Ayco Compensation & Benefits DIGEST

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Restricted Stock/RSU Survey Update

Restricted stock and/or restricted stock units (RSUs) have become one of the primary long-term incentive awards at many companies today. Once maligned as "pay for pulse" (because if vesting is time-based only, a payout is made simply by an executive remaining employed), restricted stock or RSUs are now utilized nearly as often as stock options as a long-term incentive award (see our April 2011 *Digest* for a review of the current mix of long-term incentive awards). We are continuing to see performance criteria being integrated into these awards, (sometimes for a portion or, occasionally, all of an award), so that they provide stock-denominated compensation, but only if performance hurdles are achieved.

Our Informal Survey

We recently updated our informal survey of 275 companies where Ayco provides financial counseling or financial education services as to their utilization of restricted stock or RSUs. Some companies have a history of making grants annually, while others do so only periodically or as special grants to select executives. We are seeing fewer companies granting actual stock and more utilizing RSUs, with the overall use of "full-value" awards up significantly over the past 10 years, according to this informal study of recent grants.

	Companies Today	10 Years Ago
Grant Restricted Stock Units	57%	12%
Grant Restricted Stock	25%	60%
No Grants of Stock or RSUs	18%	28%

Why Restricted Stock Units (RSUs)?

Many companies now utilize RSUs instead of restricted stock. Each unit or RSU is the economic equivalent of a share of company stock. However, the award is a bookkeeping entry similar to phantom stock; stock (or cash) is not issued until the lapse of restrictions has occurred. Thus, RSUs do not count as outstanding shares - at least until shares are actually issued after vesting.

The tax date for RSUs may differ from that of restricted stock. RSUs are taxable when distributed (as cash or stock), unlike restricted stock which is generally taxable at vesting. One significant advantage that RSUs provide is with respect to possible deferral. RSUs facilitate a deferral election much more easily than restricted stock. However, any deferral must meet the stricter timing rules under IRC §409A. In our last informal survey of Elective Deferred Compensation Plans, approximately 20% of companies currently allow for the deferral of RSUs.

Performance Vesting

Time-vesting may not necessarily align the interests of executives with shareholders or with the achievement of corporate goals. As a result, many companies have incorporated a performance feature to all or a portion of their restricted stock/RSU grants. Thus, "pay for pulse" becomes "pay for performance". Performance-based restricted stock is similar to, but distinct from, performance shares or share units. The latter have a defined performance period, most typically, three years. We counted 35% of our survey group with a performance feature for at least some grants, including several companies that have incorporated this feature into awards for the first time within the past year.

There are several types of performance features; one of the most common relates to vesting. Restrictions will lapse over time (e.g., after 5 years), but, vesting is accelerated if defined performance goals are achieved. Typical performance goals are stock price, total shareholder return or achievement of earnings per share target.

Highlights

Restricted Stock/RSU Survey
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Time - Vesting Schedule

Vesting schedules typically are defined in individual grant agreements. For those companies using time-vesting, we found almost an equal number of companies that use "cliff vesting" compared to periodic vesting incrementally over time. Vesting typically begins one year (or more) following the date of grant. For those companies with time-vesting, the following indicates the vesting schedule among our survey group:

Time Period Until Vesting	% of Companies	Time Period Until Vesting	% of Companies
1-Year cliff	0.5%	50% per Yr (2 yrs)	1.5%
2-Year cliff	2.0%	33% per Yr (3 yrs)	26.0%
3-Year cliff	37.0%	25% per Yr (4 yrs)	13.0%
4-Year cliff	5.0%	20% per Yr (5 yrs)	4.0%
5-Year cliff	1.0%	Uneven or Staggered	8.0%
		Specific Age or Retirement	2.0%
			100%

If an award recipient terminates employment prior to vesting, virtually all companies forfeit unvested awards (although, a few plans provide discretion to pay a pro-rata portion in certain circumstances, such as an involuntary termination). In contrast, just over three-quarters of companies provide for an acceleration in vesting in the event of the death of the award recipient, while just over one-half of companies provide for an acceleration in vesting in the event of a "qualified retirement". Another 10% provide for pro-rata vesting in the event of a qualified retirement and 5% provide for a continuation of vesting.

