a date no later than the earlier of the latest date on which the stock right could have expired by its original terms under any circumstances, and the tenth anniversary of the original grant date.[516]

[516] Treas. Reg. §1.409A-1(b)(5)(v)(C)(1).

ACCELERATED VESTING ON CHANGE-IN-CONTROL UNDER SECTION 280G

Under the golden parachute rules of code Sections 280G and 4999, when an acceleration of vesting occurs on a change-in-control,[517] the acceleration is treated as an acceleration of the timing of payment and as an acceleration of vesting.[518] Both forms of acceleration are treated as payments contingent on a change-in-control in the calculation of parachute payments and excess parachute payments. Excess parachute payments have the adverse tax consequences of a 20% excise tax on the disqualified individual,[519] and disallowance of a compensation deduction to the employer.[520]

[517] The definition of change-in-control under I.R.C. §§280G and 4999 is found in Treas. Reg. §1.280G-1, Q&A 27, 28, and 29. The change-in-control rules treat all members of the affiliated group as one corporation. I.R.C. §280G(d)(5); Treas. Reg. §1.280G-1, Q&A-46. Accordingly, the sale of stock or assets of a subsidiary, or the sale of assets of a particular corporation, will not be a change-in-control if the value of the stock or assets sold is not a large enough portion of the affiliated group.

In comparison, the definition of change-in-control under the Final Regulations focuses on the particular corporation for which the employee performs services at the time of the change-in-control, the corporation that is liable for the payment of the deferred compensation, or the corporation that is the majority shareholder of one of these corporations. Treas. Reg. §1.409A-3(i)(5)(ii). Accordingly, the sale of a large enough portion of the stock or assets of a subsidiary for which the employee performs services, or the sale of a large enough portion of the stock or assets of the majority shareholder of the subsidiary, can be a change-in-control.

When a transaction involves both the Section 280G affiliated group and the Section 409A applicable corporation, the Section 280G regulations and Final Regulations use different thresholds in two situations to determine whether a change-in-control occurs. First, for the acquisition of voting stock, under the Section 280G regulations a change-in-control is presumed to occur on the date that any one person, or more than one person acting as a group (as determined under Treas. Reg. §1.280G-1, Q&A-28(e)) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20% or more of the total voting power of the stock of such corporation. Treas. Reg. §1.280G-1, Q&A-28(a)(1).

Under the Final Regulations, a change-in-control occurs on the date any one person, or more than one person acting as a group (as determined under Treas. Reg. §1.409A-3(i)(5)(v)(B)) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 30% or more of the total voting power of the stock of such corporation. Treas. Reg. §1.409A-3(i)(5)(vi)(A)(i).

Second, for the acquisition of assets, under the Section 280G regulations a change-in-control occurs on the date that any one person, or more than one person acting as a group (as determined under Treas. Reg. §1.280G-1, Q&A-29(c)) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a gross fair market value equal to or more than one-third of the total gross fair market value of all the assets of the corporation immediately prior to such acquisition or acquisitions. Treas. Reg. §1.280G-1, Q&A-29(a).

Under the Final Regulations, a change-in-control occurs on the date that any one person or more than person acting as a group (as determined under Treas. Reg. §1.409A-3(i)(5)(v)(B)) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40% of the total gross fair market value of all the assets of the corporation immediately before such acquisition or acquisitions. Treas. Reg. §1.409A-3(i)(5)(vii)(A). Both the Section 280G regulations and Final Regulations use the acquisition of more than 50% of the total fair market value or total voting power of the stock of the corporation as a change-in-control. Treas. Reg. §1.280G-1, Q&A-27(a); Treas. Reg. §1.409A-3(i)(5)(v)(A). They also both use the date a majority of the members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors before the date of the appointment or election as a change-in-control. Treas. Reg. §1.280G-1 , Q&A-28(a)(2); Treas. Reg. §1.409A-3(i)(5)(vi)(A)(2).

518 Treas. Reg. §1.280G-1, Q&A-24(c)(2).

519 I.R.C. §4999(a).

520 I.R.C. §280G(a).

Thus, the critical issue is the determination of the amount of the payment contingent on a change-in-control. The use of performance goals prevents a substantial reduction in the amount of the payment contingent on a change-in-control under code Sections 280G and 4999. Section 5(b)(ii)–(iii) of the Model Plan grants the Administrator or Board the discretion to use performance goals.

The determination of the amount of the payment contingent on a change-in-control has three components: (1) determination of the value of the restricted stock or option; (2) determination of the portion of the value that is attributable to the acceleration of the timing of payment; and (3) determination of the portion of the value that is attributable to the acceleration of vesting.

The value of restricted stock is the excess of its fair market value on the date of vesting over the purchase price, if any.[521] The definition of fair market value under the Final Regulations provides useful guidance for determining the fair market value of restricted stock.[522]

521 Treas. Reg. §1.280G-1, Q&A-12(a) (regulation incorporates the income recognition rules of I.R.C. §83(a)).

522 Treas. Reg. §1.409A-1(b)(5)(iv)(A)–(B); Jeffrey A. Martin, “Golden Parachute Payments: How Stock Options and Restricted Stock Can Be Costly,” *Journal of Taxation*, at 29, 36 (July 2011).

The value of an option is based on all the facts and circumstances, including: (1) the difference between the exercise price and the stock on the date of vesting; (2) the probability of the value of the stock increasing or decreasing; and (3) the length of the period in which the option can be exercised.[523] Under Revenue Procedure 2003-68,[524] the use of any valuation method consistent with generally accepted accounting principles is permissible, such as Financial Accounting Standards Board Accounting Standards Codification Topic 718, “Stock Compensation.”[525] Black-Scholes and binomial models are also permissible. In addition, the Revenue Procedure provides for a safe-harbor based on the Black-Scholes method.

523 Treas. Reg. §1.280G-1, Q&A-13(a).

524 2003-2 C.B. 398.

[525] Under Accounting Standards Update No. 2021-07 (Oct. 2021), the Financial Accounting Standards Board amended Financial Accounting Standards Board Accounting Standard Codification Topic 718 to provide that as a practical expedient, a nonpublic entity can determine the current price input of equity-classified share-based awards using the reasonable application of a reasonable valuation method. A reasonable valuation performed in accordance with Treas. Reg. § 1.409A-1(b)(5)(iv)(B) is an example of a way to achieve the practical expedient. This rule allows private companies to satisfy the requirements of Section 409A and Topic 718 with one valuation.

Once the value of the restricted stock or option is determined, the amount of the payment contingent on a change-in-control is determined. If the requirements for the reduction in the amount of the payment contingent on a change-in-control are not satisfied, the amount of the payment contingent on a change-in-control is the value of the restricted stock or option on the date of acceleration.[526] If the requirements for the reduction in the amount of the payment contingent on a change-in-control are satisfied, the amount of the payment contingent on a change-in-control is equal to the sum of the designated value assigned to the accelerated timing of payment component, and the designated value assigned to the accelerated vesting component.

[526] Treas. Reg. §1.280G-1, Q&A-12 and 13.

The designated value of the accelerated timing of payment component is the amount by which the value of the restricted stock or option on the accelerated vesting date exceeds the present value of the amount absent the accelerated vesting.[527] Present value is determined using a discount rate of 120% of the applicable federal rate compounded semiannually under code Section 1274(d) in effect on the date of the accelerated vesting.[528] Whether the short-term, mid-term, or long-term applicable federal rate is used depends on the length of the remaining vesting period on the date of acceleration.[529]

[527] Treas. Reg. §1.280G-1, Q&A-24(b) and (e).

[528] Treas. Reg. §1.280G-1, Q&A-31(a) and 32.

[529] Treas. Reg. §1.280G-1, Q&A-32.

The designated value of the accelerated vesting component is the product of one percent of the value of the restricted stock or option on the date of acceleration multiplied by the number of full months between the accelerated vesting date and the date that the stock or option would have vested in the absence of the change-in-control.[530]

[530] Treas. Reg. §1.280G-1, Q&A-24(c).

There are three requirements for the reduction in the amount of the payment contingent on a change-in-control. First, the grant of the restricted stock or option must not be contingent on the change-in-control.[531] There is a presumption that the grant of restricted stock or an option is contingent on a change-in-control if the grant occurs within one year before the change-in-control.[532] The taxpayer can rebut the presumption with clear and convincing evidence that the payment is not contingent on the change-in-control. Factors in this determination include, without limitation, the content of the agreement and the circumstances surrounding its execution, such as whether it was entered into when a takeover attempt had commenced and the degree of likelihood that a change-in-control would actually occur. Even when the presumption is rebutted, some or all of the payments may be contingent on the change-in-control.[533]

[531] Treas. Reg. §1.280G-1, Q&A-24(a)(1) and 25.

[532] Treas. Reg. §1.280G-1, Q&A-25.

[533] Treas. Reg. §1.280G-1, Q&A-22 and 26.

Second, the vesting of the restricted stock or option must be attributable, at least in part, to the performance of services before the date that the payment is made or becomes certain to be made.[534] Third, the payment is contingent solely on the continued performance of services for a specified period without regard to the accelerated vesting on a change-in-control.[535] Restricted stock or an option does not satisfy the third requirement if vesting is based on the occurrence of an event, such as attainment of a performance goal, and the event has not occurred before consummation of the change-in-control.[536]

[534] Treas. Reg. §1.280G-1, Q&A-24(a)(1) and (c)(1)(ii).

[535] Treas. Reg. §1.280G-1, Q&A-24(a)(1) and (c)(1)(i).

[536] Treas. Reg. §1.280G-1, Q&A-24(d)(3).

For example, on January 1, 2012, ABC grants a disqualified individual 1,000 shares of ABC common stock. If the disqualified individual continues employment through January 1, 2015, the disqualified individual will become fully vested in the shares on January 1, 2015. A change-in-control under Section 280G occurs on July 1, 2013, and full vesting is accelerated on that date. The fair market value of the stock on July 1, 2013 is $1,000,000.

Assuming that the discount rate is .5 percent, the present value of the stock is $992,537. The value of the accelerated timing component is the difference between $1,000,000 and $992,537, which is equal to $7,463. The value of the accelerated vesting component is equal to the product of one percent of $1,000,000 multiplied by 18 (the number of full months between the date of acceleration and the date that the stock would have vested in the absence of the change-in-control). This amount is equal to $180,000. The amount of the payment contingent on a change-in-control is the sum of $7,463 and $180,000, which is equal to $187,463.

If vesting was based on attainment of a performance goal, such as attainment of an EBITDA amount, and this goal had not been attained on the date of consummation of the change-in-control, the amount of the payment contingent on a change-in-control is $1,000,000. The use of performance goals results in an additional payment contingent on a change-in-control of $812,537.

ACCELERATION OF VESTING ON CHANGE-IN-CONTROL UNDER SECTION 409A

When an employer wants to provide for accelerated vesting of equity awards on a change-in-control or a separation from service that occurs within a specified period after a change-in-control, the definition of change-in-control is critical. The key concerns in crafting the appropriate definition are that the definition reflects a true change in ownership or control, and does not use events so early in the process that executives have the incentive to terminate employment before the closing of a transaction. Accordingly, the definition should not use events before the closing of a transaction, such as the onset of a tender offer or proxy fight, or the signing, public announcement, or shareholder approval of a merger.[537]

[537] Jeannemarie O'Brien, “Preparing for the Unexpected: A Change of Control in 2022,” in *Hot Issues in Executive Compensation*, at 173, 179 (PLI 2022).

In addition, the definition should not seek to separate hostile transactions from friendly ones, or restrict any deactivation provisions to friendly transactions. Many so-called friendly transactions involve significant private coercion, such as threats to proceed with a hostile tender offer. From the acquiror's perspective, its use of private coercion is often more effective than a hostile tender offer that forces the target to conduct an auction. Finally, to provide executives with appropriate protection, once the definition uses a true change in ownership or control, the definition should apply regardless of whether the board of directors approves the transaction.[538]

[538] *Id.* at 119–20.

Since the Model Plan is intended to be exempt from Section 409A, the employer does not have to use a definition required by the Final Regulations when a change-in-control is a payment event for nonqualified deferred compensation plans subject to Section 409A.[539] When an employer wants to use the same definition of change-in-control in its equity compensation plans exempt from Section 409A as in its nonqualified deferred compensation plans subject to Section 409A, it may do so.[540]

[539] I.R.C. §409A(a)(2)(A)(v); Treas. Reg. §1.409A-3(a)(5) and (i)(5).

[540] *See* Jeannemarie O'Brien, "Preparing for the Unexpected: A Change of Control in 2022," in *Hot Issues in Executive Compensation*, at 173, 180 (PLI 2022) ("Change-of-control definitions should generally be the same for all compensation arrangements of the same company. This will ensure that all relevant protections are triggered upon the same transactions.").

The employer should also ensure that the definition of change-in-control is unambiguous to avoid litigation over claims for benefits in corporate transactions. For cases construing ambiguous definitions of change-in-control, see *Cassoli v. American Medical & Life Insurance Co.*, 2015 U.S. Dist. LEXIS 71009, at *10 (S.D.N.Y. June 2, 2015); *Caffrey v. Four Oaks Bank & Trust Co.*, 2011 U.S. Dist. LEXIS 70713, at *23–24 (E.D.N.C. June 29, 2011); *Wilmington Savings Fund Society, FSB v. Foresight Energy LLC*, 2015 Del. Ch. LEXIS 299 (Dec. 4, 2015); *Veloric v. J.G. Wentworth, Inc.*, 2014 Del. Ch. LEXIS 178 (Sept. 18, 2014); *Sasson v. TLG Acquisition LLC*, 127 A.D.3d 480, 481, 482–84, 9 N.Y.S.3d 2 (App. Div. 2015).

A Section 409A-compliant definition of change-in-control must use one or more of the following four events:[541]

[541] Treas. Reg. §1.409A-3(i)(5)(i).

(1) any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the corporation's stock (a "change in the ownership of a corporation");[542]

[542] Treas. Reg. §1.409A-3(i)(5)(v).

(2) any one person, or more than one person acting as a group, acquires (or has acquired in the twelve month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 30% or more of the total voting power of the corporation's stock (a "change in the effective control of a corporation");[543]

[543] Treas. Reg. §1.409A-3(i)(5)(vi)(A)(1) and (D); *see also Sharp v. Navistar Int'l Corp., 2020 WL 7062557* (N.D. Ill. Nov. 30, 2020) (portion of definition of change-in-control in executive severance plan provided that a change-in-control occurred if any person or group (as such terms are used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934 and codified at 15 U.S.C. §§ 78m(d) and 78n(d)) becomes the beneficial owner of securities of the company representing 25% or more of the combined voting power of the company's then outstanding securities; a Section 13(d) group is formed by an agreement to act in concert to acquire additional shares in support of a common objective; this interpretation does not proscribe informal discussions among existing shareholders concerning the performance of current management).