Restricted Stock As A Retention Device

Companies that do not regularly grant restricted stock or RSUs may utilize these awards for special situations. As an example, several companies disclosed in the CD&A of their 2011 proxy that they have granted restricted stock/RSUs to newly-hired executive officers to offset forfeited compensation from a previous employer, and many companies reported that they have made special grants of restricted stock or RSUs to existing executives for retention purposes. A number of companies also disclosed that they allocate a pool of RSUs or restricted stock to be used for recruitment, performance recognition or promotion awards.

A small number of companies grant awards which vest only at retirement – so called "career shares." These can be the ultimate retention device.

Reasons For Increase In Use And Other Issues To Consider

The increase in the utilization of restricted stock and/or RSUs is due to a variety of factors that make them attractive to both employers and employees.

- *Easier To Appreciate Value* – It is clearly easier for most recipients to appreciate the value at grant, as well as the future value at vesting. There is no Black-Scholes valuation needed to explain the grant value as for stock options and no risk of the award being "underwater".

- *Accounting Treatment* - Prior to the adoption of FAS 123R (now ASC Topic 718), stock options received more favorable accounting treatment than almost any other compensation award, including time-vesting restricted stock or RSUs. That is no longer true, with both having their "cost" amortized over their vesting period.

- *Overhang/Number of Shares* - Fewer shares of restricted stock need to be granted to provide the same "value" compared to the number of stock options. This helps those companies with an "overhang" problem or those who may not have a large number of available shares to grant under an existing long-term incentive plan.

Restricted Stock/RSU Survey
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- *Dividend Equivalents* - Unlike stock options and most performance awards, restricted stock often have dividend equivalents. These may be distributed as cash when regular dividends are paid or can be accrued (as cash or additional shares) and paid only when the award vests and becomes payable. But, these amounts are reportable as additional W-2 compensation and are not considered qualifying dividends (absent a §83(b) election). RSUs also could accrue a dividend equivalent (some plans do/some don't), with payout delayed until distribution of the underlying award.

- *Tax Flexibility-§83(b) Election* - The grant of restricted stock (but not RSUs) allows the recipient the right to make a special tax election. A section 83(b) election (named for the Internal Revenue Code section which authorizes it), may be made within 30 days from the date of receipt of the award. The executive elects to recognize ordinary income based on the value of the stock at grant - rather than at the date of vesting. This results in subsequent appreciation being taxed at capital gains rates. However, a significant potential downside to this election is that if the stock is eventually forfeited, the tax paid on the forfeited stock cannot be recouped. For this reason, and due to the earlier payment date of required taxes, most executives do not make the election. However, it does provide one of the few opportunities for an executive to convert a portion of compensation which would otherwise be taxed at ordinary income rates to be taxed at lower capital gains rates.

- *Easier To Administer* - Unlike a stock option, which requires an affirmative action by the recipient to exercise (which may or may not involve a stockbroker) and which may require tendering cash or stock to the company, restricted stock is much easier and less costly to administer. Upon vesting, the shares are issued, net of any shares withheld to pay taxes, if so elected. Restricted stock is considered "supplemental" wages, so the mandatory 35% federal withholding rate applies when the total of supplemental wages reaches $1 million.

- *Share Ownership Requirements* – A majority of large companies now have stock ownership guidelines for key executives. In many (but not all) cases, both vested and unvested restricted stock and RSUs count toward ownership requirements, while unexercised stock options generally are not counted. (See the September *2010 Digest* for our last survey on Share Ownership Guidelines).

- *Clawback Provisions* - Clawback, or repayment, provisions are now commonly incorporated in stock option agreements. We are starting to see similar clauses in restricted stock agreements allowing the company to recover any payment made in the event of fraud or a financial misstatement. This also is a regulatory requirement imposed on TARP companies and mandated by Dodd-Frank for certain executive officers in the event of a financial restatement.