Luther v. Navistar Int'l Corp., 2018 WL 1397425 (N.D. Ill. March 19, 2018) (a group must acquire 30% of a company's shares within a twelve-month period, and not simply exceed the 30% ownership cap; executive severance plan provided for severance benefits if a 409A change-in-control occurred within twenty-four months before executive's termination; the highest percentage of Navistar stock that the MHR Group acquired within any twelve-month period between June 2012 and June 2014 was 14.98%; the highest percentage of Navistar stock that the Icahn Group acquired during any twelve-month period was 14.94%; the combined percentage shares that the group purchased in a twelve-month period did not exceed 30%).

Luther v. Navistar, Inc., 2017 WL 1197103 (N.D. Ill. March 31, 2017) (under Treas. Reg. §1.409A-

3(i)(5)(vi)(D), persons do not act as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering; however, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase, or acquisition of stock, or similar transaction with the corporation; court held that it is reasonable to conclude that the second sentence of the regulation, beginning with the word "however," is intended to provide an example, not necessarily an exclusive definition; the term "group" under the regulation has the same meaning as under the Williams Act, 15 U.S.C. §§ 78m(d)(3) and 78n(d)(2); once it is shown that a group has agreed to pursue a common objective, and it is further shown that a member of the group thereafter purchased additional shares, then a rebuttable presumption arises that the purchase was made pursuant to an agreement of the group as of the date to acquire shares in furtherance of its objectives).

(3) a majority of members of the corporation's board of directors is replaced in any twelve month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors before the date of the appointment or election (a "change in the effective control of a corporation");[544] and

[544] Treas. Reg. §1.409A-3(i)(5)(vi)(A)(2); *see also Sharp v. Navistar Int'l Corp.*, *2020 WL 7062557* (N.D. Ill. Nov. 30, 2020) (portion of definition of change-in-control in executive severance plan provided that "a director whose initial assumption of office is in connection with an actual or threatened election contest, including, but not limited to, a consent solicitation" was not treated as a director initially serving on the board as of the effective date of an executive's participation; a threatened election contest occurs if a person, by words or conduct, expresses or gives some indication of an intent to wage a proxy fight for control of board seats; it does not require that an investor take substantial, objective, and concrete steps toward running an election contest; rather it requires that an investor communicate the intent to run an election contest and that the threat be substantial, legitimate, or credible).

(4) any one person, or more than one person acting as a group, acquires (or has acquired in the twelve month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40% of the total gross fair market value of all the assets of the corporation immediately before such acquisition or acquisitions (a "change in the ownership of a substantial portion of a corporation's assets").[545]

[545] Treas. Reg. §1.409A-3(i)(5)(vii); *see also Zwick v. Inteliquent, Inc.*, 83 F. Supp. 3d 804, 808 (N.D. Ill. 2015) (in ruling on employer's motion to dismiss, the court rejected its position that the asset values reported on the balance sheet in its 10-Q SEC filing were conclusive on the determination of fair market value; a balance sheet generally reflected the value of assets as their cost less depreciation, and not necessarily their fair market value).

The corporation that undergoes the change-in-control must be one of the following three corporations:

(1) the corporation for which the employee is performing services at the time of the change-in-control;[546]

[546] Treas. Reg. §1.409A-3(i)(5)(ii)(A)(1).

(2) the corporation liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable), but only if either the deferred compensation is attributable to the performance of services by the employee for such corporation (or corporations), or there is a bona fide business purpose for such corporation or corporations to be liable for such payment. In either case, the avoidance of federal income tax cannot be a significant purpose for making such corporation or corporations liable for the payment; [547] or

[547] Treas. Reg. §1.409A-3(i)(5)(ii)(A)(2).

(3) a corporation that is a majority shareholder of a corporation identified in clause (1) or (2) above, or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in clause (1) or (2) above.[548] A majority shareholder is one that owns more than 50% of the total fair market value and total voting power of the stock of a corporation.[549]

[548] Treas. Reg. §1.409A-3(i)(5)(ii)(A)(3).

[549] Treas. Reg. §1.409A-3(i)(5)(ii)(B).

For a change in the effective control of a corporation, the corporation that must undergo the change-in-control is the corporation under clauses (1)–(3) above for which no other corporation is a majority shareholder. [550]

[550] Treas. Reg. §1.409A-3(i)(5)(vi)(A)(2).

The definition of “Change-in-Control” in Alternative 1 of section 25(i) of the Model Plan uses the definition in the Final Regulations. The definition of “Change-in-Control” in Alternative 2 is a classic definition that was widely used in equity compensation plans before issuance of the Final Regulations, and that continues to be widely used. Since both definitions require the consummation of a transaction, they should not run afoul of the prohibition of a liberal change-in-control definition under the guidelines of Institutional Shareholder Services.[551]

[551] See discussion of a liberal change-in-control definition under the guidelines of Institutional Shareholder Services *supra* notes 209 to 211 and accompanying text.

The Alternatives in section 8(a) of the Model Plan apply to the Awards of Grantees who provide services primarily to the Company or a Subsidiary on the date of consummation of a Change-in-Control of the Company. Section 25(ccc) defines “Subsidiary” as a majority-owned corporation or other entity by ownership of more than 50% of total fair market value and total voting power of the equity interests. Accordingly, section 8(a) satisfies the Final Regulations for the identity of the corporation that must undergo the change-in-control for provision of a benefit or payment on a Section 409A-compliant change-in-control.[552]

[552] For the identity of the corporation that must undergo the change-in-control, see *supra* notes 546 to 549 and accompanying text.

The Alternatives in section 8(b) of the Model Plan apply to the Awards of Grantees who provide services primarily to a Subsidiary on the date of consummation of a Change-in-Control of the Subsidiary or its Related Parent. Section 25(qq) defines “Related Parent” as a majority shareholder by ownership of more than 50% of total fair market value and total voting power of the equity interests. Accordingly, other than for a change in effective control, section 8(b) satisfies the Final Regulations for the identity of the corporation that must undergo the change-in-control for provision of a benefit or payment on a Section 409A-compliant change-in-control.

For a change in the effective control of a corporation, the corporation that must undergo the change-in-control is one of the foregoing three corporations under Treasury Regulation Section 1.409A-3(i)(5)(ii) for which no other corporation is the majority owner. To address this issue, section 8(k) provides two Alternatives. Alternative 1 provides that for a Change-in-Control that is a change in effective control under Treasury Regulation Section 1.409A-3(i)(5)(vi), the entity that must undergo the Change-in-Control is the Company. Alternative 2 provides that for a Change-in-Control that is a change in effective control under Treasury Regulation Section 1.409A-3(i)(5)(vi), the entity that must undergo the Change-in-Control is the entity under Treasury Regulation Section 1.409A-3(i)(5)(ii) for which no other Person is the majority owner.

Under Alternatives 1, 2, and 3 of Section 8(a)–(b), the employer has the discretion to accelerate vesting in full or in part on the single-trigger event of a Change-in-Control. If the employer is concerned with retaining executives only until consummation of the Change-in-Control, and the executives are aware that the employer is considering a Change-in-Control, the employer is more likely to provide for vesting before entering into the Change-in-Control agreement. The employer is also more likely to provide for full vesting on consummation of the Change-in-Control.

If the acquiror is concerned with retaining executives both until and after consummation of the Change-in-Control, the employer and acquiror are more likely to provide for a portion of the vesting on consummation of the Change-in-Control, and a portion of the vesting based on continued service with the acquiror for a specified period of time after consummation of the Change-in-Control.

For private equity portfolio companies, a portion of the vesting on a Change-in-Control is often based on the deal price or the employer's return on investment through the date of consummation of the Change-in-Control. To the extent that vesting reflects negotiations between the employer and acquiror, a portion of the vesting is often based on continued service with the acquiror for a specified period of time after consummation of the Change-in-Control.

Under Alternative 4 of Sections 8(a)–(b), the employer has the discretion to accelerate vesting in full or in part on the double-trigger events of a Change-in-Control followed by a Separation From Service for Good Reason or an Involuntary Separation From Service Without Cause within a specified period after consummation of the Change-in-Control. Alternatively, Alternatives 3 and 4 of section 7(d)(ii) provide for mandatory full vesting after these double-trigger events.[553]

[553] For cases construing contractual rights to payments on or after a change-in-control, see *Hill v. Employee Benefits Administrative Committee of Mueller Group LLC*, 971 F.3d 1321 (11th Cir. 2020); *Gorog v. Best Buy Co., Inc.*, 760 F.3d 787 (8th Cir. 2014); *Adams v. Anheuser-Busch Companies Pension Plan*, 758 F.3d 743 (6th Cir. 2014), *petition for rehearing en banc denied*, 2014 U.S. App. LEXIS 18025 (6th Cir. Sept. 16, 2014); *Berman v. Microchip Technology Incorporated*, *2022 WL 3018060* (N.D. Cal. July 29, 2022); *Sharp v. Navistar Int'l Corp.*, *2020 WL 7062557* (N.D. Ill. Nov. 30, 2020); *Fundingsland v. OMH Healthhedge Holdings, Inc.*, 329 F. Supp. 3d 1123 (S.D. Cal. 2018).

Under Alternatives 5 and 6 of section 8(a)–(b), all Grantees whose Awards relate to Shares that are readily tradeable on a Securities Market and that are not assumed or substituted by an acquiror for comparable awards that also relate to equity securities that are readily tradeable on a Securities Market will become fully vested in their unvested Awards. These Alternatives do not require the double-trigger events of a Separation From Service for Good Reason or an Involuntary Separation From Service Without Cause within a specified period after consummation of the Change-in-Control.

When an equity compensation plan is exempt from Section 409A, the plan does not have to use a Section 409A-compliant definition of good reason. To lessen the risk of disputes, good reason definitions for terminations of senior executives after a change-in-control should not qualify the good reason event with the amorphous terms of a “meaningful,” “material,” or “substantial” change in employment. In addition, target companies may wish to address whether a change in an executive's position that results solely from the company ceasing to be publicly traded, or becoming a wholly-owned subsidiary, is a good reason event.[554]

[554] Jeannemarie O'Brien, “Preparing for the Unexpected: A Change of Control in 2022,” in *Hot Issues in Executive Compensation*, at 173, 184 (PLI 2022).

For the most senior executives, after a change-in-control the following traditional good reason events effectively serve as single-trigger vesting: a material diminution in the executive's authority, duties, or responsibilities, and a material diminution in the authority, duties, or responsibilities of the supervisor to whom the executive is required to report, including a requirement that the executive report to a corporate officer or employee instead of reporting directly to the board. For example, it is unlikely that the CEO of the target will become CEO of the surviving company who reports only to its board.[555]

[555] *Id.*

Alternative 7 of section 7(d)(ii) of the Model Plan is intended to be a best practice under the guidelines of Institutional Shareholder Services.[556] It provides that upon a Grantee's Separation From Service for Good Reason or Involuntary Separation From Service Without Cause, satisfaction of any service-based vesting requirements will be determined as of the date of Separation From Service. For vesting that uses attainment of performance goals, attainment of the performance goals will be determined as of the date of Separation From Service.

[556] See discussion of the guidelines of Institutional Shareholder Services and Glass, Lewis & Co. for vesting on a change-in-control *supra* notes 161 to 168 and accompanying text.

The argument in favor of single-trigger vesting on a change-in-control is that it aligns the interests of management with the interests of the shareholders. For example, shareholders are generally free to sell their shares immediately after a stock-for-stock transaction and realize the economic benefit of a well-managed target. Accordingly, employees should not be in a position in which they cannot realize immediately after the transaction the economic benefit of their success in building the target's value. There have been situations in which former target company employees held unvested options that were in-the-money before the transaction that became underwater after the transaction due to the acquiror's poor management.[557]

[557] *See* Jeannemarie O'Brien, “Staying Current for a Change of Control,” in *Hot Issues in Executive Compensation*, at 113, 138 (PLI 2019).

Since a major purpose of an equity compensation plan is to align the interests of management with the interests of shareholders, this alignment should not be severed on a change-in-control, but should continue. By ensuring that executives share in the value created for shareholders in closing the transaction, single-trigger vesting rewards the executives for delivering the deal to the shareholders and encourages the executives to stay with the target through closing.

Section 1(b) of the Model Plan provides that a purpose of the Plan is to “align the individual interests of Employees, Directors, and Contractors with the interests of the Company's shareholders.” Section 1(c) provides that another purpose of the Plan is to “increase shareholder value by providing incentives to Employees, Directors, and Contractors to increase the long-term growth and profitability of the Company and its Broader Related Entities.”

In contrast, double-trigger vesting rewards only those executives who separate from service within the protection period for accelerated vesting after the change-in-control. As a result, double-trigger vesting encourages executives to separate from service so that they can realize the value of their equity awards on the change-in-control.[558] It also may reward less valuable executives that the acquiror terminates after closing, and does not reward more valuable executives who stay with the company beyond the protection period.

[558] *See* Jeannemarie O'Brien, “Staying Current for a Change of Control,” in *Hot Issues in Executive Compensation*, at 113, 138–39 (PLI 2019).

Since equity awards are often granted to a broad group of employees, double-trigger vesting can lead to post-change-in-control disputes over whether a separation from service is for good reason, especially when the definition of good reason uses subjective factors, such as a materiality qualification. Furthermore, double-trigger vesting requires the good reason determination to be made post-change-in-control when the target's pre-change-in-control management will likely no longer be making this determination.[559]

[559] *Id.* at 139.

The argument in favor of double-trigger vesting is that it encourages executives to stay at least for a transition period after closing of the change-in-control. The acquiror can maintain an appropriate degree of continuity of management, and provide the executives with an incentive to maximize the long-term deal value. Double-trigger vesting encourages the acquiror to carefully evaluate and execute any future transaction so that the acquiror does not unintentionally create a good reason event that allows executives that the acquiror wishes to retain to separate from service and receive the change-in-control benefits.

Double-trigger vesting also softens the effects on the executives of an involuntary separation from service without cause or separation from service for good reason. With double-trigger vesting, the acquiror does not have to use a significant portion of the deal value to adopt a compensation package that keeps executives with the company after closing. Furthermore, investors in the target, especially a start-up, often favor double-trigger vesting for these reasons.

In contrast, single-trigger vesting does not provide the executives with any incentive to stay with the company after the change-in-control. Executives can cash-out and resign immediately after the closing and leave the acquiror without experienced management. In addition, single-trigger vesting often limits the acquiror's ability to roll the target's equity awards into the acquiror's stock.

Furthermore, investors in the target, especially a start-up, are often wary of single-trigger vesting. As a result, acquirors often make target companies pay for the single-trigger vesting. Moreover, regardless of who pays for single-trigger vesting, acquirors understand that it is more expensive to keep an executive team that has vested in and cashed out their awards than to keep an executive team with unvested awards.

Finally, when an involuntary separation from service without cause or a separation from service for good reason occurs within one to two years after a change-in-control, equity compensation plans often provide for an extended period after separation from service to exercise options, such as three years but not beyond the original term. If the options are underwater, change-of-control vesting may not ensure that an employee receives the benefit of the option if he or she has a separation from service after the change-of-control and forfeits the option shortly after separation from service. Employees are aware that three months, six months, or even a year may not be sufficient to receive the benefit of the option.[560] Finally, the plan document should permit a post-separation extended exercise period; otherwise if a plan amendment is necessary shareholder approval will likely be necessary.

[560] *See* Jeannemarie O'Brien, “Preparing for the Unexpected: A Change of Control in 2022,” in *Hot Issues in Executive Compensation*, at 173, 199 (PLI 2022).

Alternatives 3 and 4 of section 7(d)(ii) of the Model Plan provide for a three year exercise period on a Separation From Service for Good Reason or an Involuntary Separation From Service Without Cause that occurs within one year, eighteen months, and two years after consummation of a Change-in-Control.

SECTION 409A INTERPRETIVE CLAUSE

For a nonqualified deferred compensation plan that needs to use a Section 409A-compliant definition of a change-in-control, if the plan fails to define the event, or uses an ambiguous definition, there is the concern of whether a Section 409A documentary violation has occurred. For example, in Section IV.B.1 of IRS Notice 2010-6, the IRS acknowledges that when a plan uses the term “acquisition” of the employer as a payment event, “acquisition” could be interpreted to mean a permissible change-in-control event under Treasury Regulation Section 1.409A-3(a)(5) and (i)(5), or to include events that are not a permissible change-in-control.[561]

[561] IRS Notice 2010-6, §IV.B.1, 2010-1 C.B. 275, 280.

Similarly, the use of the term “termination of employment” as a payment event could be interpreted to mean only events that qualify as a separation from service under Treasury Regulation Section 1.409A-1(h), or also to include events do not qualify as a separation from service under this regulation and exclude events that must be included in the definition of separation from service.[562]

[562] *Id.*

The Final Regulations provide that general provisions in a plan that purport to nullify noncompliant plan terms, or to supply any specific plan terms required by Treasury Regulation Sections 1.409A-1, 1.409A-2, or 1.409A-3, are disregarded.[563] In IRS Notice 2010-6,[564] the IRS loosened the potential chokehold of this provision on an employer's ability to avoid documentary noncompliance. Under the Notice, when a plan subject to Section 409A designates a payment event but does not define the payment event, or has an ambiguous definition of the payment event, there is no ambiguity or a Section 409A documentary violation if the plan contains a Section 409A interpretive clause requiring that the term be interpreted to comply with Section 409A.[565]

[563] Treas. Reg. §1.409A-1(c)(1).

[564] 2010-1 C.B. 275.

[565] *Id.* at §IV.B.1.

Although Notice 2010-6 addresses specific payment events in plans subject to Section 409A, counsel can reasonably take the position that when a Section 409A interpretive clause provides for complying with Section 409A or any exemption thereto, the clause applies to all ambiguous terms regardless of whether they are specifically addressed in Notice 2010-6. The interpretive clause applies regardless of whether the employer resolves the ambiguity by an amendment that uses an exemption from Section 409A, such as the short-term deferral exemption, or that uses a correction specifically provided by Notice 2010-6.[566]

[566] *See* Rosina B. Barker & Kevin P. O'Brien, “Correcting Document Errors,” in *Section 409A Handbook* 31-1, 8–9 and 23–24 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

Accordingly, every employment agreement, whether subject to or exempt from Section 409A, should prophylactically provide that the parties shall administer, construe, and interpret the agreement to satisfy the requirements of Section 409A or any exemption thereto. Similarly, every broad-based plan, again whether subject to or exempt from Section 409A, should prophylactically provide that the plan administrator, compensation committee, and board of directors shall administer, construe, and interpret the plan, and exercise each one's authority and discretion, to satisfy the requirements of Section 409A or any exemption thereto.

Section 20(c)(i) of the Model Plan contains the following Section 409A interpretive clause: “The Administrator and Board shall administer, construe, and interpret the Plan and each Award and Award Agreement, and exercise each one's authority and discretion, to satisfy the requirements of Code Section 409A or any exemption thereto.”

Notice 2010-6 also provides that an interpretive clause will not cure a payment term that explicitly includes Section 409A noncompliant payment events, or explicitly excludes required payment events. In addition, an interpretive clause will not cure an ambiguous term when the employer has a pattern or practice on or after January 1, 2009 of applying a specific interpretation that does not comply with Section 409A. This rule applies to the plans to which the employer has applied the interpretation, and any other plan with substantially similar language regardless of whether the plans provide deferred compensation to the same employee or employees. [567]

[567] *Id.*

Finally, when a court with jurisdiction over the plan's enforcement has interpreted the plan term at issue, an interpretive clause will not cure an ambiguous term for the plan subject to the court's decision, or for any other plan of the employer with substantially similar language over which the same court has jurisdiction. This rule applies regardless of whether the plan provides deferred compensation to the same employee or employees.

Stock rights intended to be exempt from Section 409A are generally ineligible for correction of document failures under IRS Notices 2010-6 and 2010-80.[568] The only stock rights eligible for correction of document failures are those for which the employee on the grant date has the right to exercise only on a fixed date or a period beginning and ending within one taxable year, or a permissible payment event under Treasury Regulation Section 1.409A-3(a) (including any period following a payment event permitted under Treasury Regulation Section 1.409A-3(b)).[569]

[568] 2010-2 C.B. 853, §III.A.

[569] IRS Notice 2010-80, 2010-2 C.B. 853, §III.A.

Stock rights intended to be exempt from Section 409A are eligible for correction of the operational failure of an exercise price erroneously established at less than the fair market value of the stock on the grant date.[570]

[570] Notice 2008-113, 2008-2 C.B. 1305, §§IV.D and V.E. See discussion of the requirements for correction under Notice 2008-113 *supra* notes 420 to 428 and accompanying text.

PERMISSIBLE USE OF SECTION 409A-NONCOMPLIANT DEFINITION OF CHANGE-IN-CONTROL

The definition of change-in-control in a nonqualified deferred compensation plan subject to Section 409A does not have to comply with the definition under the Final Regulations in three scenarios. The employer will often want to use a different definition than the definition under the Final Regulations when it wants to provide benefits on an event with lesser degree of change than the events that qualify as a Section 409A-compliant change-in-control. Examples of potential events with a lesser degree of change are a spin-off, sale of a business, or an initial public offering.

The first scenario is continued employment until the date of the change-in-control, and payment of benefits within the short-term deferral period after the change-in-control.[571] This scenario qualifies for the short-term deferral exemption from Section 409A. Continued employment until the date of the change-in-control is a vesting event for which the right to payment is no longer subject to a substantial risk of forfeiture. [572]

[571] Treas. Reg. §1.409A-1(b)(4)(i)(A).

[572] Treas. Reg. §1.409A-1(d)(1).

Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person, or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. A condition related to a purpose of the compensation must relate to the employee's performance for the employer, or the employer's business activities or organizational goals; for example, the attainment of a prescribed level of earnings or equity value, or completion of an initial public offering.[573]

[573] *Id.*

The short-term deferral period is the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of: (1) the fifteenth day of the third month following the end of the employee's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; and (2) the fifteenth day of the third month following the end of the employer's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.[574]

[574] Treas. Reg. §1.409A-1(b)(4)(i)(A).

The Final Regulations permit delayed payment after the applicable 2½ month period in two situations. First, the taxpayer establishes that it was administratively impracticable to make the payment by the end by the end of the applicable 2½ month period, and as of the date on which the legally binding right to the compensation arose, such impracticability was unforeseeable. An action or failure to act of the employee or a person under the employee's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event. In addition, the payment is made as soon as administratively practicable. Second, the taxpayer establishes that making the payment by the end of the applicable 2½ month period would have jeopardized the employer's ability to continue as a going concern. In addition, the payment is made as soon as the payment would no longer have this effect.[575]

[575] Treas. Reg. §1.409A-1(b)(4)(ii).

The Proposed Regulations permit delayed payment in a third situation when the taxpayer "establishes that the service recipient reasonably anticipated that making the payment by the end of the applicable 2½ month period would have violated Federal securities laws or other applicable law, provided that the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that making the payment would not cause such violation. The making of a payment that would cause inclusion in gross income or the application of any penalty provision of the Internal Revenue Code is not a violation of applicable law."[576]

[576] Prop. Treas. Reg. §1.409A-1(b)(4)(ii) (as proposed at 81 Fed. Reg. 40,569, 40,578–79 (June 22, 2016)).

A payment means each separately identified amount to which an employee is entitled to payment on a determinable date, and includes amounts applied for the benefit of the employee.[577] An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula.[578] The entitlement to a series of installment payments that is not a life annuity is treated as the entitlement to a single payment, unless the plan provides at all times with respect to the amount deferred that the right to the series of installment payments is to be treated as a right to a series of separate payments.[579] Accordingly, to qualify the portion of installment payments paid within the applicable 2½ month period for the short-term deferral exemption, the plan must provide that the right to a series of installment payments is to be treated as a right to a series of separate payments.

[577] Treas. Reg. §§1.409A-1(b)(4)(i)(F) and 1.409A-2(b)(2)(i).

[578] Treas. Reg. §1.409A-2(b)(2)(i).

[579] Treas. Reg. §1.409A-2(b)(2)(iii).

Another arrangement that is exempt from Section 409A is an involuntary separation agreement that satisfies the requirements of Treasury Regulation Section 1.409A-1(b)(9)(iii). This exemption applies "to the extent that the separation pay, or portion of the separation pay, provided under the plan" satisfies the exemption's requirements. For the exemption to apply to the portion of the separation pay that satisfies the exemption's requirements, the plan does not have to provide that the series of installment payments of separation pay is a series of separate payments.

For example, an employment agreement provides that on separation from service without cause, the employer shall pay the employee separation benefits in an amount equal to the product of two multiplied by the employee's base salary for the calendar year before the year of separation. The employer shall pay the separation benefits in equal installments on the regular payroll dates under the employer's payroll practices that apply to the employee on the date of separation from service. The employer shall pay the installments for two years commencing on the first payroll period after the thirtieth day after the date of separation from service. The employment agreement provides that the right to the series of installment payments will be treated as a right to a series of separate payments. The employee is not a specified employee. An involuntary separation from service occurs on July 1, 2012, and the employer commences payment of the installments on August 15, 2012. The installments paid from August 15, 2012 until March 15, 2013 satisfy the short-term deferral exemption. The installments paid after March 15, 2013 must satisfy either the involuntary separation agreement exemption,[580] or the requirements for payments made at a specified time or pursuant to a fixed schedule for payments subject to Section 409A.[581]

[580] Treas. Reg. §1.409A-1(b)(9)(iii).

[581] Treas. Reg. §1.409A-3(a)(1) and (b) and (i)(1).

The second scenario is the double-trigger events of a change-in-control followed by one or more permissible vesting events, and payment of benefits within the applicable 2½ month period after the vesting event.[582] The permissible vesting events are separation from service due to involuntary termination as defined in the Final Regulations,[583] separation from service for good reason as defined in the Final Regulations,[584] or any other event that is a permissible vesting event under the Final Regulations.[585]

[582] Treas. Reg. §1.409A-1(b)(4)(i).

[583] Treas. Reg. §1.409A-1(d)(1); Treas. Reg. §1.409A-1(n)(1).

[584] Treas. Reg. §1.409A-1(n)(2).

[585] Treas. Reg. §1.409A-1(d)(1).

One commentator takes the position that regardless of whether the separation from service satisfies the requirements for a good reason separation under the Final Regulations, as long as the good reason event creates a substantial risk of forfeiture and the payment of separation benefits occurs within the applicable 2½ month period after the good reason event, the short-term deferral exemption applies.[586] Like the first scenario, this scenario relies on the short-term deferral exemption to be free from the requirement to use a Section 409A-compliant definition of change-in-control.

[586] Erica F. Schohn, “Short-Term Deferrals,” in *Section 409A Handbook* 6-1, 17–18 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

The second scenario raises the issue of whether an employee's right to separation benefits under a walk-away right upon the occurrence of a vesting event after a change-in-control, otherwise known as a modified double-trigger, can satisfy the short-term deferral exemption.[587] When separation from service is a within an employee's control, such as a voluntary separation other than for good reason, the employee's right to the benefits on separation from service is not subject to a substantial risk of forfeiture. The employee vests in the right to the benefit when he or she obtains a legal right to the benefits, which occurs when there is a binding contract for the benefits.

[587] For critiques of walk-away rights, see Joseph A. Hearn & Marc R. Trevino, “Compensating and Protecting Executives in a Change-in-Control Context,” in *Hot Issues in Executive Compensation*, at 73, 79 (PLI 2013); Jeannemarie O'Brien, “Preparing for the Unexpected: A Change of Control in 2022,” in *Hot Issues in Executive Compensation*, at 173, 185 (PLI 2022).

If the employee has a walk-away right during a thirty day window period following the one year anniversary of a change-in-control, the walk-away right under the following arrangement satisfies the short-term deferral exemption: (1) the separation benefits are subject to a substantial risk of forfeiture until the window period opens, and the employee vests in the separation benefits on the date that the window period opens; (2) the payment of separation benefits occurs no later than seventy-four days after the window period opens; and (3) the right to separation benefits ends when the window period closes.[588]

[588] *See* Jeannemarie O'Brien, “Change-of-Control Protections in a Changing Environment,” in *Hot*

Issues in Executive Compensation, at 741, 755 & n. 2 (PLI 2011).

The walk-away right under the following arrangement also satisfies the short-term deferral exemption. An employee is entitled to a lump sum separation benefit equal to two times base salary if the employee is involuntarily terminated or exercises a walk-away right by February 15 of the year following the year in which a change-in-control occurs. The employer will pay the benefit by March 15 of that following year. After February 15 the employee's right to the separation benefit ends. The February 15 date enables the employee to sign a release and have it become effective by March 15. Since the right to the separation benefit ends on February 15 and is paid by March 15, there are no payments made after the short-term deferral period ends on March 15. Accordingly, the arrangement satisfies the short-term deferral exemption.[589]

[589] *See* Erica F. Schohn, "Short-Term Deferrals," in *Section 409A Handbook* 6-1, 19–20 ex. 3 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

Since the first and second scenarios rely on the short-term deferral exemption, payment of benefits from the employer's nonqualified deferred compensation plans otherwise subject to Section 409A in these scenarios is not subject to the six month delay requirement for payments to specified employees of publicly-traded corporations on separation from service.[590]

[590] I.R.C. §409A(a)(2)(B)(i); Treas. Reg. §§1.409A-1(c)(3)(v) and 1(i), and 1.409A-3(a)(1) and (i)(2).

The third scenario in which the definition of change-in-control does not have to comply with the definition under the Final Regulations is the double-trigger events of a change-in-control followed within a specified period by separation from service. The employer pays the benefits on separation from service in the same time and form of payment as on all other separations from service that do not follow a change-in-control. In this scenario, the payment event is the separation from service, rather than the change-in-control.[591]

[591] I.R.C. §409A(a)(2)(A)(i); Treas. Reg. §1.409A-3(a)(1).

Alternatively, the change-in-control is a vesting event, and the payment event is the employee's separation from service. In this situation, the definition of change-in-control does not have to comply with the definition under the Final Regulations.