- *Implications For Golden Parachute Excise Tax* - Typically, there is an acceleration in vesting of all restricted stock/RSUs and stock options as of the date of a change in control. Thus, the "value" of the acceleration will be considered in any golden parachute calculation. Recently, a number of companies have been replacing single-trigger vesting acceleration with a double-trigger requirement (both CIC and a termination of employment). This can help reduce or minimize any excess parachute payment potential.

- *Impact of IRC §409A* – While restricted stock generally will not be considered deferred compensation subject to §409A, restricted stock units, phantom stock or similar awards payable in stock (or cash) at a future date are subject to IRC §409A. The most significant impact of this is the necessity of a 6-month delay in payments to "specified employees" triggered by a separation from service. But, a plan that provides for automatic acceleration in vesting upon retirement eligibility with payout delayed until after actual retirement will create §409A issues. A deferral election with respect to RSUs may be made in the year prior to grant (usually extremely impractical) or within 30 days after grant. Deferral elections may no longer be made just prior to vesting. This has led to fewer companies allowing a deferral election for these awards.

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IRS final regulations under §409A indicate that a choice given to an employee to elect between restricted stock and stock options, neither of which is subject to §409A, will not be subject to §409A. However, if there is a choice involving restricted stock units, any election must meet the §409A timing rules.

- *Divorce* – The IRS has confirmed in PLR 201016031 that the division of restricted stock pursuant to a state court divorce decree is a nontaxable event under IRC §1041. The IRS also agreed that the income reported upon vesting of the stock could be divided between the parties, with the value of stock received by the non-employee spouse being reported as income on a Form 1099-MISC. Although, this ruling did not address the FICA consequences, in Notice 2002-31, the IRS indicated that when nonqualified stock options were transferred pursuant to a divorce order, FICA is payable by the employee on all of the options, including those transferred to the former spouse. A similar result may occur upon vesting of the restricted stock or any RSUs divided in a divorce.

- *Counts Toward IRC §162(m)* - While §162(m) applies to a small number of executive officers of the company, stock options generally will be treated as performance compensation and exempt. In contrast, time-based restricted stock or RSUs will count against the $1 million deductible limit in the year it is subject to taxation. In the case of a non-public company that goes public following an IPO, a special transition rule exempts stock options and SARs from being subject to §162(m) if the grant occurs before the end of a defined reliance period. But, under newly released IRS proposed regulations this relief is not available to restricted stock, RSUs or phantom stock. They must be paid prior to the end of the reliance period or will count toward the $1 million deduction limit.

- *Cost Basis Reporting* – New rules for reporting the cost basis of securities (including company stock) become effective this year, but with extensive transition rules. While these rules apply to stock options upon exercise and stock acquired through an ESPP, restricted stock and RSUs generally will not be considered to be a "covered security" subject to these reporting requirements. (However, if the employer transfers the stock directly to a broker, it may be subject to transfer statement reporting for a non-covered security.)

- *Compensation for Other Company Benefits* – Income from restricted stock and RSUs is taxable wages reported on Form W-2 (Form 1099-MISC for directors), but it is not eligible compensation for purposes of a qualified pension or 401(k) plan. While some or all of the value could be counted toward SERP benefits if a plan so provides (and a few companies plans did so several years ago), this is almost never found in current plans. Eligible pay for group life and disability insurance never includes long-term incentive income.

- *Insider Form 4 Reporting* - For SEC reporting by corporate insiders (including directors), the grant of restricted stock or RSUs is an "exempt" transaction, but is still reportable. This means that a Form 4 must be filed within two days of the date of grant. No further reporting is required for restricted stock at vesting, unless share withholding is utilized to pay taxes (when Form 4 reporting is required with Transaction Code "F"). In contrast, RSUs are reportable again on a Form 4 at vesting or when shares are issued. Reporting for both is required if shares are forfeited while the executive is a §16 insider.

Update On Domestic Partner/Spousal Benefits

Last month, Illinois approved civil unions for same-sex couples and New York has now become the 6th state to permit the marriage of same-sex couples (12 states have laws that ban recognition of same-sex marriage; although, California's ban was ruled unconstitutional last year.) Under New York's Marriage Equality Act, parties to a same-sex marriage are to be treated the same as opposite-sex married couples in all respects under state law. This will impact employment related rights, as well as certain employee benefits. However, benefits governed by federal law, including the Internal Revenue Code and ERISA, are not impacted due to the federal Defense of Marriage Act (DOMA). It provides that the term "spouse" can only refer to married persons of the opposite sex. Thus, DOMA prevents same-sex spouses from being considered

Domestic Partner
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surviving spouses under qualified retirement plans, precludes reimbursement for a same-sex spouse's medical expenses under an FSA and prevents COBRA continuation rights. But, DOMA is currently under attack in federal courts and has been declared unconstitutional by several lower court decisions. Ultimately, the constitution ability of DOMA is a matter that likely will be decided by the U.S. Supreme Court, but not in the immediate future.

Despite the growing differences between the laws of some states and federal law, employers can voluntarily grant rights to the domestic partners and spouses of employees – both same-sex and opposite-sex - if they choose to. We are seeing this occur throughout corporate America without waiting for this matter to be determined by state legislatures or federal courts. In fact, employers may require same-sex partners to get married, if allowed, to qualify for certain benefits, in the same way that opposite-sex couples must marry to qualify for coverage of medical and other benefits. We also are seeing a few companies allow same-sex spouses be eligible for distinct survivor benefits under pension and 401(k) plans, despite DOMA.

Nearly 60% of Fortune 500 companies currently offer domestic partner health coverage, according to the Business Coalition for Benefits Tax Equity. Medical coverage for domestic partners and their children helps employers attract and retain qualified employees and also is a more equitable means of providing a comprehensive benefits package. Unfortunately, federal tax law currently is not equitable (see PLR 20103007). While a married employee does not pay income taxes on the value of employer-paid premiums for their opposite-sex spouse, employees who wish to cover a domestic partner or same-sex spouse under their employer's plan will have imputed income for the value of coverage. Slowly, we are seeing more companies reimburse employees for this tax cost and other companies are considering it, according to the Human Rights Campaign. Legislation has been introduced into Congress by a bi-partisan group of House members that would exclude the value of employer-provided healthcare provided to domestic partners and non-spouse dependents from an employee's taxable income. The bill would not mandate that employers provide health insurance for such individuals. However, it is unlikely that this bill will be enacted apart from a broader effort at tax law reform.

The state income tax consequences of same-sex marriage can be challenging (even to tax lawyers) in states that allow for equal rights. For example, in these states (CT, IA, MA, NH, NY, VT) and others that recognize civil unions, couples should be able to file married/filing joint state tax returns even if they cannot do so for federal income tax filings (but, state law must be checked).

Domestic partners may qualify for benefits other than medical coverage. For example, a majority of large companies now allow life insurance coverage for qualified domestic partners. Any individual, including a domestic partner, can be designated as a beneficiary under an employee benefit plan, subject to ERISA's spousal benefit rules (see article in May 2011 *Digest*). The issue of whether an opposite-sex domestic partner was the rightful beneficiary under a group life insurance plan was the subject of a federal lawsuit recently (*Union Security Ins. Co. vs. Blakely*). Thomas Blakely was unmarried but lived with his fiancée, Sandra Billet. When he died in December 2007, he had failed to designate a beneficiary for the group term life insurance policy. The plan provided that in the absence of a designated beneficiary, or if the beneficiary predeceased, benefits were to be distributed in the following order: spouse, domestic partner, child(ren), parents, or estate. The insurance company, Union Security, filed a court action to determine who should receive the policy proceeds – his three surviving children or his fiancé with whom he lived. The lower court initially determined that the plan was subject to ERISA and looked to Ohio state law for its definition of a "domestic partner". Under Ohio law, a domestic partner is defined as "a person with whom another person maintains a household and an intimate relationship, other than a person to whom he/she is legally married, and whose relationship shares other indicia of being more than mere companions or friends". Based on this definition, the court found that Billet qualified and would be entitled to the proceeds. The three children appealed.