Under the Final Regulations, the general rule is that payments of nonqualified deferred compensation on each permissible payment event must have the same time and form of payment.[592] An exception permits different times and forms of payment on the following separations from service: (1) a separation that occurs within two years after a Section 409A-compliant change-in-control;[593] (2) a separation that occurs: (a) before or after a specified date (for example, the attainment of a specified age);[594] or (b) before or after a combination of a specified date, such as attaining a specified age, and a specified period of service as determined under a predetermined, nondiscretionary, objective formula, or pursuant to the method for crediting service under a qualified plan sponsored by the employer;[595] and (3) a separation not described in clauses (1) and (2).[596]

[592] Treas. Reg. §1.409A-3(c).

[593] Treas. Reg. §1.409A-3(c)(1).

[594] Another exception to the same time and form of payment rule permits an alternative payment schedule if disability, death, or an unforeseeable emergency occurs on or before one (but not more than one) specified date. Treas. Reg. §1.409A-3(c).

[595] Treas. Reg. §1.409A-3(c)(2).

[596] Treas. Reg. §1.409A-3(c)(3). Another exception to the same time and form of payment rule is for separation benefits that satisfy the involuntary separation agreement exemption of Treas. Reg. §1.409A-1(b)(9)(iii).

For example, a plan may provide that an employee will receive a lump sum payment of the employee's entire benefit on the first day of the month following a change-in-control that occurs before the employee attains age 55. The plan may also provide that the employee will receive five substantially equal annual payments commencing on the first day of the month following a change-in-control that occurs on or after the employee attains age 55. The definition of change-in-control must comply with the Final Regulations.

Employers often use this exception to pay a single lump sum payment on a separation from service within two years after a Section 409A-compliant change-in-control, and installment payments on other separations from service. Employers often bargain for the clawback of the installments already paid and forfeiture of the remaining installments to be paid if the former employee violates post-separation covenants. Common covenants are covenants to assign intellectual property, covenants not-to-compete, covenants not to solicit customers and employees, covenants not to disclose confidential information, and covenants against disparagement.[597]

[597] *See, e.g.*, *Pickett v. Gorevic*, *2021 WL 4927061* (S.D.N.Y. March 26, 2021) (Report and Recommendation of Barbara Moses, U.S.M.J.) (magistrate upheld separation agreement for COO who had a sexual relationship with a subordinate; agreement designated COO's separation as a resignation with Good Reason and provided for payment of severance of one year's base salary of $425,500 and his earned but unpaid 2018 bonus and his retention of his unvested equity awards in exchange for his release of the company and confidentiality, cooperation, and nondisparagement covenants) (Delaware law), *Report and Recommendation adopted in full*, 2021 WL 4239176 (S.D.N.Y. Sept. 17, 2021) (Gregory H. Woods, U.S.D.J.).

Shabbouei v. Potdevin, 2020 WL 1609177, at *12–13 (Del. Ch. April 2, 2020) (directors may, within the bounds of proper business judgment, negotiate a quiet exit, complete with severance payments, for a senior executive who arguably could be fired for cause, thereby avoiding an embarrassing legal battle and additional negative publicity for the company; under this rule, demand was not excused when, after verifying reports of pervasive sexual misconduct by the CEO, the board decided to settle rather than fire the CEO for cause, ultimately agreeing to pay $5 million in severance under a contract that included not only a release and nonsolicitation covenant, but also liberated the company from the CEO's troublesome tenure without litigation).

The Federal Trade Commission has issued a proposed rule that it is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker or maintain with a worker a non-compete clause. The proposed rule defines a non-compete clause as a contractual term between an employer and a worker that prevent the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer. Under this definition, a non-compete clause would generally not include a nondisclosure agreement or a client or customer nonsolicitation agreement. These agreements generally do not prevent a worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer. However, such agreements would be considered non-compete clauses if they are so unusually broad in scope that they serve as *de facto* non-compete clauses. Federal Trade Commission, Notice of Proposed Rulemaking, “Non-Compete Clause Rule,” 88 Fed. Reg. 3,482, 3,484, and 3509–10 (Jan. 19, 2023).

TREATMENT OF STOCK RIGHTS ON A CHANGE-IN-CONTROL AND SECTION 424 CORPORATE TRANSACTIONS

In a change-in-control, acquirors and targets often wish to cash-out holders of the target's options and SARs. Alternatives 1 and 2 of section 8(c) of the Model Plan grant the Administrator or Board the discretion to cancel vested Options and SARs whether the Options and SARs vested before the Change-in-Control or as part of the Change-in-Control, and to pay the in-the-money value of the cancelled Options and SARs. The Preamble to the Proposed Section 409A regulations provides that the cancellation and payment is not a modification of the option or SAR.[598] The cash-out of an incentive stock option results in ordinary income to the employee and a deduction to the employer.[599]

[598] Department of the Treasury, Internal Revenue Service, Notice of Proposed Rulemaking, "Application of Section 409A to Nonqualified Deferred Compensation Plans," Preamble §II(C), 70 Fed. Reg. 57,930, 57,935 (Oct. 4, 2005). For a discussion of the definition of a modification and its consequences under Section 409A, see *supra* notes 46 to 60 and accompanying text.

[599] *Bagley v. Commissioner*, 85 T.C. 663 (1985), *aff'd*, 806 F.2d 169 (8th Cir. 1986); Rev. Rul. 67-366, 1967-2 C.B. 165.

Alternatives 1 and 2 of section 8(d) of the Model Plan grant the Administrator or Board the discretion to cash-out the Options and SARs that vested before the Change-in-Control. For the unvested Options and SARs, the Administrator or Board has the discretion to cancel the Options and SARs, or have the Options and SARs continue and have the acquiror pay an amount equal to the in-the-money value of the Option or SAR determined as of the date of consummation of the Change-in-Control. If the employees satisfy the post-Change-in-Control vesting requirements, the acquiror will pay this amount on the same schedule as the vesting schedule established on the Option's or SAR's Grant Date. Acquirors favor this structure since it locks-in the value of the stock right on the change-in-control, avoids large compensation payments on consummation of a change-in-control, and preserves the retention value of the unvested stock rights by requiring the employees to continue employment with the acquiror to receive the cash-out amount.[600]

[600] *See* Laurence Seymour, "IRC Section 409A Conundrums," in *U.S.C. Tax Institute* ¶602 (Aug. 2014).

Alternatives 1 and 2 of section 8(d) of the Model Plan raise the issue of whether payment of the in-the-money value in accordance with the vesting schedule is an impermissible feature for the deferral of compensation. An exempt option cannot have any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option under Treasury Regulation Section 1.83-7, and the time that the stock acquired on the option's exercise first becomes substantially vested under Treasury Regulation Section 1.83-3(b).[601] An exempt SAR cannot have any feature for the deferral of compensation other than the deferral of recognition of income until its exercise.[602]

[601] Treas. Reg. §1.409A-1(b)(5)(i)(A)(3).

[602] Treas. Reg. §1.409A-1(b)(5)(i)(B)(3).

Since an impermissible extension includes the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year,[603] the IRS can take the position that for vested stock rights, the payment of the in-the-money value other than as an immediate cash-out runs afoul of Section 409A. However, the answer to the question of whether the payment of the in-the-money value on the same schedule as the vesting schedule established on the grant date is an impermissible extension should be no for three reasons.[604]

[603] Treas. Reg. §1.409A-1(b)(5)(v)(A) and (C)(1).

[604] *See* Daniel L. Hogans, "Mergers and Other Corporate Transactions," in *Section 409A Handbook* 17-1, 16–18 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023); Sharon J. Hendricks, "Cash-Out/Liquidation of Options in Connection With Mergers and Acquisitions," *Executive Compensation: Strategy, Design, and Implementation* 29 (ALI-ABA June 2010); Laurence Seymour, "IRC Section 409A Conundrums," in *U.S.C. Tax Institute* ¶¶602 to 602.7 (Aug. 2014).

Cf. PLR 199901006 (company granted options that vested over three to five years; as part of an acquisition of the company, executives were given an election to surrender their nonvested options and receive a deferred compensation account balance equal to the spread between the stock's price under the acquisition agreement and the option's exercise price; the deferred compensation would vest and be distributed at the same times when the options would have vested; IRS ruled that neither the opportunity to surrender nor the actual surrender of the options would be a taxable event to the executives, and benefits payable under the deferred compensation plan would be included in income in the earlier of the years distributed or made available).

First, there is no deferral of the recognition of income beyond the stock right's exercise date. For a stock right, the date of payment is generally the date of exercise.[605] Payment of the in-the-money value on the same schedule as the vesting schedule for the stock right provides for payment on the earliest possible payment date. There is no additional period to exercise the stock right.[606]

[605] Treas. Reg. §1.409A-3(d).

[606] *See* Department of the Treasury, Internal Revenue Service, "Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §III.D.5–6, 72 Fed. Reg. 19,234, 19,242 (April 17, 2007) ("[I]f an arrangement provides for a potential to defer the payment of cash or property upon the exercise or exchange of a stock right beyond the year the right is exercised or beyond the original term of the stock right, the arrangement provides for a deferral feature and must comply with the requirements of section 409A from the time the legally binding right granted by the award arises.").

Moreover, the Final Regulations permit the deferral of recognition of income beyond the date of an option's exercise until the date the stock received on exercise vests.[607] The Final Regulations permit the recognition of income beyond the exercise date without the creation of an impermissible feature for the deferral of compensation. A grantee can exercise an option for unvested shares, and on subsequent vesting receive cash or otherwise recognize income without running afoul of the Section 409A exemption. The payment of the in-the-money value of the stock right on the same schedule as the original vesting schedule is the economic equivalent to the deferral of income recognition until the receipt of cash or vested shares.

[607] Treas. Reg. §1.409A-1(b)(5)(i)(A)(3)(ii).

Second, the Final Regulations are aimed at preventing the abuse of grantees who before they exercise an option elect to defer their receipt of vested shares. This abuse is not at issue when the acquiror pays the in-the-money value on the same schedule as the original vesting schedule. Indeed, the recognition of income occurs on the original vesting schedule. There is no extension of the vesting schedule that results in the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year.

Furthermore, since the grantees do not have control over the post-acquisition vesting schedule, which is usually continued at the acquiror's behest, the grantees do not have the ability to engage in abusive deferral practices. Moreover, holders of unvested options and SARs usually prefer to be cashed-out at closing, rather than continue to be subject to the vesting schedule with the acquiror as their new employer.

Third, the Final Regulations permit a change in the vesting schedule on a change-in-control for any stock right or plan of deferred compensation that would otherwise vest on the change-in-control without treatment as an impermissible subsequent deferral election or acceleration of payments.[608] Since the creation of a new vesting schedule on a change-in-control does not run afoul of Section 409A, neither should continuation of the same vesting schedule on a change-in-control.

[608] Treas. Reg. §1.409A-3(i)(5)(iv)(B).

Finally, acquirors and targets often wish to cancel the unexercised options and SARs of the target's employees. Section 8(h) of the Model Plan provides that in a Section 424 Corporate Transaction, the Administrator or Board may: (1) contingent on consummation of the Section 424 Corporate Transaction, vest all or any portion of unvested Options and SARs at least fifteen days before the reasonably anticipated date of consummation of the Section 424 Corporate Transaction; (2) require the Grantees to exercise their vested Options and SARs before consummation of the Section 424 Corporate Transaction; and (3) cancel the vested Options and SARs that were not exercised.

The Final Regulations and incentive stock option regulations provide that a change to the terms of a stock right that shortens the exercise period is not a modification.[609]

[609] Treas. Reg. §§1.409A-1(b)(5)(v)(B) and 1.424-1(e)(4)(i). For a discussion of the definition of a modification and its consequences under Section 409A, see *supra* notes 46 to 60 and accompanying text.

Determination of Fair Market Value of Stock and Payment for Stock of Option Holders on a Change-in-Control

In *Fox v. CDx Holdings, Inc.*,[610] the plan sponsor of an equity compensation plan, Caris Life Sciences, Inc., cashed-out the options held by employees on a change-in-control. As part of the cash-out, the plan sponsor had to determine the fair market value of the stock underlying the options. The court addressed whether the plan sponsor's determination of fair market value satisfied the standard of good faith for valuation of the stock under the plan document and Delaware law.

[610] 2015 WL 4571398 (Del. Ch. July 28, 2015), *aff'd*, 141 A.3d 1037 (Del. 2016) (en banc).

Section 2.25 of the 2007 Stock Incentive Plan (the "Plan") defined Fair Market Value to mean "as of any date, the value of the Common Stock as determined in good faith by the Administrator." Section 3.4 of the Plan provided that "[a]ll decisions made by the Administrator pursuant to the provisions of the Plan shall be final and binding on the Company and the Participants, unless such decisions are determined to be arbitrary and capricious."

Section 12.3 of the Plan granted the Administrator the discretion to cancel outstanding Awards on a change-in-control "in consideration for a payment equal in value to the Fair Market Value of vested Awards, or in the case of an Option, the difference between the Fair Market Value and the exercise price for all shares of Common Stock subject to exercise (*i.e.*, to the extent vested) under any outstanding Option."

Section 12.1 of the Plan provided that if any change is made in the Common Stock of the Company without the Company's receipt of consideration, then "the exercise price of any Option in effect prior to such change shall be proportionately adjusted by the Administrator to reflect any increase or decrease in the number of issued shares of Common Stock or change in the Fair Market Value of such Common Stock resulting from such transaction."

Caris Life Sciences, Inc. ("Caris") was a privately-held Delaware corporation with three subsidiaries: (1) Caris Diagnostics, which was engaged in the anatomic pathology business, and was consistently profitable; (2) TargetNow, which was engaged in profiling genetic and molecular changes to a cancer patient's tumor, and generated revenue but not profit; and (3) Carisome, which was engaged in the development of blood tests to detect cancers and other complex diseases, and was in the developmental stage.

To achieve the goals of securing financing for TargetNow and Carisome and generating a return for its stockholders, Caris transferred ownership of TargetNow and Carisome to a new subsidiary, and spun-off the subsidiary to its shareholders (the transfer and spin-off, the "Spinoff," and the spun-off entity, "SpinCo").

Caris, now owning only Caris Diagnostics, then merged in the fall of 2011 with a wholly-owned subsidiary of Miraca Holdings, Inc. (the "Merger"). Miraca was Japan's largest clinical diagnostics and laboratory testing company. In the Merger, Miraca paid $725 million for what was left of Caris after the Spinoff ("RemainCo"). Each share of RemainCo stock was converted into the right to receive $4.46 in cash. David Halbert, who owned 70.4% of Caris' stock, and JH Whitney VI, L.P., a private equity firm that owned 26.7% of Caris' stock, received total proceeds of $560 million from the Merger, and financed SpinCo by reinvesting $100 million.

The remaining 2.9% of Caris' stock was held by employees through options. The employees had their options cancelled as part of the Merger, and received $4.46 for RemainCo. Under the capitalization adjustment provision of Section 12.1, the employees received $0.61 for SpinCo. Thus, the employees received $4.46 per share of RemainCo, and $0.61 per share for SpinCo, for a total consideration of $5.07 per share of Caris. Of this amount, 8% went into an escrow account established under the Merger agreement. The employees had the right to receive as additional consideration for cancellation of their options a portion of the escrow upon the release from escrow of any remaining amounts after all claims against the escrow had been released or satisfied.

SpinCo was valued at $65 million, or $0.61 per share; of this amount, TargetNow was valued at $47.23 million, and Carisome was valued at $17.79 million. Under this valuation, SpinCo would not recognize a corporate-level tax on the Spinoff. Accordingly, neither Halbert nor Whitney Fund VI would bear the economic cost of a tax liability. However, Caris could not undervalue SpinCo for tax purposes while valuing it fairly for the option holders. In performing the valuation of SpinCo, Halbert and Whitney Fund VI faced the choice between a zero-tax valuation that would generate an unrealistically low payout for the options, and a realistic valuation that would result in Halbert and Whitney Fund VI paying tax on 97% of the equity.

The court held that the valuation of SpinCo was not made in good faith, and was arbitrary and capricious. The $65 million valuation was generated by Caris' tax advisor, PricewaterhouseCoopers (the "Tax Advisor"), which used an intercompany transfer tax valuation of intellectual property to determine the fair market value of SpinCo's businesses. Critically, the transfer tax valuation excluded goodwill as an asset.

Caris' CFO told the Tax Advisor where to come out, and supplied the Tax Advisor reduced projections to support the valuation he wanted. The Tax Advisor's valuation conflicted with the CFO's subjective belief from earlier in the year that TargetNow was worth between $150 and $300 million. It also conflicted with the views held by Halbert, Whitney Fund VI, and Caris' financial advisor, Citigroup Global Markets. Furthermore, it conflicted with higher values that a different accounting firm, Grant Thornton LLP (the "Second Advisor"), generated for the same businesses in valuation reports prepared in 2011.

Miraca questioned the Tax Advisor's valuation, and insisted on a second opinion from the Second Advisor. The CFO and Tax Advisor met with the Second Advisor before it started work. Two days later, the CFO sent an e-mail to Halbert that precisely anticipated the range of consideration per share that the two reports would support. The Second Advisor then proceeded to prepare a valuation that abandoned the methodologies it had used for its prior valuation reports, and largely copied the Tax Advisor's analysis.

For example, in 2008, Caris paid $40 million for TargetNow when it was generating $1 million in annual revenue. At the time of the Merger, its revenue had increased by 5,000% to approximately $50 million, but the Second Advisor's valuation reflected an increase in value of only 17%. Furthermore, the Second Advisor's ordinary course asset impairment analyses valued TargetNow's trade name and clinical database at $104 million excluding debt.

In addition, JH Whitney had made a presentation to its advisory board that valued its 26.7% interest in TargetNow at $41 million, which reflected a $153 million valuation for TargetNow.

With respect to Carisome, Halbert's and Whitney Fund VI's decision to reinvest $100 million in Carisome showed confidence in its prospects. Moreover, the Second Advisor's prior valuation reports for the stock options valued Carisome at between $116 and $199 million. However, the Second Advisor reached the same valuation for Carisome as the Tax Advisor even though the Second Advisor used materially different inputs in its analysis.

The court found that the fair market value of SpinCo was $305.03 million, or $2.11 per share. Accordingly, the option holders were entitled to receive the sum of $4.46 and $2.11 for a total of $6.57 for each share of Caris represented by an option, rather than $5.07 for each share.[611]

[611] After the Delaware Supreme Court affirmed the trial court's judgment, the parties entered into a settlement agreement that provided for damages of $24 million, rather than the $16.3 million awarded by the trial court. The trial court's opinion had a clerical error that stated an erroneous value for one of the spun-off subsidiaries. The error subtracted from the total valuation of the spun-off subsidiaries, instead of adding to it. Vince Sullivan, "Clerical Error Spurs $24M Deal To End Caris Merger Suit," *Law360 Employment* (Portfolio Media June 23, 2016) (available at http://www.law360.com/articles/809787/clerical-error-spurs-24m-deal-to-end-caris-merger-suit).

The court also held that Caris breached its obligation under the Plan for the amount and timing of the payment on cancellation of the options by the holdback for the escrow:

> The Plan could have been drafted differently, such as by providing that holders of options cancelled in connection with the merger would receive the same consideration of holders of stock, less the exercise price. The Plan did not say that. The Plan said that holders of cancelled options would receive the difference between the Fair Market Value of the underlying shares and the exercise price for their options.
>
> Caris breached the Plan by deducting the escrow amount from the consideration it paid to holders of cancelled options. The Plan obligated Caris to pay them the full amount of the difference between Fair Market Value and the exercise price.[612]

[612] 2015 WL 4571398, at *35; *see also Hilton Hotels Corp. v. Dunnet*, 275 F. Supp. 2d 954 (W.D. Tenn. 2002) (option agreement prevented any nonconsensual amendment from "impair[ing] any rights or obligations under any Options;" option holders' interpretation that this provision prevented options from being cashed out was the more reasonable one).

Although the court did not consider the tax treatment of the option holders, the opinion raises a number of Section 409A issues. Since the court cited code Section 422(b)(4) for the rule that the exercise price for the options cannot be less than the fair market value of the underlying stock at the grant date, the options apparently were incentive stock options. Since the incentive stock option regulations use good faith as the standard for determining fair market value of stock at the grant date,[613] the Plan's use of good faith as the standard was in documentary compliance with the Section 409A exemption for incentive stock options.[614]

[613] Treas. Reg. §1.422-2(e)(2).

[614] Treas. Reg. §1.409A-1(b)(5)(ii).

For nonqualified stock options for stock not readily tradable on an established securities market, the Section 409A exemption requires that the stock underlying the option be valued by the "reasonable application of a reasonable valuation method."[615] This is a higher standard than good faith.[616] If a plan were to use a good faith standard, the IRS can take the position that the plan is not in documentary compliance with the Section 409A exemption.

[615] Treas. Reg. §1.409A-1(b)(5)(iv)(B)(3). Under Accounting Standards Update No. 2021-07 (Oct. 2021), the Financial Accounting Standards Board amended Financial Accounting Standards Board Accounting Standard Codification Topic 718 to provide that as a practical expedient, a nonpublic entity can determine the current price input of equity-classified share-based awards using the reasonable application of a reasonable valuation method. A reasonable valuation performed in accordance with Treas. Reg. §1.409A-1(b)(5)(iv)(B) is an example of a way to achieve the practical expedient. This rule allows private companies to satisfy the requirements of Section 409A and Topic 718 with one valuation.

[616] Department of the Treasury, Internal Revenue Service, "Application of Section 409A to

Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments," §III.D.4.a, 72 Fed. Reg. 19,234, 19,240 (April 17, 2007).

Furthermore, the escrow holdback on cash-out of the option raises the issue of whether it runs afoul of the Section 409A exemption for nonqualified stock options. One of the exemption's requirements is that the option not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of: (1) the exercise or disposition of the option under Treasury Regulation Section 1.83-7; and (2) the time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in Treasury Regulation Section 1.83-3(b).[617]

[617] Treas. Reg. §1.409A-1(b)(5)(i)(A)(1).

In the absence of an exception for payments on a change-in-control, payment of the holdback amount after cancellation of the option would likely be a feature for the deferral of compensation. In addition, the IRS can take the position that adoption of the escrow holdback arrangement after the grant of a nonqualified option is an impermissible extension of a stock right. An extension includes the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation.[618]

[618] Treas. Reg. §1.409A-1(b)(5)(v)(C)(1). For a discussion of the definition of an extension and its consequences under Section 409A, see *supra* notes 46 to 60 and accompanying text.

Fortunately, the Final Regulations provide an exception for payments on certain changes-in-control that allow for cash-outs without violating Section 409A.[619] The Proposed Regulations provide that this exception applies to incentive stock options, nonqualified stock options, and SARs exempt from Section 409A.[620]

[619] Treas. Reg. §1.409A-3(i)(5)(iv)(A).

[620] Prop. Treas. Reg. §1.409A-3(i)(5)(iv)(A) (as proposed at 81 Fed. Reg. 40,569, 40,582 (June 22, 2016)).

The Final Regulations permit deferred payments of compensation related to a change-in-ownership of a corporation (as defined in Treasury Regulation Section 1.409A-3(i)(5)(v)), or change in the ownership of a substantial portion of a corporation's assets (as defined in Treasury Regulation Section 1.409A-3(i)(5)(vi)), that occur because an employer purchases its stock held by the employee, the employer or a third-party purchases a stock right held by an employee, or the payments are calculated by reference to the value of the employer's stock (collectively, "transaction-based compensation").

The transaction-based compensation must be paid: (1) on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to the employer's stock; and (2) not later than five years after one of the permissible change-in-control events.

Upon satisfaction of these requirements, the transaction-based compensation is treated as paid at a designated date or pursuant to a payment schedule that complies with the Final Regulations, and the payment of the transaction-based compensation does not violate the initial or subsequent deferral election rules of Treasury Regulation Section 1.409A-2(a)–(b).[621]

[621] Treas. Reg. §1.409A-3(i)(5)(iv)(A); *see also* Daniel L. Hogans, "Mergers and Other Corporate Transactions," in *Section 409A Handbook* 17-1, 10 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

To prevent the situation that occurred in *CDx Holdings*, Alternative 2 of section 8(c) and 8(d) of the Model Plan grant the Administrator or Board the discretion on a permissible Section 409A change-in-control to cash-out vested options in full within thirty days after the consummation of the change-in-control, or to pay the cash-out amount as adjusted after the change-in-control on the same schedule and under the same terms and conditions that apply to payments to shareholders for up to five years.

ASSUMPTION AND SUBSTITUTION OF STOCK RIGHTS IN SECTION 424 CORPORATE TRANSACTIONS

The Final Regulations provide rules for when an assumption or substitution of a nonqualified stock option or SAR in a corporate transaction does not cause a modification to the stock right, and does not result in the loss of the stock right's status as service recipient stock.[622] A corporate transaction means: (1) an acquisition of property or stock, consolidation, liquidation, merger, reorganization, or separation; (2) a distribution (excluding an ordinary dividend or a stock split or stock dividend) or change in the terms or number of outstanding shares of the corporation; or (3) such other corporate events as may be prescribed by the IRS in published guidance.[623]

[622] Treas. Reg. §1.409A-1(b)(5)(iii)(E)(4) and (v)(D).

[623] Treas. Reg. §§1.409A-1(b)(5)(v)(D) and 1.424-1(a)(3).

The Model Plan satisfies these rules in the Section 424 Corporate Transaction provisions in section 8(e), and in the definition of “Section 424 Corporate Transaction” in section 25(ww).

The rules on assumption and substitution under the Final Regulations are largely borrowed from Treasury Regulation Section 1.424-1 of the incentive stock option regulations.[624] These rules prevent any improvement in the holder's economic position free of tax consequence, and allow the amount of the exercise price and number of shares to be adjusted when the stock rights are converted from the target's stock to the acquiror's stock.

[624] Treas. Reg. §1.409A-1(b)(5)(v)(D).

The Final Regulations do not adopt the requirement of the incentive stock option regulations that an eligible corporation must assume or grant the substituted option.[625] An eligible corporation is the employer of the optionee or a related corporation of the employer corporation determined immediately after the corporate transaction.[626] A related corporation means a parent or subsidiary under code Section 424(e)–(f).[627]

[625] Treas. Reg. §1.409A-1(b)(5)(v)(D).

[626] Treas. Reg. §1.424-1(a).

[627] Treas. Reg. §1.421-1(i)(2).

Under the incentive stock option regulations, the conversion must satisfy a spread test and ratio test. Under the spread test, the new right's aggregate spread of the excess of the fair market value of the shares over the exercise price must not exceed the old right's aggregate spread at the time of conversion.[628]

[628] Treas. Reg. §1.424-1(a)(5)(ii).

Under the ratio test, on a per share basis, the ratio of the exercise price to the fair market value of the shares must not be more favorable for the new right than it was for the old right at the time of conversion.[629] Thus, the ratio for the new right can only be the same or greater than the ratio for the old right. As long as the aggregate spread is maintained, each new right can be less in-the-money than the old right. Thus, the new right can have a larger number of shares with a smaller per share spread.

[629] Treas. Reg. §1.424-1(a)(5)(iii).

For nonqualified stock options and SARs, the Final Regulations adopt the spread test, and favorably modify the ratio test. The ratio test will be deemed satisfied if, on a per share basis, the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately after the conversion is not greater than the ratio of the exercise price to the fair market value of the shares immediately before the conversion.[630] Thus, the ratio for the new right can be less than the ratio for the old right. As long as the aggregate spread is maintained, each new right can be more in-the-money than the old right.

[630] Treas. Reg. §1.409A-1(b)(5)(v)(D).

The modification of the ratio test allows an acquiror to increase the number of shares subject to an existing stock right with a smaller per share spread, and decrease the number of shares subject to an existing stock right with a larger per share spread. In either case, the aggregate spread must be maintained. The modification also enables an acquiror to limit dilution by issuing options covering fewer shares than required under the incentive stock option regulations.

For nonqualified stock options and SARs, these rules raise the issue of whether the ratio test under the Final Regulations replaces the ratio test under the incentive stock option regulations, or is an alternative test to the test under the incentive stock option regulations. In other words, if an assumption or substitution satisfies either test, will the transaction avoid a modification and preserve service recipient stock status?

Counsel can reasonably take the position that satisfaction of either test is permissible. First, the language of the Final Regulations states that the ratio test of Treasury Regulation Section 1.424-1(a)(5)(iii) “will be deemed to be satisfied” if the test under the Final Regulations is satisfied. The use of this language is not language of replacement. Second, use of the alternative tests is not inconsistent with any policy of the Final Regulations.[631] Accordingly, for nonqualified stock options and SARs section 8(e)(i)–(ii)(B) of the Model Plan uses the alternative tests.

[631] *See* Erica F. Schohn, “Equity Arrangements,” in *Section 409A Handbook* 14-1, 21–23 (Regina Olshan & Erica F. Schohn eds., Bloomberg Law 2023).

The remaining requirements for an assumption or substitution are that the assumed or new stock right must: (1) contain all the terms of the old stock right except to the extent that the corporate transaction renders these terms inoperative;[632] and (2) not give the holder additional benefits that the holder did not have under the old stock right.[633]

[632] Treas. Reg. §1.424-1(a)(5)(iv).

[633] Treas. Reg. §1.424-1(a)(5)(v).

For example, an employee holds an option for 100 shares of the common stock of Oldco. Before Oldco's acquisition by Newco, the option's exercise price is $25, and the stock's fair market value is $40. The aggregate spread is $1,500, and the ratio of the exercise price to fair market value is 25/40, which is equal to .625. After the acquisition, a Newco option is substituted for the Oldco option. The Newco option is for sixty shares of the common stock of Newco, has an exercise price of $25, and the stock has a fair market value of $50. The aggregate spread is $1,500, and the ratio of the exercise price to fair market value is 25/50, which is equal to .5. The ratio after the acquisition is not greater than the ratio before the acquisition, and is more favorable to the employee. The ratio test of the Final Regulations is satisfied, but the ratio test of the incentive stock option regulations is not satisfied. The substitution does not result in a modification of the Oldco option.