Domestic Partner
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The 6th Circuit Court of Appeals concluded that the lower court should not have looked at either federal common law or state law to determine the appropriate beneficiary. Under ERISA, as confirmed by the U.S. Supreme Court in a 2009 decision (*Kennedy vs. DuPont Sav. & Inv. Plan*), the plan administrator should look at the plan documents to determine who would be the proper beneficiary. The court found that although "domestic partner" was not defined in the plan's general definition section, the plan elsewhere did list criteria to pinpoint a domestic partner. The definition had seven separate requirements including that the employee and domestic partner have a committed relationship of mutual caring which has existed for at least six months, and that they have registered as domestic partners. Another of the seven requirements was that the employee and domestic partner must have a power of attorney for each other. The court went on to conclude that Sandra could qualify as a domestic partner under the plan – and, thus, be the rightful beneficiary of the insurance proceeds, if she could prove that she met all of the requirements. As a result, the court remanded the case to the lower court to determine whether all requirements were met. Another example of why it is so important that employees have the ability to work with a financial planner to ensure that they achieve their personal objectives.

The Debate Over Pay Ratio Disclosure

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the SEC was directed to amend its disclosure rules and require public companies to report the "median" annual income of the CEO as well as the median pay for all employees, and to calculate the ratio of these two figures. Whether these rules will ever be issued remains to be seen. The business community has mounted a huge lobbying effort to rescind the requirement or limit its scope. Last month, a bill was approved by the House Financial Services Committee that would eliminate the pay ratio requirement. Even supporters agree that there most likely needs to be clarification regarding the measurements. For example, it isn't clear whether part-time employees or non-U.S. employees are to be included in the calculation. Exactly how to define the pay to be measured also needs to be clarified. For example, the current proxy disclosure rules include some, but not all company provided benefits in the definition of Total Compensation (e.g., company contributions for medical coverage is not included). The effective date for the pay ratio disclosure will be only after the SEC issues guidance explaining how the measures are to be made.

There also is a legitimate question as to whether the cost to companies of compiling this data will be worth the effort. There already are estimates of what these pay ratios are – although, they indicate a wide variability. For example, The Institute of Pay Studies, a Washington think tank, reported that the ratio of CEO pay to that of the average U.S. worker was 263:1 in 2009. According to a study by the AFL-CIO, this ratio was 343:1 in 2010 based on data from 299 U.S. companies traded on the S&P 500. Previous studies have reported the ratio at more than 500:1. In contrast, similar CEO to worker pay ratios in Europe have been reported at 40:1 and those in Japan at 20:1. But, the CEO to average U.S. worker pay ratio hasn't always been so great. It was approximately 50:1 through the 1970s and 1980s. It really wasn't' until the dynamic growth in the use of stock options and other long-term incentives beginning in the 1990s at many companies that pay ratios began to expand. Those that supported making this part of Dodd-Frank claimed that disclosing this ratio would make executive compensation more transparent to investors and employees.

But, would it? After all, the total compensation paid to the CEO at a public U.S. company, as well as all "named executive officers", already is disclosed in the annual proxy statement for the three most recent years. Furthermore, it is broken out by elements of pay – rather than only as one aggregate number. The annual pay of the CEOs at major companies is highlighted each year in various studies, such as the *Wall Street Journal* – Hay Group analysis of CEO pay. In fact, the *New York Times* reported earlier this month that the 2010 median pay of the CEO at 200 large companies as reported in 2011 proxy statements was $10.8 million, a 23% increase from 2009. Is the time, expense and effort of calculating the total average pay of all of a company's workers really worth it considering differences in company size, industry, geographic location, and other factors?

Pay Ratio Debate
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Further complicating this issue is the fact that the SEC has a large number of rulemaking projects already on its plate and has not received the funding it requested to meet all of the projects created by Dodd-Frank. At the same time, companies are uncertain whether they should spend the time and effort to begin these calculations until there is further clarification from the SEC. This appears to be a project that most likely will be put on hold for the time being.