As another example, the facts are the same as in the first example for the Oldco option. After the acquisition, a Newco option is substituted for the Oldco option. The Newco option is for 100 shares of the common stock of Newco, has an exercise price of $35, and the stock's fair market value is $50. The aggregate spread is $1,500, and the ratio of the exercise price to fair market value is 35/50, which is equal to .7. The ratio after the acquisition is greater than the ratio before the acquisition, and is not more favorable to the employee. The ratio test of the Final Regulations is not satisfied, but the ratio test of the incentive stock option regulations is satisfied. Under the position that the ratio tests of the Final Regulations and incentive stock option regulations are alternative tests, the substitution does not result in a modification of the Oldco option.

The assumption or substitution of a target's equity award in a merger or acquisition by an acquiror listed on the NYSE or NASDAQ raises the issue of whether shareholder approval under the listing rules is necessary for the assumption or substitution. These rules generally do not require shareholder approval to convert, replace, or adjust outstanding stock options or other equity awards in a merger or acquisition. In addition, if the target is not a listed company after the transaction, shares available for grant under the target's plan may be used for post-transaction grants of the acquiror's equity. These rules have the following requirements:

(1) the shares available for grant under the target's plan must be available under a pre-existing plan that was previously approved by the target's shareholders. A plan adopted in contemplation of the merger or acquisition is not considered pre-existing;

(2) the number of shares available for grant must be appropriately adjusted to reflect the transaction;

(3) the time period during which the shares are available for grant cannot be extended beyond the period in which they would have been available under the pre-existing plan absent the transaction; and

(4) the grants cannot be made to individuals who were employed immediately before the transaction by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction; as a result, the grants are limited to the target's employees continuing employment with the acquiror and new hires.[634]

[634] NYSE Listed Company Manual §303A.08; NASDAQ Rule 5635(c)(3), NASDAQ IM-5635-1 (March 12, 2009).

Section 2(g) and the definition of Substitute Award in Section 25(ddd) of the Model Plan satisfy the NYSE and NASDAQ requirements for the exemption from the shareholder approval requirement for the assumption or substitution of a target's equity award in a merger or acquisition.

ADJUSTMENTS ON EQUITY RESTRUCTURING EVENTS

The Final Regulations and incentive stock option regulations permit an adjustment of the exercise price and number of shares subject to options and SARs for stock splits (including reverse stock splits) and stock dividends.[635] Section 10(c) of the Model Plan provides that the Administrator or Board shall make this adjustment.

[635] Treas. Reg. §§1.409A-1(b)(5)(v)(H) and 1.424-1(e)(4)(v).

Section 10(a) of the Model Plan provides for mandatory adjustments of Awards on the occurrence of an equity restructuring event, and the adjustment is necessary or appropriate to prevent dilution or enlargement of Grantees’ rights. When an adjustment is made on the occurrence of an equity restructuring event, whether a plan uses a discretionary adjustment provision, or a mandatory adjustment provision, affects the accounting treatment of an equity compensation award.

Under Accounting Standards Codification Topic 718, on the grant date of an equity award (e.g., an option, stock-settled SAR, or restricted stock), the company recognizes a compensation expense equal to the fair value of the award. On an adjustment under a discretionary provision, the company records an additional compensation expense for a vested award equal to the excess of the fair value of the award immediately after the adjustment over the fair value of the award immediately before the adjustment. For an unvested award, the company amortizes this amount over the remaining service or performance period. Amortization of this amount is in addition to amortization of the remaining expense from the initial award. On an adjustment under a mandatory provision, the company does not record any additional compensation expense.[636]

[636] *See* PricewaterhouseCoopers LLP, "Modifications to Awards in an Equity Restructuring," in *Stock-based Compensation,* §4.5.2 at 4–18 (Nov. 2022) ("If awards are adjusted based on an existing antidilution provision that requires the adjustment in the event of an equity restructuring, and is properly structured to preserve the value of the awards upon completion of the equity restructuring, incremental fair value generally should not result from the modification. . . . In order for a company to conclude that an award's terms require modification in the event of an equity restructuring, we believe the terms of the award need to, at a minimum, specify that an 'equitable' or 'proportionate' adjustment is required (not just that the company 'may' make such an adjustment). It is not necessary for an antidilution provision to specify exactly how the awards will be adjusted. When assessing whether an antidilution provision is mandatory or discretionary, consideration should be given to whether the employees could require the company to make 'equitable' adjustments to an award's terms if an equity restructuring event occurs. In some cases, input from legal counsel may be necessary.").

See generally Frederic W. Cook & Co., Inc., "Accounting for Stock Compensation Under FASB ASC Topic 718" (Nov. 1, 2021) (available at http://www.fwcook.com/Publications-Events/Publications/).

INDEMNIFICATION, ADVANCEMENT, AND FEES FOR FEES

The Final Regulations contain an exemption from Section 409A for the employer's indemnification of the employee to the extent permissible under applicable law against all or part of the expenses incurred, or damages paid or payable by the employee, for a bona fide claim against the employee or employer.**[637]** The exemption also applies to the purchase of an insurance policy providing for payment of these items.**[638]** The indemnified expenses include amounts paid or payable by the employee in settlement when the claim is based on the employee's acts or failures to act in his or her capacity as an employee of the employer.**[639]** The indemnification provisions of section 18(a) and (c)–(f) of the Model Plan are intended to satisfy this exemption.

[637] Treas. Reg. §1.409A-1(b)(10). For the issues to consider in drafting indemnification provisions, see Joel Wolfson, "Language Issues in Drafting Indemnification Clauses in High-Tech Contracts," 3 *PLI Current: The Journal of PLI Press* 321 (Spring 2019).

[638] Treas. Reg. §1.409A-1(b)(10).

[639] *Id.*

Under corporate law principles, the right to indemnification and the right to advancement of attorneys' fees and other litigation expenses are separate rights.**[640]** Accordingly, section 18(b) of the Model Plan provides for advancement.**[641]**

[640] *Aleynikov v. The Goldman Sachs Group, Inc.*, 765 F.3d 350, 358–59 (3d Cir. 2014) ("Indemnification and advancement are related but distinct avenues by which a business entity pays for an individual's legal expenses. In both, the corporation pays the legal expenses of the officer, director, or other employee when that individual is accused of wrongdoing in the course of performing duties for the corporation. For indemnification, the corporation reimburses the individual for his or her legal expenses once he or she has been successful in the underlying proceeding on the merits or otherwise. For advancement, on the other hand, the corporation pays legal expenses on an ongoing basis in advance of the final disposition of the lawsuit, provided that the individual must repay the amount advanced if it turns out he or she is not entitled to be indemnified — i.e., he or she is not successful on the merits or otherwise in the underlying lawsuit.") (citations omitted) (Delaware law); *United States v. Stein*, 452 F. Supp. 2d 230, 272 (S.D.N.Y. 2006) (under Delaware corporation statutes, "a company that undertakes to advance defense costs may not avoid that obligation by claiming that the litigation against its former employee for which the employee seeks advancement of defense costs accuses the employee of conduct that, if proved, would foreclose indemnification or establish a breach of the employment contract or of a fiduciary or other duty owed to the company");

Booth Oil Site Administrative Group v. Safety-Kleen Corp., 137 F. Supp. 2d 228, 236 (W.D.N.Y. 2000) (under sections 721 to 725 of the New York Business Corporation Law and the Not-For-Profit Corporation Law, advancement of fees and indemnification are two distinct corporate obligations; advancement concerns interim relief during the pendency of an action, and indemnification is available only after resolution of the action and only if the defendant is found not liable for the claim alleged).

Homestore, Inc. v. Tafeen, 888 A.2d 204, 212–13 (Del. 2005) ("Although the right to indemnification and advancement are correlative, they are separate and distinct legal actions. The right to advancement is not dependent on the right to indemnification. The right to indemnification requires 'success on the merits or otherwise' in defending proceedings brought under section 145(a) or (b) [of the Delaware General Corporation Law]. Section 145(e), however, expressly contemplates that corporations may confer a right to advancement that is *greater* than the right to indemnification and recognizes that advances must be repaid if it is ultimately determined that the corporate official is not entitled to be indemnified.") (footnotes omitted).

[641] *See generally* William D. Johnston, "Flexibility Under Delaware Law in Drafting Advancement Provisions on a 'Clear Day,' and Potential Surprises For Those Who Do Not Take Advantage of That Flexibility," 13 *Delaware Law Review* 21 (2011); Andrew M. Johnston, Amy L. Simmerman & Jeffrey M. Gorris, "Recent Delaware Law Developments in Advancement and Indemnification: An Analytical Guide," 6 *New York University Journal of Law & Business* 81 (Fall 2009); Carina M. Meleca, "An 'Officer' and a G[old]man: The Third Circuit Finds Ambiguous Corporate Titles Jeopardize Right to Advancement Under Delaware Law in Aleynikov v. Goldman Sachs Group, Inc.," 60 *Villanova Law Review* 781 (2015); Richard A. Rossman, Matthew J. Lund & Kathy K. Lochmann, "A Primer on Advancement of Defense Costs: The Rights and Duties of Officers and Corporations," 85 *University of Detroit Mercy Law Review* 29 (Fall 2007); Megan Wischmeier Shaner, "Interpreting Organizational 'Contracts' and the Private Ordering of Public Company Governance," 60 *William & Mary Law Review 985* (Fall 2019).

Steven A. Radin, '"Sinners Who Found Religion:' Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing," 25 *Review of Litigation* 251 (2006); David A. Rothstein, Lorenz Michel Prüss & Elliot B. Kula, "Indemnification is Good, But Advancement is Even Better: Make Sure You Know the Difference and Level the Playing Field From the Start," 93-DEC *Florida Bar Journal* 8 (Nov./Dec. 2019); James D. Wing & Andrew L. Oringer, "Discipline Involving Multiple Disciplines — Protecting Innocent Executives in the Age of 'Cooperation,'" 70 *Business Lawyer* 1123 (Fall 2015).

James Wing, Geoffrey Fehling & Brian T.M. Mammarella, "Training for Tomorrow: 2021 Checklist for Entity Counsel Supervising the Creation or Renewal of an Executive Protection Program in the Age of 'Cooperation,'" *Business Law Today* (ABA Nov. 1, 2021) (available at https://businesslawtoday.org/2021/11/training-for-tomorrow-2021-checklist-for-entity-counsel-supervising-executive-protection-program/?utm_source=newsletter&utm_medium;=email&utm_campaign;=november21_articles).

The Final Regulations do not address advancement. There are three potential approaches for the treatment of advancement under the Final Regulations: (1) the exemption for indemnification; (2) the short-term deferral exemption; and (3) the rule for reimbursement of expenses or provision of in-kind benefits.

Counsel can reasonably take the position that since the purpose of advancement is to cover the expenses that come within the exemption for indemnification, this exemption should also cover advancement.[642]

[642] *Cf. Davis v. EMSI Holding Co.*, 2017 WL 1732386 (Del. Ch. May 3, 2017) (carve-out from general release given by seller to buyer in stock purchase agreement applied to "any right to indemnification that any Releasing Party has, in his or her capacity as an officer or director (or former officer or director), under the Governing Documents of the applicable EMSI Entity;" court held that since indemnification under EMSI's bylaws incorporated advancement, indemnification under the stock

purchase agreement also did; bylaws provided that the right to indemnification “shall include the right to be paid by the Corporation the expenses (including attorneys’ fees) incurred in defending any such Proceeding in advance of its final disposition”); *Sodano v. American Stock Exchange LLC*, 2008 WL 2738583 (Del. Ch. July 15, 2008) (Strine, V.C.) (indemnification carve-out in a settlement agreement preserved both indemnification and advancement rights of former officer and director; carve-out provided for corporation to indemnify “to the fullest extent permitted by law and the [company's] organizational documents;” bylaws provided for advancement in an article entitled only “indemnification; court held that agreement's language was best read as intending to cover both indemnification and advancement), *aff'd on the opinion below sub nom. American Stock Exchange LLC v. Financial Industry Regulatory Authority, Inc.*, 970 A.2d 256 (Del. 2009) (Table).

To rely on the short-term deferral exemption for advancement is problematic for two reasons. First, the right to advancement may not be subject to a substantial risk of forfeiture.[643] Compensation is subject to a substantial risk of forfeiture if entitlement to it is conditioned on the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. A condition related to a purpose of the compensation must relate to the employee's performance for the employer, or the employer's business activities or organizational goals; for example, the attainment of a prescribed level of earnings or equity value, or completion of an initial public offering.[644]

[643] Treas. Reg. §1.409A-1(b)(4)(i)(A) and (C) and (d)(1).

[644] Treas. Reg. §1.409A-1(d)(1).

Under this rule, the IRS can take the position that an employee vests in the right to advancement when the employee acquires the contractual right to advancement, and not when a claim is asserted that triggers the employer's obligation to advance the indemnified expenses. In other words, the assertion of a claim is not a condition that relates to the employee's performance for the employer, or the employer's business activities or organizational goals. The Delaware case law on advancement and indemnification is consistent with this position, and provides that a director or employee vests in these rights at the time of that person's service when the act or omission giving rise to the claim occurred.[645]

[645] *Marino v. Patriot Rail Co. LLC*, 131 A.3d 325, 343 n. 19 (Del. Ch. 2016); *Salaman v. National Media Corp.*, 1992 WL 808095, at *6 (Del. Super. Oct. 8, 1992).

Furthermore, depending on the facts, the IRS can take the position that regardless of whether the assertion of a claim is a condition related to the employee's performance or the employer's business activities, the possibility of forfeiture is not substantial.

Second, once a claim is asserted that triggers the employer's advancement obligation, it is unlikely that the advancement of expenses through the final resolution of the claim will be completed within the short-term deferral period.[646]

[646] See discussion of the short-term deferral period *supra* notes 574 to 579 and accompanying text.

The rule for the reimbursement of expenses or provision of in-kind benefits is a method to satisfy the permissible payment time of a specified time or fixed schedule for deferred compensation subject to Section 409A.[647] The requirements of the rule are:

[647] I.R.C. §409A(a)(2)(A)(iv); Treas. Reg. §1.409A-3(a)(4) and (i)(1)(iv)(A).

(1) the plan provides an objectively determinable, nondiscretionary definition of the expenses eligible for reimbursement or the in-kind benefits to be provided;

(2) the plan provides for the reimbursement of expenses incurred or the provision of the in-kind benefits during an objectively and specifically prescribed period (including the employee's lifetime);

(3) the plan provides that the amount of expenses eligible for reimbursement, or in-kind benefits to be provided, during an employee's taxable year may not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year;

(4) the reimbursement of an eligible expense is made on or before the last day of the employee's taxable year following the taxable year in which the expense was incurred; and

(5) the right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.[648]

[648] Treas. Reg. §1.409A-3(i)(1)(iv)(A).

Since the Final Regulations do not define "objectively determinable" or "nondiscretionary,"[649] and these terms are otherwise vague,[650] section 18(h)(i)–(iii) of the Model Plan takes a conservative approach in satisfying the first requirement. Section 18(h)(i)–(iii) caps the Advanced Amounts to the Maximum Fees and Maximum Disbursements. Section 18(h)(ii) defines "Maximum Fees" by reference to the average hourly rates of different groups of personnel in the ten largest accounting firms, actuarial firms, and law firms in the United States. Section 18(h)(iii) provides a similar definition of "Maximum Disbursements."

[649] The *Shorter Oxford English Dictionary* defines "objective" as "[d]ealing with or laying stress on what is external to the mind; concerned with outward things or events; presenting facts uncoloured by feelings, opinions, or personal bias; disinterested." 2 *Shorter Oxford English Dictionary*, "Objective," sense 9, subsense a, at 1969 (6th ed. Oxford University Press 2007). In the arm's length relationship between employer and employee, most expenses subject to negotiation over reimbursement should satisfy this definition. In addition, in the arm's length relationship between the employee and the third-party provider of services to the employee, most expenses for the services that are subject to negotiation between the employee and third-party service provider should satisfy this definition.

The *Shorter Oxford English Dictionary* defines "discretion" as the "[f]reedom to decide or act as one thinks fit, absolutely or within limits; having one's own judgment as sole arbiter." 1 *Shorter Oxford English Dictionary*, "Discretion," sense 4, subsense a, at 701 (6th ed. Oxford University Press 2007). Does this definition mean that if the third-party service provider, such as an accounting firm or law firm, retains the discretion to periodically increase its fees, the fees are discretionary? Does this definition also mean that if the expenses eligible for reimbursement are subject to negotiation between the employee and third-party service provider, or renegotiation after expiration of the contract term, the expenses are discretionary? Finally, does this definition mean that once negotiations with a third-party service provider are concluded, the expenses are no longer discretionary?

[650] *See generally* Albert Choi & George Triantis, "Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions," 119 *Yale Law Journal* 848 (2010); Mark Cooney, "Analogy Through Vagueness," 16 *Legal Communication & Rhetoric* 85 (Fall 2019); Robert E. Scott, "Contract Design and the Shading Problem," 99 *Marquette Law Review* 1 (Fall 2015).

Section 18(h)(ix) satisfies the second requirement. It provides that the obligation to pay Advanced Amounts will apply from the date that an Indemnitee first has the right to act in the Plan's administration until the expiration of the statute of limitations as it may be tolled or extended for each claim by the Indemnitee for payment of an Advanced Amount (the "Claim Period"). If a claim is made during the Claim Period, the obligation will continue beyond the Claim Period until the final and nonappealable resolution of the claim.

Section 18(h)(vi) satisfies the third requirement.

Section 18(b)(iv) satisfies the fourth requirement of payment by the end of the taxable year following the taxable year in which the expense was incurred. It provides that the Company shall pay the Advanced Amounts within thirty days after its receipt of each statement from the Indemnitee describing the Advanced Amounts in reasonable detail and requesting payment thereof.

Section 18(h)(vii) satisfies the fifth requirement.

Finally, when a plan document does not satisfy the rule for reimbursements, the plan is eligible for the IRS correction program for document failures.[651]

[651] IRS Notice 2010-6, 2010-1 C.B. 275, §VII.F.

Section 18(h)(iv) of the Model Plan provides for the six month delay for specified employees of publicly-traded corporations when the obligation to pay Advanced Amounts is triggered on a Separation From Service.[652] A plan document that does not satisfy the requirements for the six month delay is eligible for the IRS correction program for document failures.[653]

[652] I.R.C. §409A(a)(2)(B)(i); Treas. Reg. §§1.409A-1(c)(3)(v) and 1(i), and 1.409A-3(a)(1) and (i)(2).

[653] IRS Notice 2010-6, 2010-1 C.B. 275, §VIII.

In addition, under corporate law principles the right to indemnification or advancement does not necessarily cover the attorney's fees and litigation expenses that an employee incurs in bringing a claim against the employer to recover on the employer's indemnification or advancement obligation ("Fees for Fees").[654] When the right to indemnification does not cover Fees for Fees, a separate provision for the payment of Fees for Fees is necessary. Section 18(g) of the Model Plan contains a separate provision for the payment of Fees for Fees.

[654] For cases holding that a general indemnification does not cover Fees for Fees in the absence of a clause that provides for them, see *Stephens Inc. v. Flexiti Financial Inc.*, 2019 WL 2725627 (S.D.N.Y. July 1, 2019); *MCM Holdings, Inc. v. Levy*, 2017 U.S. Dist. LEXIS 107022 (S.D. Fla. July 10, 2017) (Florida law); *Islip U-Slip LLC v. Gander Mountain Co.*, 2 F. Supp. 3d 296, 308–09 (S.D.N.Y. 2014) ("Courts in the Second Circuit have employed the following principles of construction to determine whether indemnification provisions are intended to include attorneys' fees in suits between parties to the contract: (1) the analysis begins with the presumption that the agreement does not cover attorneys' fees in an action between the parties; (2) a provision containing only broad language that does not unequivocally indicate that the parties intended to indemnify attorneys' fees will not support such a claim; (3) if it is apparent that no third-party claims were contemplated between the parties, the agreement should be construed to provide indemnity for claims between the parties; (4) likewise, if future third-party claims were possible at the time of the contract, there should be no indemnification for suits between the parties; and (5) indemnification provisions that specifically distinguish third-party claims from interparty claims indicate an intent to cover claims between the parties.") (citation omitted), *aff'd*, 561 F. App'x 48 (2d Cir. 2014); *In re Paragon Trade Brands, Inc.*, 324 B.R. 829 (N.D. Ga. 2005); *Great Hill Equity Partners IV, L.P. v. SIG Growth Equity Fund I, LLLP*, 2020 WL 7861336, at *5 (Del. Ch. Dec. 31, 2020) (merger agreement for an acquisition by a private equity fund provided for indemnification of losses "whether or not arising out of third-party claims" including reasonable legal fees and expenses; this language was insufficiently clear and unequivocal to shift fees in disputes between the parties, especially when another provision in the agreement specifically addressed fee shifting in such disputes), *aff'd on opinion below sub nom. Herzog v. Great Hill Equity Partners IV, LP*, 2021 WL 5993508 (Del. Dec. 20, 2021) (Table) (unpublished disposition); *Winshall v. Viacom International Inc.*, 2019 WL 5787989 (Del. Super. Ct. Nov. 6, 2019); *Senior Housing Capital, LLC v. SHP Senior Housing Fund, LLC*, 2013 WL 1955012, at *44 (Del. Ch. May 13, 2013) (Strine, V.C.) (indemnity agreements are presumed not to require reimbursement for attorneys' fees incurred as a

result of substantive litigation between the parties to the agreement absent a clear and unequivocal articulation of that intent); *Flaherty & Collins, Inc. v. BBR-Vision, L.L.P.*, 990 N.E.2d 958, 968 (Ind. Ct. App. 2013), *transfer denied*, 996 N.E.2d 1278 (Ind. 2013); *Kessler v. Gleich*, 13 A.3d 109 (N.H. 2010); *Baker v. Health Management Systems, Inc.*, 745 N.Y.S.2d 741, 743, 746 (2002); *Hooper Associates, Ltd. v. AGS Computers, Inc.*, 549 N.Y.S.2d 365, 367 (1989); *Needham & Co., LLC v. UPHealth Holdings, Inc.*, 183 N.Y.S.3d 30 (App. Div. 2023); *546-552 West 146th Street LLC v. Arfa*, 950 N.Y.S.2d 24 (App. Div. 2012); *Ganske v. Spence*, 129 S.W.3d 701, 708 (Tex. Ct. App. 2004).

For cases holding that a broad indemnification provision covers Fees for Fees, see *Wal-Mart Stores, Inc. v. Qore, Inc.*, 647 F.3d 237 (5th Cir. 2011) (Mississippi law); *AMS Sensors USA Inc. v. Renesas Electronics America Inc.*, 2022 WL 3270007 (E.D. Tex. Aug. 10, 2022) (California law); *Zalkind v. Ceradyne, Inc.*, 124 Cal. Rptr. 3d 105 (Ct. App. 2011); *Shah v. 20 East 64th Street, LLC*, 154 N.Y.S.3d 6, 20–22 (App. Div. 2021); *WSA Group, PE., PC v. DKI Engineering & Consulting USA PC*, 116 N.Y.S.3d 719, 724– 25 (App. Div. 2019); *Crossroads ABL LLC v. Canaras Capital Management, LLC*, 963 N.Y.S.2d 645, 645–46 (App. Div. 2013).

Cf. Stifel Financial Corp. v. Cochran, 809 A.2d 555, 561–62 (Del. 2002) (corporate bylaws provided for indemnification to the full extent authorized by law of any person in any action, suit, or proceeding by reason of the fact that he is or was a director; court interpreted the indemnification "in any action" of Section 145(a) of the Delaware General Corporation Law broadly to cover expenses incurred by a director in successfully prosecuting an indemnification suit; broad interpretation promoted the policies to promote the desirable end that corporate officials resist unjustified suits and claims, and to encourage capable persons to serve as corporate directors); *International Rail Partners LLC v. American Rail Partners*, 2020 WL 6882105 (Del. Ch. Nov. 24, 2020) (LLC agreement provided that the company shall indemnify, defend, and hold harmless each covered person against any losses and claims arising from any and all claims, actions, or proceedings in connection with any matter arising out of the company's business or the LLC agreement; court held that this provision covered claims between the company and a covered person; Section 18-108 of the Delaware LLC Act allows an LLC to provide for indemnification for any and all claims subject to such standards and restrictions, if any, as are set forth in the LLC agreement; "Unlike typical commercial contracts, indemnification and advancement provisions in LLC agreements are derived from clear statutory authority and apply much more broadly"), *interlocutory appeal refused*, *245 A.3d 1317* (Del. 2021) (Table).

See also Jeannemarie O'Brien, "Preparing for the Unexpected: A Change of Control in 2022," in *Hot Issues in Executive Compensation*, at 173, 191 (PLI 2022) ("Another part of the change-of-control agreement is the legal fee reimbursement provision. The purpose of the legal fee provision is to level the playing field due to the disparity in financial resources between the employer and the individual seeking to enforce his or her rights under the agreement, not to encourage frivolous litigation. Consideration should be given as to the applicable standard for the executive being entitled to reimbursement for reasonable legal fees. In change-of-control agreements, it is common for the executive to be entitled to reimbursement regardless of the outcome of the dispute, although alternative standards require the executive to prevail on one material issue or for his or her position not to be found to be frivolous.").

George Bundy Smith & Thomas J. Hall, "Extending Indemnification Clauses To Claims Between Contracting Parties," *New York Law Journal*, Aug. 20, 2010, at 3.

Under the Final Regulations, the exemption from Section 409A for indemnification does not apply to Fees for Fees. Fortunately, the Proposed Regulations provide an exemption for them. The proposed exemption provides that a plan does not provide for a deferral of compensation "to the extent it provides for a payment of reasonable attorneys' fees or other reasonable expenses incurred by the service provider to enforce any bona fide legal claim against the service recipient with respect to the service relationship between the service provider and the service recipient."[655]

[655] Prop. Treas. Reg. §1.409A-1(b)(11) (as proposed at 81 Fed. Reg. 40,569, 40,580 (June 22, 2016)). The Final Regulations already provide an exemption for "amounts paid as settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, including claims under applicable Federal, state, local, or foreign laws, or for reasonable attorneys' fees or other reasonable expenses incurred by the service provider related to such bona fide legal claims, regardless of whether such settlements, awards, or reimbursement or payment of expenses pursuant to such claims are treated as compensation or wages for Federal tax purposes." Treas. Reg. §1.409A-1(b)(11).

ELECTRONIC DELIVERY OF AWARDS

Employers often use electronic delivery systems to make awards of equity compensation. Section 21 of the Model Plan provides for the use of electronic delivery and signatures. To ensure that the employer obtains an enforceable agreement by the employee to the plan and award documents,[656] the employer should use a clickwrap[657] or scrollwrap process,[658] rather than a browsewrap[659] or sign-in wrap process.[660] The process should provide the employee with a reasonable opportunity to review the plan and award documents, require the employee to acknowledge his or her receipt and review of the documents, and obtain the employee's agreement to the documents.[661]

[656] *See* Woodrow Hartzog, "Website Design as Contract," 60 *American University Law Review* 1635 (2011); Curtis E.A. Karnow, "The Internet and Contract Formation," 18 *Berkeley Business Law Journal* 135 (2021); Nancy S. Kim, "Adhesive Terms and Reasonable Notice," 53 *Seton Hall Law Review* 85 (2022); Nancy S. Kim, "New Developments in Digital and Wrap Contracts," 76 *Business Lawyer* 349 (Winter 2020–2021); Nancy S. Kim, "Digital Contracts," 75 *Business Lawyer* 1683 (Winter 2019–2020); Juliet M. Moringiello & William L. Reynolds, "From Lord Coke to Internet Privacy: The Past, Present, and Future of the Law of Electronic Contracting," 72 *Maryland Law Review* 452 (2013); Stephen L. Sepinuck, "Designing a User Interface for Customer Assent," 11 *Transactional Lawyer* 1 (June 2021); A.J. Zottola, Christopher Kim, Allison Laubach & Stephanie Molyneaux, "Online Contract Formation," 22 No. 4 *Journal of Internet Law* 3 (Oct. 2018).

See also Nancy S. Kim, "Online Contracts," 78 *Business Lawyer* 275, 280 (Winter 2022–2023) ("First, online contract formation requires that the seller communicate reasonable notice of the terms to the user. Reasonable notice requires either actual notice or notifying terms that are presented so that a reasonably prudent user would have been aware of them given the totality of the circumstances (including consideration of the website features, interface, and website interaction). Second, reasonable notice is not sufficient to form a contract; the user must also have manifested asset to the terms. Manifestation of assent requires unambiguous language that indicates that a given action constitutes assent. Although the court [in *Sarchi v. Uber Technologies, Inc.*, 268 A.3d 258 (Me. 2022)] did not rule that any given category of wrap contract was unenforceable, it clearly stated that browsewraps and sign-in wraps were less likely to be enforceable than clickwraps and scrollwraps because the former lack a clear and unambiguous manifestation of assent by the user.").

[657] A clickwrap process means website users are first after presented with reasonable notice of an agreement's provisions. The users must then manifest consent to the agreement by clicking on a radio button or checkbox that is in close proximity to a hyperlink to the full agreement, and that is also in close proximity to a statement instructing users that their click constitutes consent to the agreement. *See, e.g.*, *ADP, LLC v. Lynch*, 678 F. App'x 77, 80 (3d Cir. 2017); *Nguyen v. Barnes & Noble*, 763 F.3d 1171, 1175–76 (9th Cir. 2014); *Specht v. Netscape Communications Corp.*, 306 F.3d 17, 28–30 (2d Cir. 2002) (Sotomayor, J.).