Complete Non-Compete to Receive Executive Benefits

In last month's *Digest*, we discussed several recent court decisions involving an employer's refusal to pay executive benefits. Here is another example of litigation involving the payment of executive benefits tied to a covenant not to compete (*Marsh USA vs. Cook*).

Rex Cook was a Managing Director of Marsh USA and, as a valuable employee, received a special stock option grant in 1996 made to a select group of key employees. The terms of this special award included a requirement that, upon exercise of the option, Cook would sign an agreement that he would not disclose confidential company information and trade secrets both during and after his term of employment and would refrain from going to work for a competitor for a 2-year period if he left the company within three years of exercising the options. In February 2005, Cook notified the company that he wanted to exercise the 3,000 options granted in 1996 and he signed the agreement. However, within the three year period following exercise, he resigned his position and immediately began employment with a direct competitor. Marsh sued both Cook and his new employer in a state court in Texas seeking damages for a violation of the agreement. The trial and appellate courts denied the company's claim, holding that the exercise of the stock options did not give rise to an employer's interest in restraining the employee from working for a competitor. This followed a historical pattern that Texas courts generally would not uphold non-compete agreements that do not provide a reasonable relationship between the consideration provided and a legitimate protectable interest. Last month, the Texas Supreme Court reversed the lower courts and upheld the restricted covenants.

The court agreed that some of its previous decisions were overly convoluted. Texas law does require a nexus between what is a protectable corporate interest and consideration received. Thus, a non-compete executed in connection with another agreement (stock option) must reasonably relate to an interest worthy of protection. In this case, the court found that the company's good will, which included relationships developed with customers and employees, was a protectable interest. Thus, the issuance of stock upon the exercise of stock options was sufficient consideration in return for the employees agreeing to the restrictive covenants that would protect the company's goodwill.

Thus, it appears that tying the execution of a non-compete to the exercise of stock options will now be more easily enforceable in Texas, but it remains to be seen whether a cash payment would achieve the same result. The issue of whether such restrictive covenants will be upheld is largely a matter of state law.

The same issue also has been litigated in federal court. Last year, a U.S. District Court in Illinois agreed that Aon did not abuse its discretion when it forfeited nonqualified excess benefit plan benefits that an executive had accrued when he moved to a competitor and solicited clients of his former employer (*Wignes vs. Aon Corp. Excess Benefit Plan*). When Wayne Wignes voluntarily terminated employment with Aon in 2007, he was reminded that he was prohibited from soliciting clients. When Aon became aware that he had done so, they ceased paying excess plan benefits. Wignes sued claiming the non-solicitation clause in the plan was unenforceable as it reduced earned benefits. But, the federal court found otherwise. It also agreed with the company that Wignes had adequate disclosure about this provision in the plan. Not only was he told at his separation, but he was reminded of this plan provision several times after his employment began with the competitor. Refusal to pay executive benefits incorporated into a plan and properly disclosed to plan participants can avoid the necessity of a clawback (or attempted clawback) of payments already made.

Did You Know....

Due primarily to the increase in the cost of gasoline, the IRS increased the optional standard mileage rates used for computing deductible cost of operating an automobile for business, medical and moving expenses for the period July 1 – December 31, 2011. The new rates will be 55.5¢ per mile for business use and 23.5¢ per mile for medical and moving expenses, an increase of 4.5¢ each. Charitable use remains at 14¢ per mile because it is set by statute.

The SEC entered into settlement agreements relating to charges of securities law violations with 344 defendants in the first half of its 2011 fiscal year. The number of settlements with companies rose by 43% compared to last year, while individual settlements declined by 12%, but include 25 insider trading settlements. The largest settlement this year was for $310 million.

In a Q&A session with the ABA Joint Committee on Employee Benefits, an IRS official indicated that cash or cash equivalent prizes awarded to employees who took a health risk assessment, including a $25 gift card and raffle prizes, must be reported as income on the recipient's Form W-2. However, a T-shirt given to all participants would qualify as a de minimus fringe benefit and not be taxable.

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