See also Nancy S. Kim, Juliet M. Moringiello & John E. Ottaviani, "Notice and Assent Through Technological Change: The Enduring Relevance of the Work of the ABA Joint Working Group on Electronic Contracting Practices," 75 *Business Lawyer* 1725 (Spring 2020); American Bar Association

Joint Working Group on Electronic Contracting Practices, “Click-Through Agreements: Strategies for Avoiding Disputes on Validity of Assent,” 57 *Business Lawyer* 401 (Nov. 2001) (article presented five categories of strategies: opportunity to review terms; display of terms; acceptance or rejection of terms; opportunity to correct errors; and keeping records to prove assent).

658 An enforceable scrollwrap process must provide the user with a meaningful opportunity to review and scroll through the agreement. For cases enforcing scrollwrap agreements, *see, e.g.*, *Starkey v. G Adventures, Inc.*, 796 F.3d 193, 197 (2d Cir. 2015); *Hancock v. American Telephone & Telegraph Co., Inc.*, 701 F.3d 1248, 1256 (10th Cir. 2012), *cert. denied*, 569 U.S. 948 (2013).

For cases declining to enforce scrollwrap agreements, *see, e.g.*, *Nicosia v. Amazon.com, Inc.*, 834 F.3d 220 (2d Cir. 2016); *Sgouros v. TransUnion Corp.*, 817 F.3d 1029, 1035–36 (7th Cir. 2016).

659 A browsewrap process means website users are presented with the agreement via a hyperlink at the bottom of the screen, and the user can continue to use the website without visiting the webpage hosting the browsewrap agreement or even knowing that the webpage exists. A browsewrap agreement is enforceable only when the user has actual or constructive knowledge of the agreement. *See, e.g.*, *Register.com, Inc. v. Verio, Inc.*, 356 F.3d 393, 403 (2d Cir. 2004).

When the user does not have actual knowledge of the agreement, enforceability turns on whether the website provides a reasonably prudent user with inquiry notice of the agreement. In determining whether there is inquiry notice, courts consider the clarity, conspicuousness, and placement of the terms of use hyperlink, other notices given to users of the terms of use, and the website's design. Courts often require a conspicuous hyperlink or a display of a portion of the agreement's text, and an explicit text referring to the agreement or instructing the user that he or she is consenting to the agreement. *See, e.g.*, *Small Justice LLC v. Xcentric Ventures LLC*, 99 F. Supp. 3d 190 (D. Mass. 2015) (browsewrap agreement enforceable), *aff'd*, 873 F.3d 313 (1st Cir. 2017).

For cases declining to enforce browsewrap agreements, *see, e.g.*, *Wilson v. Huuuge, Inc.*, 944 F.3d 1212 (9th Cir. 2019); *Starke v. SquareTrade, Inc.*, 913 F.3d 279 (2d Cir. 2019); *Cullinane v. Uber Technologies, Inc.*, 893 F.3d 53 (1st Cir. 2018); *Nguyen v. Barnes & Noble*, 763 F.3d 1171 (9th Cir. 2014); *Specht v. Netscape Communications Corp.*, 306 F.3d 17 (2d Cir. 2002) (Sotomayor, J.).

See also Soliman v. Subway Franchisee Advertising Fund Trust, Ltd., 999 F.3d 828, 839 (2d Cir. 2021) (“[C]ompanies relying on the mixed-media incorporation of contractual terms involving a combination of a print advertisement, text messaging, and a website (rather than a purely paper or purely web-based medium) must take into account the practical obstacles in each situation relating to the conspicuousness of the notice, as well as access to the terms and conditions, that may be created by the various modes of communication being utilized.”).

*See generally*Nancy S. Kim, Juliet M. Moringiello & John E. Ottaviani, “Notice and Assent Through Technological Change: The Enduring Relevance of the Work of the ABA Joint Working Group on Electronic Contracting Practices,” 75 *Business Lawyer* 1725 (Spring 2020); American Bar Association Joint Working Group on Electronic Contracting Practices, “Browse-Wrap Agreements: Validity of Implied Consent in Electronic Form Agreements,” 59 *Business Lawyer* 279, 281 (Nov. 2003) (a user should be bound by an electronic agreement only if: “(1) The user is provided with adequate notice of the existence of the proposed terms. (2) The user has a meaningful opportunity to review the terms. (3) The user is provided with adequate notice that taking a specified action manifests assent to the terms. (4) The user takes the action specified in the latter notice.”).

660 A sign-in wrap process means that the website notifies the user of the website's terms of use as the user proceeds through the website's sign-in or login process. For cases enforcing sign-in wrap agreements, *see, e.g.*, *Oberstein v. Live Nation Entertainment, Inc.*, 60 F.4th 505 (9th Cir. 2023); *Meyer v. Uber Technologies, Inc.*, 868 F.3d 66 (2d Cir. 2017); *Grice v. Uber Technologies, Inc.*, 2020 WL 497487 (C.D. Cal. Jan. 7, 2020), *petition for writ of mandamus denied*, 974 F.3d 950 (9th Cir.

2020).

For cases declining to enforce sign-in wrap agreements, *see, e.g.*, *Berman v. Freedom Financial Network, LLC*, 30 4th 839 (9th Cir. 2022); *McKee v. Audible, Inc.*, 2017 WL 4685039 (C.D. Cal. July 17, 2017); *Metter v. Uber Technologies, Inc.*, 2017 WL 1374579 (N.D. Cal. April 17, 2017); *Berkson v. Gogo LLC*, 97 F. Supp. 3d 359, 400–02 (E.D.N.Y. 2015) (Weinstein, J.).

See also Nancy S. Kim, "Online Contracts," 78 *Business Lawyer* 275, 275 (Winter 2022–2023) ("Sign-in wrap agreements are dubious and require that notifying terms be conspicuous *and* expressly advise users that taking a specified action signifies assent.").

661 *See, e.g.*, *Cullinane v. Uber Technologies, Inc.*, 893 F.3d 53 (1st Cir. 2018); *Meyer v. Uber Technologies, Inc.*, 868 F.3d 66 (2d Cir. 2017); *Berkson v. Gogo LLC*, 97 F. Supp. 3d 359, 384, 386–87, 401–03 (E.D.N.Y. 2015) (Weinstein, J.).

For the employer to obtain an additional degree of protection, the process should require the employee to scroll through the plan and award documents before the employee can click on an "accept" button to complete the transaction. The process should also provide a table of contents for each document with hyperlinks to each section of the document. Each document's vesting, restrictive covenant, forfeiture, and clawback provisions should be in separate sections.

It is important that the language used to show the employee's acceptance be unequivocal. In *Shockley v. PrimeLending*,[662] the employer electronically delivered an employee handbook with an arbitration provision. The employee accessed the handbook by using a computer to click and open company documents. Clicking on the handbook automatically generated an acknowledgment of review, and the employee was advised that by entering into the computer system she acknowledged her review of the handbook. That same click would also have generated a pop-up window containing a hyperlink to open the full text of the handbook. The court held that under Missouri law the employee's document review and the system-generated acknowledgment did not create an unequivocal acceptance of the arbitration provision.

662 929 F.3d 1012 (8th Cir. 2019).

To avoid the result in *Shockley*, the process should require the employee to provide an electronic signature following language that states the employee accepts all the provisions of the document. Alternatively, the process should require the employee to scroll to the end of the document before the employee clicks an "I accept" button.

In *Cameron International Corp. v. Guillory*,[663] the court enforced an RSU agreement that the employer sent via e-mail to the employee. The e-mail instructed the employee that "[t]he Notice of Grant of Award and RSU Agreement . . . should be accepted online at www.etrade.com as soon as possible." The instructions provided for the following steps:

663 445 S.W.3d 840 (Tex. Ct. App. 2014), *rehearing denied*, 2014 Tex. App. LEXIS 13186 (Oct. 23, 2014).

> To accept your new award, click on Requires Acceptance under the Status column.
>
> a. You are required to open and review each document before you can accept the award. You will not be able to accept the award without opening each document.
>
> b. To accept your award, enter your Login Password and click on the Accept button. A confirmation of Acceptance message will appear.
>
> c. Copies of the award documents and Confirmation of Acceptance page may then be printed for your file.

The website activity history showed that the employee opened the RSU agreement and answered a prompt stating that he read and understood the agreement. An archived screenshot of the page containing the Accept button showed:

> a notice above the button entitled **"Message From Your Company,"** explaining: "By acceptance of this Award you agree to be bound by the terms and conditions of the [RSU] Agreement."
>
> A direction to review certain grant documents, and
>
> Appearing immediately above the Accept button, a statement declaring **"I acknowledge that I have reviewed and understood the following grant document(s),** followed by a list of download links for each document.

The RSU agreement also contained a Delaware choice-of-law clause, and the following provision entitled, "Electronic Delivery/Acceptance:"

> The Company may, in its sole discretion, decide to deliver any documents related to the RSUs by electronic means. The Participant hereby consents to receive such documents by electronic delivery and agrees to participate in the Plan through an on-line or electronic system established and maintained by the Company or a third party designated by the Company.

The court upheld the Delaware choice-of-law clause. Under Delaware law, the employee's electronic acceptance of the RSU agreement created a binding contract. Delaware adopted the Uniform Electronic Transactions Act, which provides that as long as the parties have agreed to conduct a transaction by electronic means, a "record or signature may not be denied legal effect or enforceability solely because it is in electronic form," or "because an electronic record was used in its formation."[664]

[664] Del. Code Ann. Tit. 6, subtit. II, §§12A-107(a), B, 12A-108.

Furthermore, under Delaware law, the employee's failure to carefully read the agreement before electronically accepting it did not make it unenforceable.[665]

[665] *Scion Breckenridge Managing Member, LLC v. ASB Allegiance Real Estate Fund*, 68 A.3d 665, 677 (Del. 2013); *Pellaton v. Bank of New York*, 592 A.2d 473, 477 (Del. 1991); *Newell Rubbermaid, Inc. v. Storm*, 2014 WL 1266827, at *7–8 (Del. Ch. March 27, 2014).

In holding that the clickwrap agreement was enforceable, the court relied on *Newell Rubbermaid, Inc. v. Storm*.[666] In *Newell*, the employer awarded RSUs in 2011, 2012, and 2013. The 2013 award agreement contained confidentiality and nonsolicitation covenants, but the 2011 and 2012 award agreements did not.

[666] 2014 WL 1266827 (Del. Ch. March 27, 2014).

The employer made the awards and the employee accepted them through the following online procedure. The employee went to a website operated by Fidelity Investments, which maintained the investment and retirement accounts of the employer's employees. Once at the website, the employee first had to select that he or she will accept the grant from a list of "Unaccepted Grants." The employee would then navigate to a page that explained more fully how to accept the award. Therein, a box entitled, "Grant Terms and Agreement," stated that "[y]ou must read your Grant Agreement and review the terms to continue."

Below that was a hyperlink to a "Grant Agreement (PDF)," which the user could click to review the agreement. Upon clicking on the hyperlink, the Grant Agreement appeared as a lengthy scrolling pop-up.

Under the hyperlink, a checkbox was accompanied by text that read: "I have read and agree to the terms of the Grant Agreement." Below that, bold text provided: "To complete your Grant Agreement online, you must read and accept the terms outlined in the document posted above. . . . Your grant acceptance will be final once you click Accept. To cancel the transaction, click the Cancel link." "Previous" and "Accept" buttons appeared below as did a link allowing the user to "Cancel." Text under the "Accept" button read "Submit Grant Acceptance."

The court held that under this procedure, the employee had reasonable notice, whether actual or constructive, of the terms of the 2013 award agreement, and that the employee consented to those terms. The confidentiality and nonsolicitation covenants were in normal-sized font, preceded by clear titles, and were easily ascertainable had the employee read the 2013 award agreement. Accordingly, the employer did not have any obligation to advise the employee on the Fidelity website that the 2013 award agreement contained these provisions.

The court also held that it was not determinative that the 2013 award agreement was part of a lengthy scrolling pop-up. The employee's failure to fully review the terms on a 10-page readily accessible agreement to which she assented did not invalidate her consent. A party can consent to an agreement on the Internet without reading its terms and still be bound by it when the party is on notice that she is changing her legal rights, just as with a paper contract.[667]

[667] *See also Starke v. SquareTrade, Inc.*, 913 F.3d 279, 295 (2d Cir. 2019); *Awuah v. Coverall North America, Inc.*, 703 F.3d 36, 44 (1st Cir. 2012); *Specht v. Netscape Communications Corp.*, 306 F.3d 17, 30 (2d Cir. 2002) (Sotomayor, J.); *Scherillo v. Dun & Bradstreet, Inc.*, 684 F. Supp. 2d 313, 322 (E.D.N.Y. 2010).

Finally, the court held that there was nothing inherently wrong in conditioning the grant of the RSUs on compliance with restrictive covenants.[668] The plan on which the employee's prior awards were issued was explicitly referenced in the award agreements, and provided that the employer might condition future awards on complying with restrictive covenants. To the extent that the employee argued that she read the earlier award agreements, but not the 2013 award agreement, she was on notice that the employer could make the change in a later agreement.

[668] *See also Realogy Holdings Corp. v. Jongebloed*, 957 F.3d 523 (5th Cir. 2020) (employee accepted grant of restricted stock units in a clickwrap agreement; grant was conditioned on employee's acceptance of noncompetition agreement; court upheld trial court's preliminary injunction enforcing noncompetition agreement and held that noncompetition agreement was supported by sufficient consideration of employer's provision of confidential information to employee) (Texas law); *ADP, LLC v. Lynch*, 678 F. App'x 77, 80 (3d Cir. 2017) (stock awards were conditioned on noncompete agreements; former employees argued that since they were not required to check a box stating that I have read and agreed to the terms set forth in the agreement, the noncompete agreements were unenforceable; court rejected this argument, and pointed out that the employees checked a box affirming that they read the documents; "The documents explicitly advised them that the noncompetes were a condition of accepting the stock award. After checking this box, they also clicked the 'Accept Grant' button and entered their personal passwords. It is thus irrelevant that Lynch and Halpin contend that they do not recall reading the documents. The District Court thus correctly concluded [in issuing the preliminary injunction] that Lynch and Halpin were likely bound by the terms of the noncompetes") (citation omitted) (New Jersey law); *Western Union Co. v. Kula*, *2017 WL 2973584*, at *5–6 (N.D. Ill. July 12, 2017) (Merrill Lynch website required that employees of Western Union open each stock grant document, including a restrictive covenant agreement, in a separate window before they could move forward and provide their acceptance of the award) (Illinois law).

The Federal Trade Commission has issued a proposed rule that it is an unfair method of competition for an employer to enter into or attempt to enter into a non-compete clause with a worker or maintain with a worker a non-compete clause. The proposed rule defines a non-compete clause as a contractual term between an employer and a worker that prevent the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer. Under this definition, a non-compete clause would generally not include a nondisclosure agreement or a client or customer nonsolicitation agreement. These agreements generally do not prevent a worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer. However, such agreements would be considered non-compete clauses if they are so unusually broad in scope that they serve as *de facto* non-compete clauses. Federal Trade Commission, Notice of Proposed Rulemaking, “Non-Compete Clause Rule,” 88 Fed. Reg. 3,482, 3,484, and 3509–10 (Jan. 19, 2023).

General Information